BUSINESS INTERRUPTION

Basic Underwriting Notes

Prepared by:
Mark Rothmann
Head: Technical Underwriting
+27834569381

BUSINESS INTERRUPTION

- INTRODUCTION
- **TURNOVER**
- **GROSS PROFIT**
- **RATE OF GROSS PROFIT**
- MEASURING THE LOSS – BASIS OF INSURANCE
- ADDITIONAL EXPENDITURE
- PERILD COVERED – DAMAGE
- OPERATIVE CLAUSE
- MATERIAL DAMAGE PROVISO
- **INDEMNITY PERIOD**
- **STANDARD TURNOVER**
- **INDEMNITY PERIOD AND TURNOVER**
- **SUM INSURED – ADEQUACY**
- **INDEMNITY PERIOD AND SUM INSURED**
- AVERAGE
- **VALUE ADDED TAX**
- **GROSS PROFIT CALCULATOR**
- INCREASED COST OF WORKING
- SAVINGS CLAUSE
- **CONTINGENT BI EXTENSIONS**

INTRODUCTION

BI cover is an essential complement to a Property Damage Insurance. Few, if any, business operations having suffered damage by fire or other contingencies to productive assets, would not suffer financially either through loss of trade or additional expenditure during the immediate period following such damage.

Such financial losses might arise from -

- the non fulfillment of orders
- the unavoidable breaking of contracts
- the loss of customers to competitors
- the inability to attract new customers
- the necessity to meet continuing expenses from reduced earnings
- additional expenditure related to the hire of temporary premises, plant and other facilities
- additional expenditure to meet the costs of overtime, express freight and similar expediting expenses
- additional expenditure to purchase goods from competitors in order to meet existing orders
- to name but a few.

A Business Interruption policy is designed to provide the necessary funding to enable a business to achieve the financial results which would otherwise have been achieved had the damage not occurred.

TURNOVER

Reduction in turnover is not synonymous with loss of net profit; on the basis that each R100 of turnover contributes an equal share of:

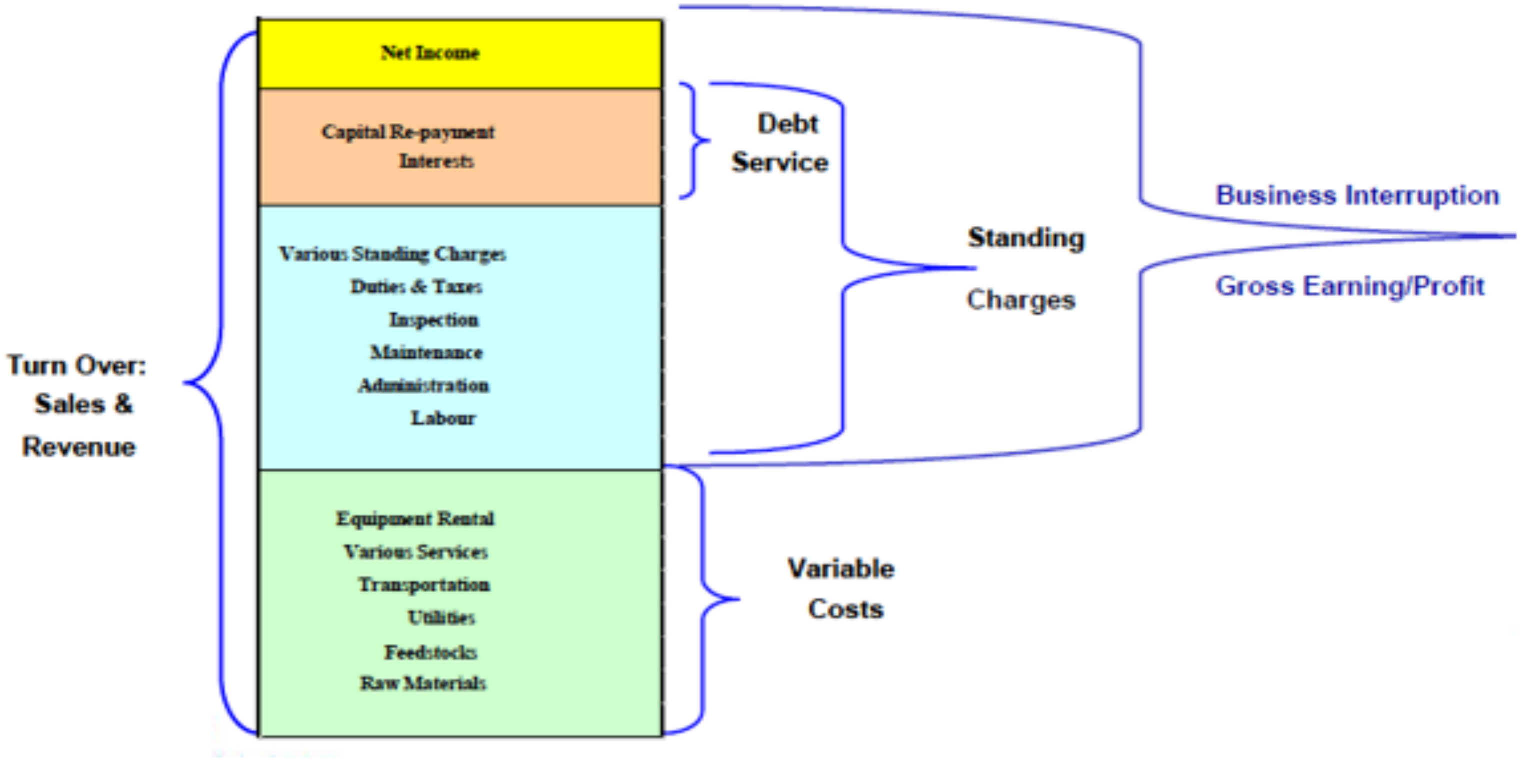
1. prime costs such as purchases, wages, power, process and manufacturing costs - generally described as variable expenses in that they will vary proportionately with a rise or fall in turnover; and
2. overheads such as administrative costs, selling and distribution expenses - these, by reason of the fact that they are not controllable as are the costs mentioned above, are referred to as standing charges; and
3. the residual, being the net profit.

