The Insurance Institute

# Commercial General Insurance

## **CIP-04** KEY POINTS

Advancing *Your* Career.

## CHAPTER 5

## BUSINESS INTERRUPTION INSURANCE

In addition to arranging adequate property insurances, most businesses also require some protection from the financial consequences of a sudden interruption to their operations.

Business interruption policies aim to place the insured in the same financial position after the loss that they would have enjoyed had the loss not happened. Most business interruption policies indemnify the policyholder by compensating the insured for their loss of gross profit for a specific period after the event.

As well as replacing lost profits, business interruption policies can also cover some of the extra expenses involved in helping the business return to its pre-loss trading position, i.e. the increased cost of working expenses.

### Arranging business interruption insurance

Two fundamental considerations are as follows:

1. Insurers are not willing to cover losses for an indefinite period of time. Each policy has a maximum indemnity period for which payments can be made.
2. Cover is limited by the sum insured, so it is important that this is set at the correct level.

A key feature of business interruption insurance is that claims are always triggered by a material damage loss, which must be covered by an insurance policy, i.e. the 'material damage proviso'.

The indemnity period

Many clients choose a 12-month indemnity period. The client should carefully select the length of the indemnity period: it should represent the maximum foreseeable period of business interruption arising from an insured peril.

Several important factors must be considered in relation to the:

- Premises
- Raw materials and components

- Plant and equipment
- The business environment.

The sum insured

Most business interruption policies are written on a gross profit basis, as their main purpose is to protect the gross profit of the business after the insured event.

The definition of **gross profit** in an insurance policy is different from that used by accountants:

The amount by which:

- the sum of the amount of the **turnover** and the amounts of the **closing stock and closing work in progress** shall **exceed**
- the sum of the amounts of the **opening stock and opening work in progress** and the amount of the **uninsured working expenses**.

The term '**turnover**' relates to the income or revenue of the business:

The money paid or payable to the insured for goods sold and delivered and for services rendered in the course of the business at the premises.

Most businesses have two main types of expenses:

- Variable costs
- Fixed costs/standing charges.

It is vital to establish whether charges directly vary with changes in turnover. If so, they are the **uninsured working expenses** and are deducted when calculating the gross profit sum insured.

Once the adviser has calculated the turnover figure and established the uninsured working expenses, they can then calculate the gross profit figure.

Calculating the sum insured requires two more steps:

1. As the formula for calculating the gross profit of a business uses the previous year's accounts, the adviser must therefore adjust the gross profit to take account of (a) current trends in the business and (b) future trends.
2. The indemnity period also needs to be taken into account.

With declaration-linked gross profit policies, the client must declare a value that represents the estimated gross profit for the period of insurance. The insurer will then increase this figure by one-third meaning that the sum insured shown on the policy schedule is 133.33% of the declared value.

The client benefits from this arrangement in three ways:

1. It is relatively straightforward to estimate the next year's gross profit.
2. The client has an uplift of 33.33%, which will provide a comfort zone for any expansion of the business.
3. 'Average' does not apply in the event of a loss.

## Range of perils and clauses

The impact of the material damage proviso means that business interruption policies cover a similar range of perils to a material damage policy.

One exception, however, is that the standard business interruption policy provides cover following the explosion of an industrial boiler, whereas a standard material damage policy will not.

Standard clauses on a business interruption policy include:

- Alternative trading clause
- Departmental clause
- Payments on account clause
- Professional accountants' charges.

**Extensions to cover**


Typical extensions are:

- Suppliers and customers
- Prevention/denial of access
- Loss of attraction
- Public utilities
- Notifiable diseases and ancillary extensions.

For some of these extensions, insurers will apply a time franchise, before cover is activated.

## Additional increased cost of working (AICOW)

It is also possible for an insured to request additional cover under the policy to cover the additional increased cost of working (AICOW). This cover can be very useful where a client anticipates a need to inject funds greater than the immediate savings in gross profit, in order to carry on trading at pre-loss levels. The economic test (you must save €1 to spend €1) does not apply.

### Other types of business interruption insurance

Gross profit cover is particularly suited to manufacturers, wholesalers, retailers and other businesses that generate their income from what they do, trade and produce at their business premises.

However, many businesses need a more limited form of cover, or a policy wording that reflects the specific ways their profits are generated:

- Increased cost of working only cover – covers increased expenditure to maintain turnover after the damage only (no cover for loss of profit or earnings).
- Gross revenue/gross fees – covers the entire income of the business without any deductions for items such as stock.
- Gross rentals/rent receivable – covers loss of rental income to property owners as a result of damage to their property.

### Questions to ask the client

- Business description
- Basis of cover
- Buildings
- Plant and equipment
- Raw materials
- General
- Selecting the maximum indemnity period.
- Extensions required
- Data back-up procedures

## FIDELITY GUARANTEE INSURANCE

Fidelity guarantee insurance covers losses to a business from the fraudulent or dishonest activities of employees or other trusted persons.

It may relate to direct pecuniary loss only or provide cover for loss from theft of stock and money.

Cover will exclude any undisclosed change to the systems and controls that were noted on the proposal form. Policies also exclude cover for situations where the insured had previous knowledge of a perpetrator’s fraudulent acts.

The most straightforward means of insuring this risk is an overall limit per employee.

As we saw in Chapter 4, a money policy covers the first 7-day discovery period. A fidelity guarantee policy will normally cover the loss beyond this period, but only if caused by an employee covered by the policy.

## ENGINEERING INSURANCE

Under the provisions of safety, health and welfare at work legislation, an item needs to be inspected at specified time intervals by a competent person if it:

- utilises pressurised gas or liquid
- performs a lifting function.

As noted in Chapter 4, a boiler used for commercial purposes would be covered by an engineering policy. Engineering insurance can cover a wide range of risks including:

- material damage
- breakdown, explosion and collapse of plant
- damage to surrounding property
- damage to goods being lifted
- third party liability
- a limited form of business interruption.