In the event then of a reduction in turnover by reason of damage, the prime costs will reduce proportionately resulting in no change in their ratio to turnover. In respect of standing charges however and because they do not reduce in proportion to turnover, their ratio will in fact increase. At the same time and by reason of the reduced turnover, there will also be a concurrent loss of net profit.

If however under the business interruption policy cover is provided for the amounts on standing charges and net profit on every R100 of lost turnover, the financial position will be restored to the extent of the results which would have been achieved had the damage not occurred.

GROSS PROFIT

As the ratio of variable expenses to turnover is generally constant so also the balance of combined expenses (standing charges) and net profit must also be constant even though the relative proportions of those standing charges and net profit may vary.



The definition of C should not be confused.

RATE OF GROSS PROFIT

In calculating the amount payable and using the reduction in turnover as the 'yardstick' it will be apparent that by applying the percentage which the gross profit bore to the turnover, then that percentage which is termed 'Rate of Gross Profit', applied to the actual reduction in turnover will result in an amount sufficient to fund the standing charges and net profit resulting in the financial position being obtained which would, but for the damage have been achieved.

Accounts for the financial year preceding the damage

	R			R
Purchases	50 000 000		Sales	110 000 000
Variable Expenses				
Freight costs	10 000 000			
Manuf. wages	20 000 000			
Fixed Expenses				
Salaries	10 000 000			
Finance charges	10 000 000	Rate of gross		
Net Profit	10 000 000	profit – 27.27%		
	110 000 000			110 000 000

RATE OF GROSS PROFIT CONT.

Accounts for the 12 months during which a 50% reduction in Sales has resulted from “damage”

	R		R
Purchases	25 000 000	Sales	55 000 000
Variable Expenses			
Freight costs	5 000 000		
Manuf. wages	10 000 000		
Fixed Expenses			
Salaries	10 000 000		
Finance charges	10 000 000	Claim - Rate of gross profit applied	
Net Profit	10 000 000	to reduction in turnover	
		(55 000 000 x 27.27%)	15 000 000
	70 000 000		70 000 000

It will be seen that despite the reduction in sales the claim payment has enabled the business to maintain their overheads and net profit at their previous levels.

MEASURING THE LOSS – BASIS OF INSURANCE

Comparing turnover figures before and after the damage is generally a satisfactory basis for measuring the effect of the reduction in earning capacity of a business as a result of damage, subject to appropriate adjustments for special circumstances and business trends.

Seasonal comparisons of turnover before and after damage will also form a reliable basis of measurement in cases where there are seasonal fluctuations in business activity.

ADDITIONAL EXPENDITURE

The occurrence of damage and a consequent interruption to the business will inevitably involve additional expenditure in order to minimise the reduction in turnover and to return the business to normal operations as quickly as possible.

Thus an indemnity for financial loss resultant upon such damage must also provide compensation for such additional expenditure which is undertaken to reduce prospective loss of turnover.

This is provided in the standard policy to the extent that such additional expenditure does not exceed the reduction in gross profit thereby avoided (the economic limit - the policy will not pay more than R100 to save R100).

PERILS COVERED – “DAMAGE”

The perils insured against are the same as those insured under the corresponding material damage policy, without such perils having specific definition, which is unnecessary because of the ‘material damage proviso’ which forms an integral part of the policy preamble. Collectively the perils are referred to as ‘Damage’.

The standard exclusions such as those relating to War/Political and Nuclear risks etc. are applicable and call for no particular comment.

THE CONDITIONS OF THE OPERATIVE CLAUSE (PREAMBLE)

The consequential loss must result from destruction or damage by an insured peril, which is referred to as Damage.

Damage must occur at premises used by the Insured for the purpose of the Business which is defined in the schedule to the policy.

The damage must cause an interruption of or interference with the Business carried on by the Insured at the Premises as stated in the specification to the policy.

The interruption or interference with the Business must be in consequence of destruction of or damage to any building or property or part thereof, used by the Insured at the Premises for the purpose of the Business.

There must be in existence a material damage policy covering the interest of the Insured in the property damage sustained, and the Insurer under such policy must have admitted liability for such property damage - ‘the material damage proviso’.

MATERIAL DAMAGE PROVISO

This provision ensures that the Insured will be in a financial position to repair or reinstate the property damage, otherwise rehabilitation of the Business might be delayed or even financially impossible.

At the same time the proviso ensures that the Insured has complied with the conditions of the material damage policy thus obviating the need for such conditions to be embodied in the business interruption policy and also relieves the underwriters of the business interruption policy of the necessity of enquiring into the circumstances of the property damage.

Whilst generally the Underwriters under both the material damage and business interruption policies are the same, it is not essential that they should be, although insurers always prefers to play the dual role.

It may be the case that the material damage policy is made subject to an excess or deductible which could well preclude the admission of liability for the property damage, in which circumstances it is usual to amend the proviso appropriately with regard to losses under the material damage policy below a specified amount - the excess figure.

INDEMNITY PERIOD

The definition of the indemnity period is –

> **'the period beginning with the occurrence of the Damage and ending not later than the maximum indemnity period thereafter during which the results of the Business shall be affected in consequence of the Damage'**

and is completed by the maximum indemnity period being the number of months selected (generally reflected in the schedule) for the time limit for the payment of compensation.

Subject to the maximum period selected the indemnity period continues until the results of the Business are restored to normal, which may be well after the physical damage to buildings, machinery and stock has been made good. It should be noted that in the event of damage causing an interruption of business the indemnity period is not necessarily the same as the maximum period selected; it is the period starting from the date of the damage and ending when the results of the business are no longer affected by the damage, subject to such period not exceeding the maximum number of months selected.

STANDARD TURNOVER

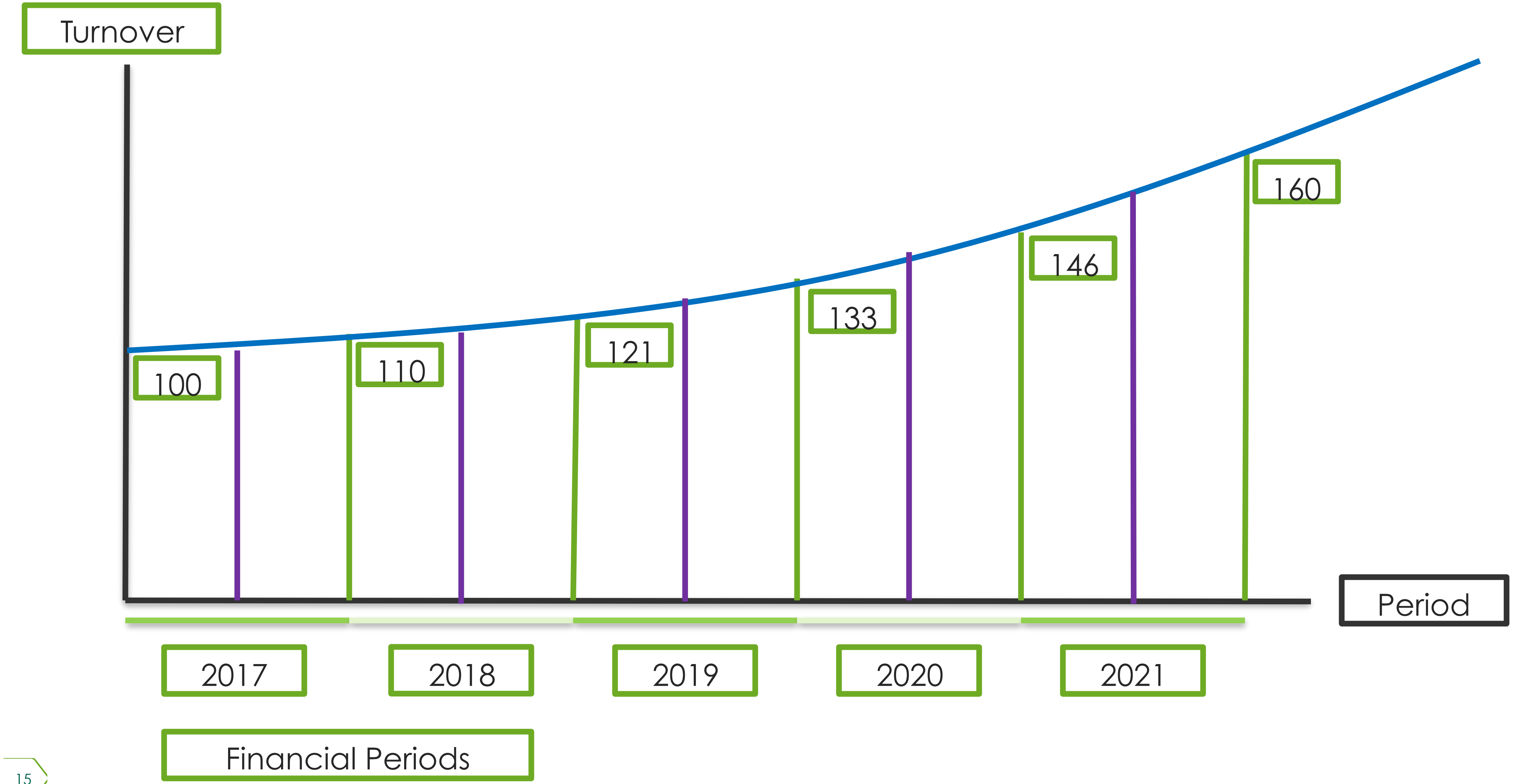
The standard turnover is that against which a comparison is made in order to ascertain the shortage in turnover as a result of the damage; being the turnover during the period in the twelve months immediately before the date of the damage which corresponds with the period of interruption within the selected maximum indemnity period. Such a comparison against the same calendar period in the preceding twelve months provides for seasonal fluctuations which affect a large proportion of businesses.

The definition is also qualified by the 'Special circumstances clause' allowing for adjustments in the trend of the business and other circumstances affecting the business either before or after the damage.

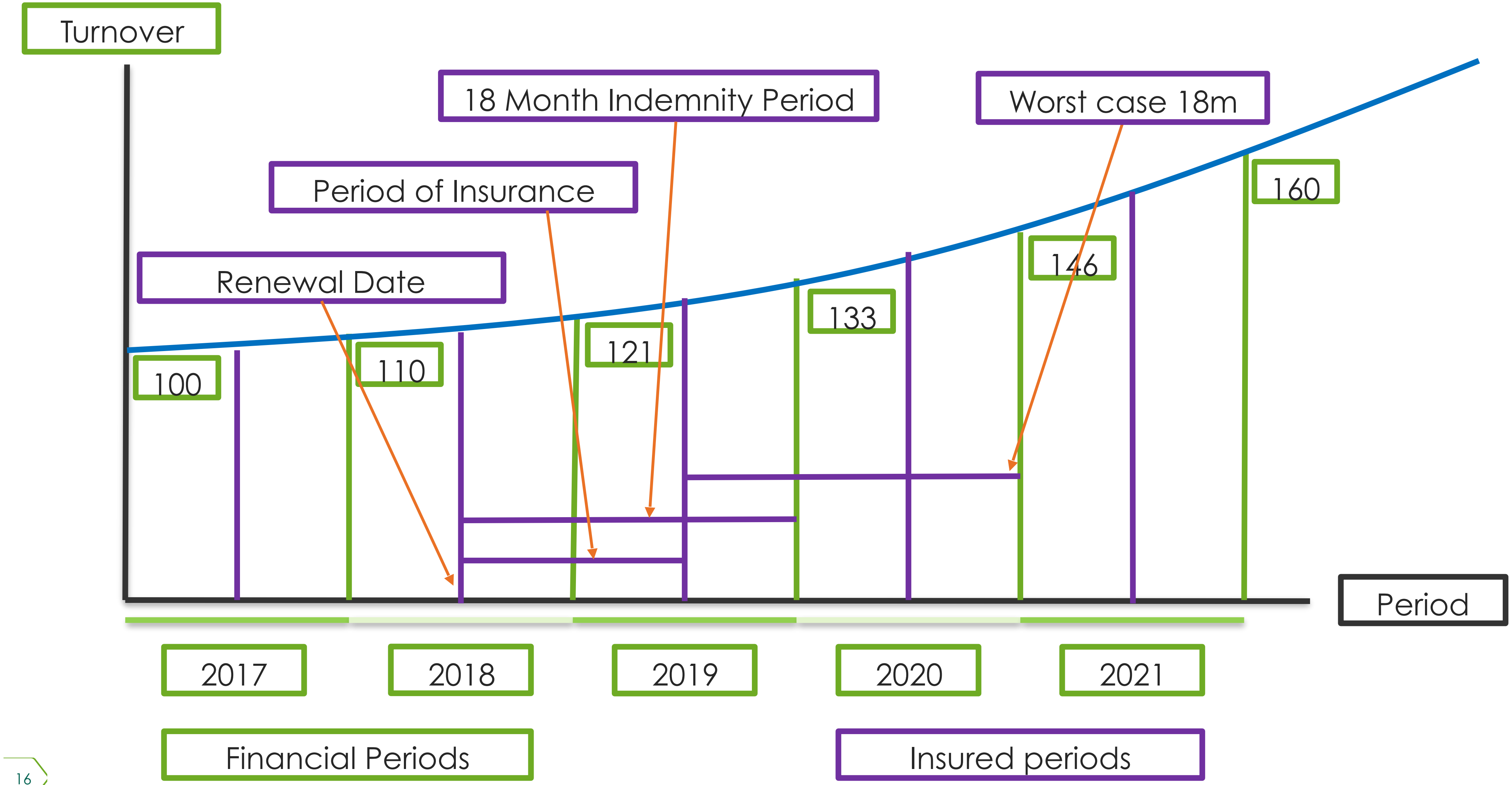
'In consequence of the Damage'

It must be borne in mind that the indemnity related to reduction in turnover is qualified by - "in consequence of the Damage", it being the underlying intention to adjust the claim against projected results which but for the Damage would have been obtained in the relative period following the Damage.

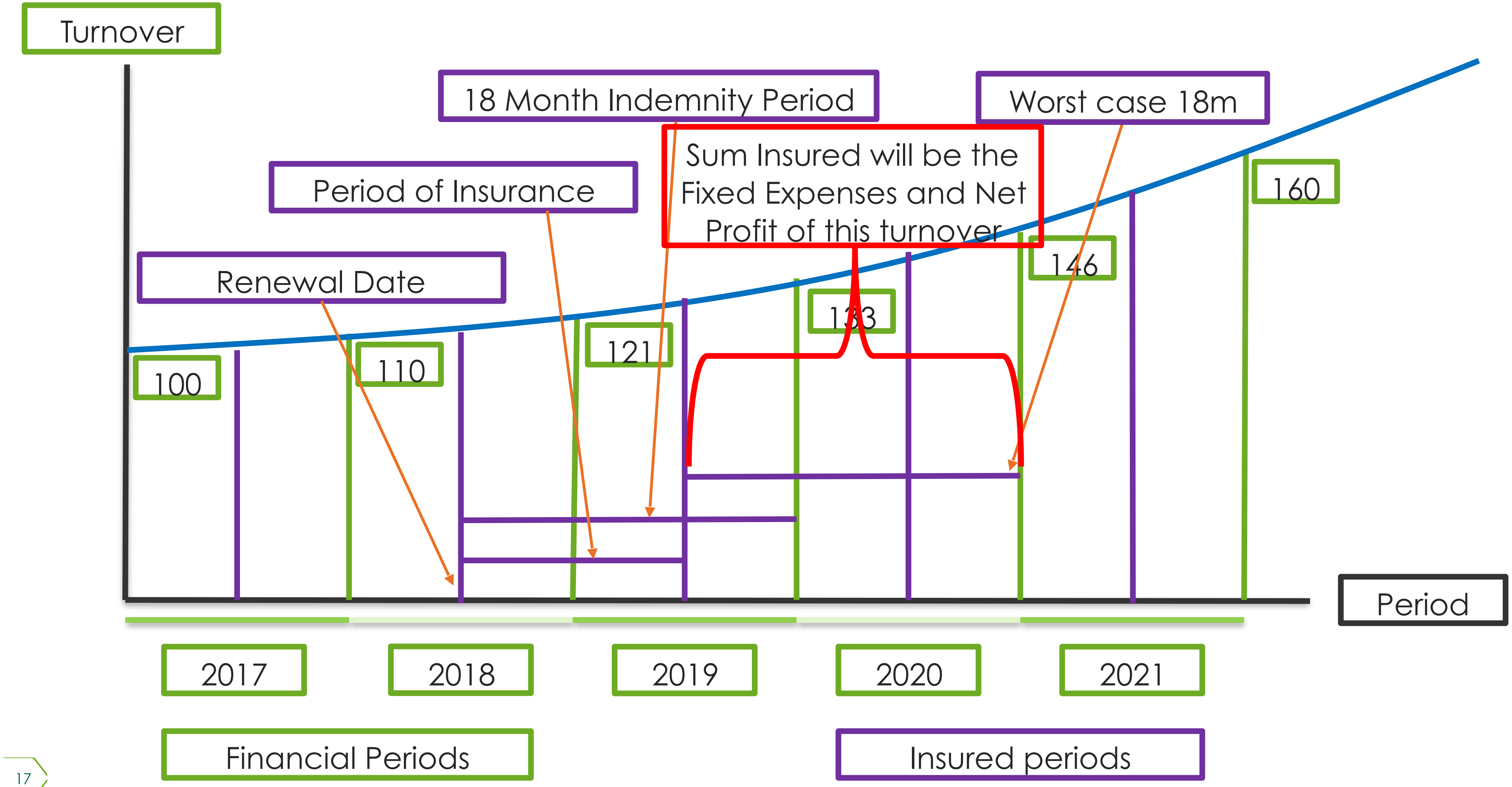
INDEMNITY PERIOD AND TURNOVER



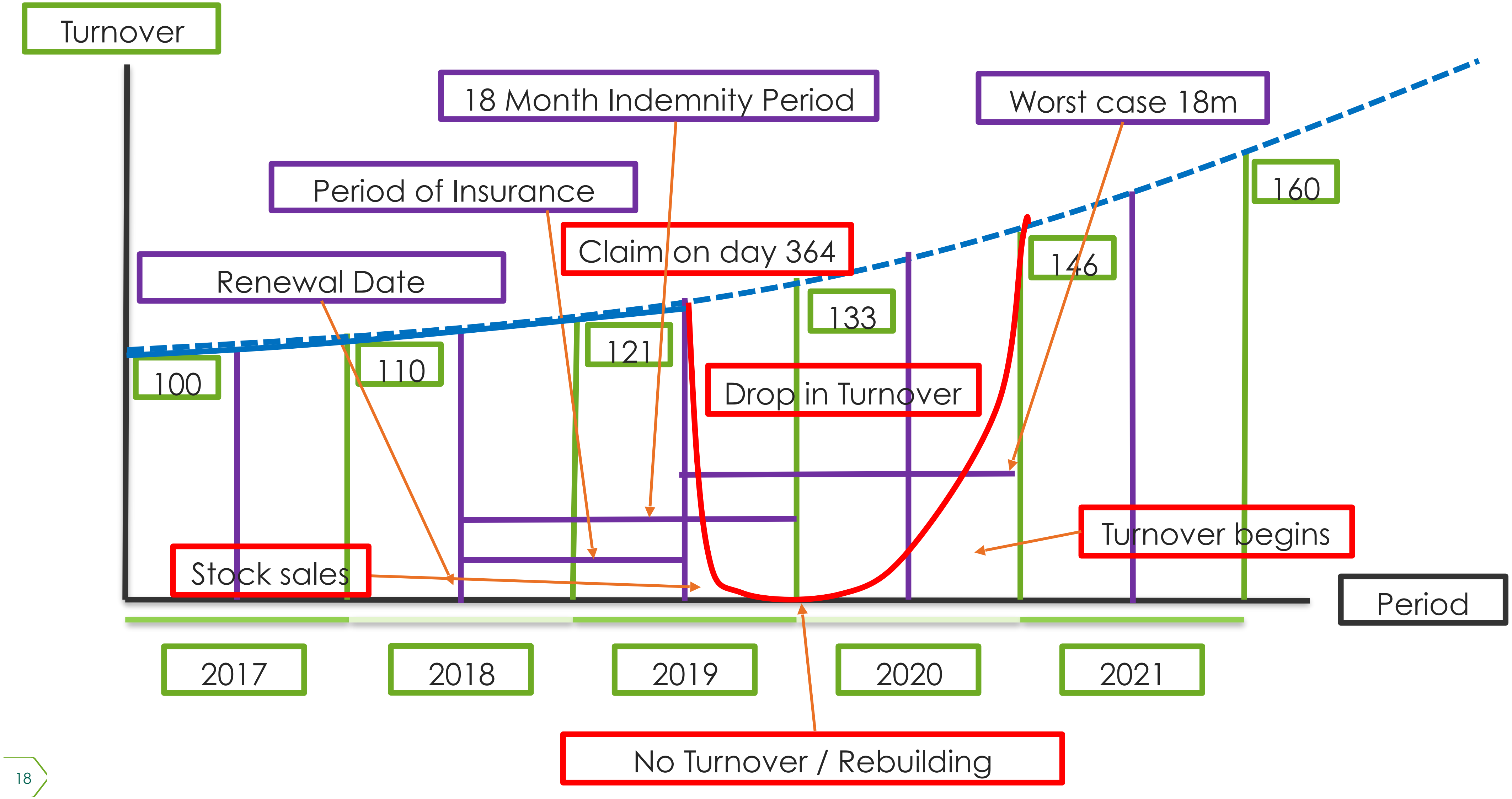
INDEMNITY PERIOD AND TURNOVER CONT.



INDEMNITY PERIOD AND TURNOVER CONT.



INDEMNITY PERIOD AND TURNOVER CONT.



SUM INSURED - ADEQUACY

In setting the sum insured against the Gross Profit figure it is essential that projected figures reflecting the anticipated financial results of the future be utilised as those of the last financial year will not take cognisance of increasing trends, planned changes and extensions of the future, or other factors such as economic inflation on future turnover and gross profit.

On the basis of a maximum indemnity period of twelve months therefore and on the basis that the damage might occur during the last week of the insurance period the forward projection will need to be made two years into the future.

In those cases where the maximum indemnity period is longer than twelve months the projection must be correspondingly that much further into the future to cater for such extended maximum period of indemnity.

INDEMNITY PERIOD AND SUM INSURED

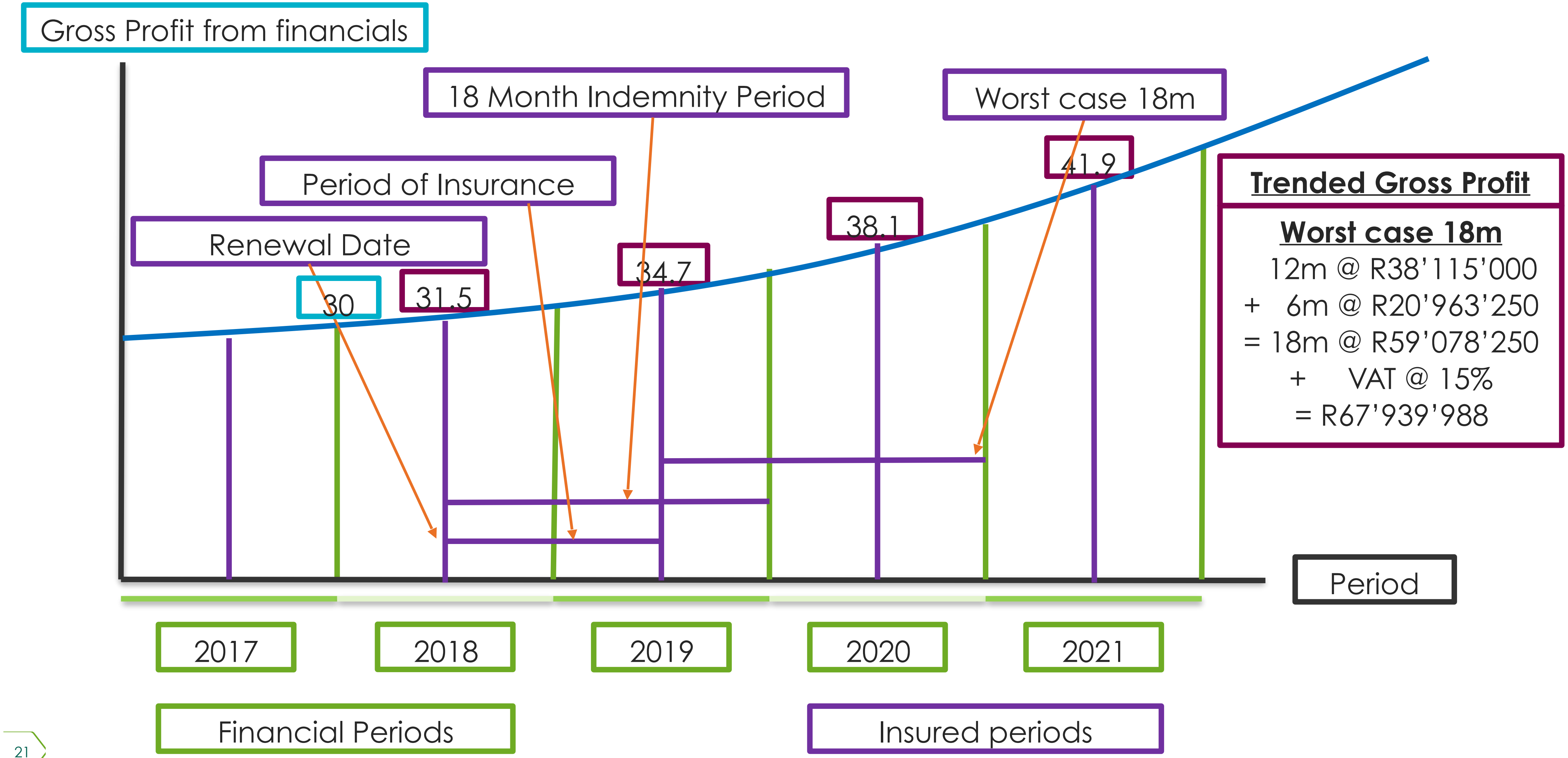
When the maximum indemnity period is twelve months or less the sum insured should not be less than the amount of the annual gross profit which is estimated will be earned in the future, with the premium rating table making allowance for a reduced premium by reason of the shorter indemnity period.

In the case of maximum indemnity periods in excess of twelve months the sum insured should represent the estimated gross profit which will be earned in the future, during a corresponding period of time. Thus in the case of an eighteen month period the sum insured should be one-and-a-half times the annual projected figure.

With regard to businesses of a seasonal nature however where for example two years gross profit might be earned in eighteen consecutive months, the sum insured for a maximum indemnity period of eighteen months should equate to that for a two year period.

Further, it should be appreciated that the maximum period of indemnity selected should be adequate not only to reinstate the damage, but also to regain markets and customers it being the case that the policy continues to provide an indemnity until such time that the financial results of the business cease to be affected by the damage subject to the entire period not exceeding the maximum indemnity period.

INDEMNITY PERIOD AND SUM INSURED CONT.



AVERAGE CLAUSE

This operates on the universally accepted principle that in the event of there being less than full insurance, the Insured is his own insurer for the difference between that proportion of the claim which the actual sum insured bears to the full insurable figure and the total figure.

VALUE ADDED TAX

Policy terminology and definitions relating to items such as net profit, standing charges, turnover, gross profit and the like do not embrace VAT, however it is recommended that the VAT inclusive route be followed in all Business Interruption covers with the sum insured being expressed as including VAT. On that basis and to the extent that the Insured may be liable for VAT on any indemnity payment, such will be added to the final claim payment. VAT on the premium is also included at the time of premium computation and only reflected separately on the policy schedule for legislative reasons.

GROSS PROFIT CALCULATOR

Information required for calculating the Gross Profit Sum Insured

- Indemnity Period
- Renewal/Inception date
- Date of last financials
- Turnover/Sales from last financials or estimated Turnover/Sales for start-up business
- Turnover/Sales from second last financials
- Expected growth percentage
  - From date of financials to Renewal/ Inception
  - For period of insurance
  - For Indemnity Period following the period of insurance

- Opening stock from last financials
- Closing stock from last financials
- Purchases
- Discount received
- Additional uninsured working expenses
- Additional ICOW
- Professional fees / CPC / loss management fees

INCREASE IN COST OF WORKING

It is in the interest of the Insured to restore normal trading conditions as quickly as possible after the occurrence of Damage and there is a duty imposed on the Insured to do so by the "Due Diligence Clause". This may involve considerable expense in undertaking special measures to reduce the loss of turnover during the indemnity period and to hasten the resumption of normal trading. Action on these lines is also of benefit to the Insurers as its affect is to reduce the amount which would otherwise be payable against loss of gross profit.

Payments under this heading may be varied embracing for example additional overtime wages either to an Insured's own employees to make good loss of production, or to builders and other tradesmen's workers to hasten the restoration of the damaged property and plant. Additional expenditure may also take the form of the hire of temporary premises or purchase of temporary plant and advertising expenditure in order to regain lost custom.

The cost of demolition and removal of debris in connection with damaged buildings and their contents does not constitute increase in cost of working as such costs are recoverable under the material damage policy, but additional expenditure involved to speed up such work and hasten rebuilding operations would be admissible.

INCREASED COST OF WORKING

Abnormal Expenditure only is covered

If following Damage certain charges of the business do not reduce proportionately with the reduction in turnover their increased incidence will result in a financial loss. That however should be adequately catered for under the heading of standing charges within the gross profit item. Thus increase in cost of working does not provide for an increase in ratio of cost of working.

The expenditure must be of an additional nature or what might more appropriately be termed abnormal expenditure.

The Economic Limit

Additional expenditure in the form of increased cost of working for the sole purpose of avoiding or diminishing the reduction in turnover is limited by - ‘not exceeding the sum produced by applying the rate of gross profit to the amount of the reduction (in turnover) thereby avoided’. This, the economic limit says the Insurers will not pay more than Rx to save Rx

INCREASED COST OF WORKING

During the Indemnity Period

Payment in relation to increase in cost of working is limited to the additional expenditure incurred to minimise the reduction in turnover during the indemnity period. In the event that the period of interruption following the damage exceeds the maximum indemnity period then Insurers will not be liable for that proportion of any additional expenditure incurred which benefits the business following the expiration of that maximum period.

On the other hand the results of the business might well be restored to normal by means of the payment of additional expenditure under the heading of increase in cost of working within the maximum period of indemnity, in which event it will be realized that but for such ongoing additional expenditure the result of the business would still be affected and therefore the period during which such expenditure is incurred (subject to the maximum indemnity period) will be admissible, it being the case that the indemnity continues, subject only to the maximum period, as long as the results of the business continue to be affected as a result of the damage.

INCREASED COST OF WORKING

Apportionment for uninsured standing charges

In utilising the form of specification in which the gross profit is defined as being the net profit plus insured standing charges, (Additions basis) increase in cost of working is limited to that proportion of such expenditure which the sum of the net profit and insured standing charges bears to the sum of the net profit and all the standing charges.

This is equitable, as additional expenditure incurred to minimise potential loss of turnover will assist in paying not only for those standing charges included within the gross profit, but also for those standing charges which have been omitted.

In the specification on the Difference basis in which gross profit is defined as turnover less variables, although all standing charges will automatically be included it may be the case that within the uninsured working expenses have been included some not wholly variable charges thus creating an inadequate insurance against gross profit.

In a similar manner this specification provides that the amount recoverable on increase in cost of working shall be that proportion of the additional expenditure which the gross profit bears to the sum of the gross profit and the uninsured standing charges.

INCREASED COST OF WORKING

Necessity for adequate insurance

The foregoing slides in relation to Increase in Cost of Working which generally forms a major part of any claim settlement emphasise the necessity for insurance on an adequate basis both with regard to the sum insured on gross profit and in relation to the maximum indemnity period.

SAVINGS CLAUSE

The specification provides for a deduction from the claim of any sum saved during the indemnity period in respect of such charges included within the gross profit figure as may cease or be reduced in consequence of the damage.

This maintains a true indemnity as the Insured will not have to disburse such charges.

However it may be the case that certain charges are less during the period of interruption than they were in the relative period of the preceding year, due to causes unrelated to the damage. For example interest on overdraft may have reduced in which event the Insured should not be deprived of that benefit which would have taken place irrespective of the damage. in that regard the Savings Clause is qualified by the words - ‘in consequence of the Damage’

RATE OF GROSS PROFIT AND ALLOWANCE FOR STOCK VARIATION

In calculating the amount payable and using the reduction in turnover as the 'yardstick' it will be apparent that by applying the percentage which the gross profit bore to the turnover, then that percentage which is termed 'Rate of Gross Profit', applied to the actual reduction in turnover will result in an amount sufficient to fund the standing charges and net profit resulting in the financial position being obtained which would, but for the damage have been achieved.

Accounts for the financial year preceding the damage

	R			R
Purchases	50 000 000		Sales	110 000 000
Opening Stock	10 000 000		Closing Stock	7 500 000
Variable Expenses			Discount Received	2 500 000
Freight costs	10 000 000			
Manuf. wages	20 000 000			
Fixed Expenses				
Salaries	10 000 000			
Finance charges	10 000 000	Rate of gross		
Net Profit	10 000 000	profit – 27.27%		
	120 000 000			120 000 000

RATE OF GROSS PROFIT AND ALLOWANCE FOR STOCK VARIATION CONT.

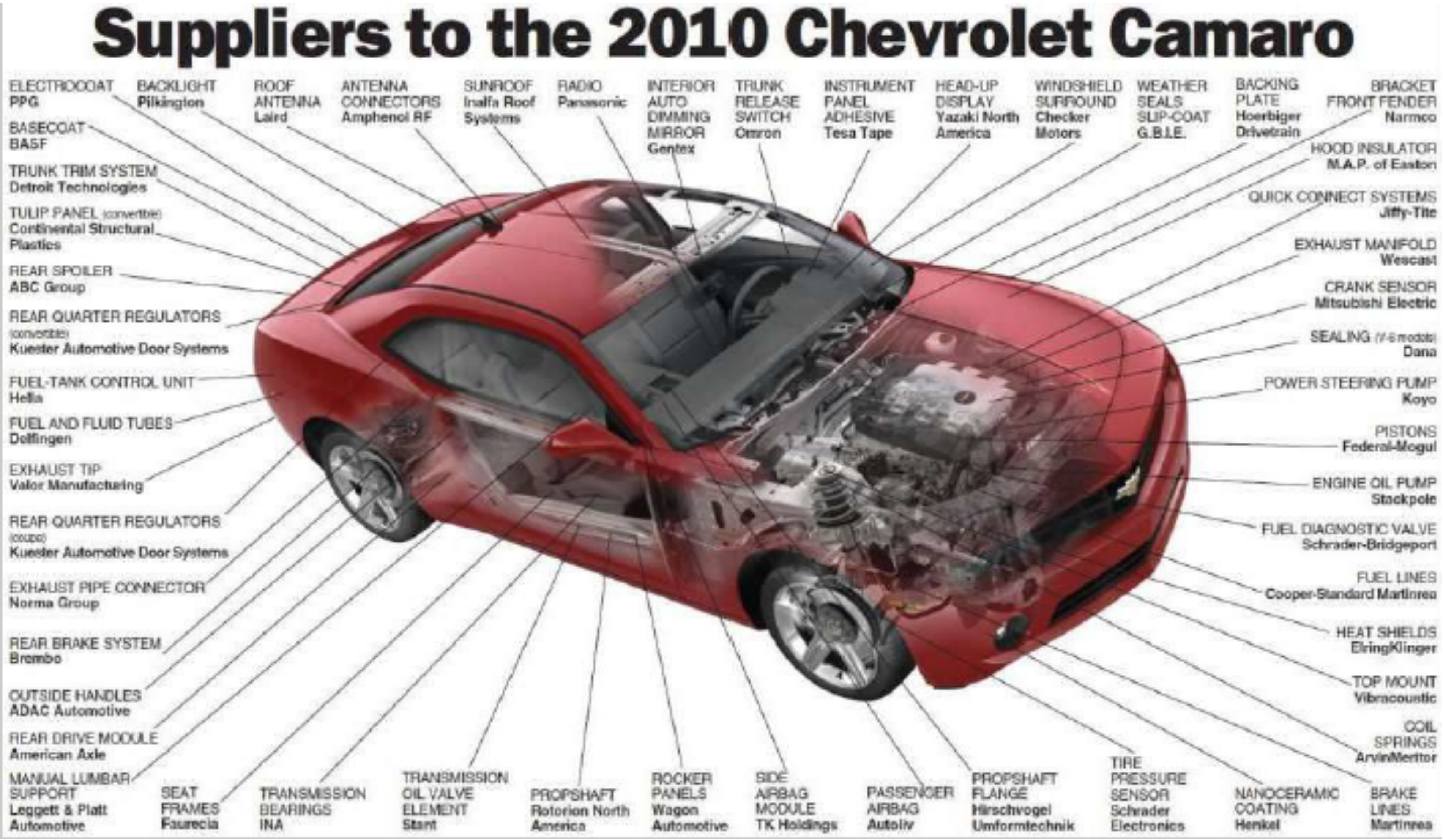
Accounts for the 12 months during which a 50% reduction in Sales has resulted from "damage"

	R		R
Purchases	25 000 000	Sales	55 000 000
Opening Stock	7 500 000	Closing Stock	5 000 000
Variable Expenses		Discount Received	1 250 000
Freight costs	5 000 000		
Manuf. wages	10 000 000		
Fixed Expenses		Claim - Rate of gross profit applied	
Salaries	10 000 000	to reduction in turnover	
Finance charges	10 000 000	(55 000 000 x 27.27%)	15 000 000
Net Profit	10 000 000	Adjustment for stock	1 250 000
	77 500 000		77 500 000

It will be seen that despite the reduction in sales the claim payment has enabled the business to maintain their overheads and net profit at their previous levels and compensation is provided for the reduced stock levels.

CONTINGENT BUSINESS INTERRUPTION (CBI) EXTENSIONS

CONTINGENT BUSINESS INTERRUPTION (CBI) EXTENSIONS



CONTINGENT BUSINESS INTERRUPTION (CBI) EXTENSIONS

EXTENSIONS TO OTHER PREMISES

Within modern industry major manufacturers rely upon the supply of many components from other specialist manufacturers who if Damage were experienced at their Premises, might be unable to supply such components resulting in a loss of turnover on the part of the major manufacturer.

In a similar way, in the event of a customer experiencing serious Damage they may be unable to accept the product of a manufacturer thus resulting in a loss of turnover on the part of that manufacturer.

Interdependency situations as may arise in circumstances as outlined above, may be insured in terms of the policy extensions relating to Suppliers and Customers.

In all such cases the perils within the definition of Damage may not be wider than those applying to the Insured’s own Premises.

CONTINGENT BUSINESS INTERRUPTION (CBI) EXTENSIONS

SPECIFIED SUPPLIERS EXTENSION

UNSPECIFIED SUPPLIERS EXTENSION

CUSTOMERS EXTENSION

STORAGE, TRANSIT AND VEHICLE EXTENSION

CONTRACT SITES EXTENSION (Not in the Insured's Occupation)

PREVENTION OF ACCESS

PUBLIC UTILITIES EXTENSION (Electricity, Gas and Water)

INTERGROUP DEPENDENCY