



Loss of Profit Policy

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Birla Insurance Advisory & Broking Services Limited



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Introduction to the Policy

Insurance policies usually cover only physical damage to property by insured peril i.e. covers the expenses incurred for repairing or replacing the damaged property. But what about the financial loss suffered due to interruption of business operations whilst the damaged property is being repaired or replaced?

This policy offers a solution by covering profit lost due to reduction in turnover arising from interruption of business following damage to the property insured.

Property Insured means the locations that have been declared – which is why it is important to mention not only the manufacturing locations but also storage locations, if it will have a bearing on your profitability

This policy can be taken only in conjunction with Fire Policy or Machinery Breakdown policy. This policy is also known as Business Interruption Policy or Loss of Profit Policy. Even though it is not mandatory that the LoP policy must be taken with the same insurer, it is generally advisable.

Scope of Cover

The policy covers:

- Loss of gross profit* due to reduction in turnover/output
- Increase in cost of working - This is the additional expenditure that has to be incurred in order to avoid or diminish the reduction in turnover following a loss payable under the Fire (Material Damage) Policy.

* Gross profit – It is the sum of net profit & standing charges.

Net profit – It is the net trading profit excluding capital receipts, accretions and outlay chargeable to capital after making provisions for all standing charges.

Standing charges – It means all expenses which do not reduce proportionately with a reduction in turnover. For e.g.:

- Interest on Loans
- Traveling expenses
- Insurance Premium
- Salaries to permanent staff & wages
- Office expenses
- Company's contribution to the Provident Fund
- Company's contribution to the Gratuity Fund
- Maintenance of Building, Plant and Machinery
- Depreciation (excluding stocks and stores)
- Auditors Fees
- Etc.

Additional covers on payment of Additional Premium

You may extend your policy by paying additional premium. Major optional extensions available are:

- Auditor's fees
- Extension to cover supplier's premises
- Extension to cover customer's premises
- Extension to cover loss due to accidental failure or public electricity/gas/water supply

Improving the Coverage

Accumulated stocks clause: In adjusting any loss, due allowance shall be made if shortage in turnover is postponed by its being temporarily maintained from accumulated stocks of finished goods in the warehouses.

Departmental clause: If business has different departments/sections, each earning a different rate of gross profit, this clause can be incorporated so that the gross profit suffered by the affected department will be indemnified. It must be established quite in advance that the accounts of the business are arranged in such a way that independent trading results of each department are ascertainable.

Factors that determine the Policy Sum Insured

- The basis of sum insured for Consequential Loss Insurance Policy is the annual gross profit
- Your gross profit should represent the net trading profit plus insured standing charges (fixed charges)
- The standing charges which are to be insured have to be specified.

Indemnity

- The indemnity period is the maximum period required to put your business back into normal operation after damage to insured property
- The indemnity period could vary from 6 months to 3 years
- Up to an indemnity period of one year, your annual gross profit should be selected as sum insured. Thereafter the gross profit should be in proportion to the indemnity period selected.

Exclusions in the Policy

This Policy does not cover

- loss that is not admissible under the fire (Material Damage) policy. The difference between the value of stock at the time of fire and value at the time of subsequent replacement
- Depreciation of undamaged stock after a fire
- Cost of preparation of fire and consequential loss claims
- Litigation costs connected with fire or consequential loss claims generally
- Third party claims
- Failure to recover book debts owing to destruction of records
- Loss of goodwill
- Loss of market
- Fines and penalties payable due to delayed fulfilment or cancellation of sale/service contract
- War, invasion, act of foreign enemy, hostilities or warlike operations (whether war be declared or not), civil war
- Mutiny, civil commotion assuming the proportion of or amounting to a popular rising, military rising, insurrection, rebellion, revolution, and military usurped power
- Nuclear power reactions and radiations

This is not an exhaustive list. Insurance policies terms and conditions should be referred for more exclusions.

Rating under the Policy

The system of rating is governed by the provisions of the erstwhile CL tariff. There are two factors in the rating system:

- The multiplier which is associated with the selected indemnity period.
- The basis rate which arises from the premises concerned.

Additional rates will be applicable for additional perils and for extensions to other premises.

Factors determining the Premium Payable

The premium payable depends on the following factors:

- Average rate of the contents of the process blocks under Fire Material Damage Insurance
- Duration of indemnity period
- Nature of process – continuous or otherwise

Provision for refund of premium on expiry of the policy -

If the insured declares, at the latest twelve months after the expiry of the policy, that the Gross Profits earned during the accounting period of 12 months most nearly concurrent with the policy period, as certified by the Insured's Auditors, was less than the Sum Insured thereon, a pro-rata return of premium not exceeding 50% of the premium paid on such Sum Insured for such period of insurance shall be made in respect of the difference.

Calculation for Claim Amount payable

The policy operates once there is a valid claim under the Fire Policy or Machinery Breakdown Policy.

The loss of profit is measured by comparing the turnover/output/revenue during the indemnity period with the turnover during the corresponding period in the previous year (known as the standard turnover).

Hence loss of gross profit = Rate of gross profit X Reduction in turnover

$$= \frac{\text{Gross Profit}}{\text{Annual turnover}} \times \text{Reduction in turnover}$$

The documents establishing reduction in turnover have to be submitted to the surveyor appointed by the insurance company.

In addition if any extra expenses have been incurred to minimize reduction in turnover the same are also payable subject to the overall sum insured.

Procedure for settlement of claim

As the insurance company will be advised regarding the occurrence of damage due to fire or any of the insured allied perils, only a letter has to be addressed to the insurance company that a loss under the LOP policy has arisen and they should arrange to adjust the claim early.

However, it must be ensured that

- The surveyor appointed by the insurance company is given full co-operation by one and all concerned
- All such records as may be required by the surveyor for completion of his task are made available to him
- All steps are taken to avoid any aggravation of loss.

Modern developments in the consequential loss of profit policy

Though earlier, the consequential loss policy was issued only in respect of fire insurance, modern industrial and commercial requirements have paved the way for consequential loss cover as an adjunct to: Machinery breakdown insurance, contractors' all risks insurance, marine-cum-erection insurance, boiler insurance and electronic equipment insurance among others. In respect of all these developments, the basis for handling losses is by and large the same as for fire insurance.

In all cases, the decision whether to go in for consequential loss insurance or not will depend on the period for which the business interruption may occur; and the magnitude of standing charges that would have to be borne whether there is any production or not and the speed with which production can be restarted in alternative premises.

For instance, for many IT companies a fire loss could probably involve only increase in cost of working for a certain period with no violent impact on net profit. This is because an IT company can restart its internet and software development work in alternative premises almost immediately.

Frequently Asked Questions (FAQ's)

Q: Can I buy a Consequential Loss Policy if I do not have a Fire Insurance Policy?

A: No, you cannot as a Consequential Loss Policy contains a Material Damage Proviso which states that a claim must be admitted in the Fire Policy before the loss in the Consequential Loss Policy is payable.

Q: Is it therefore necessary that the cover in the Consequential Loss Policy must be the same as that in the Fire Insurance Policy?

A: Yes, the perils insured under the Consequential Loss Policy should be the same as those in the Fire Insurance Policy.

Q: In arriving at the Gross Profit to be insured, what are Uninsured Working Expenses and why must I deduct such expenses from the Gross Profit.

A: Uninsured Working Expenses are specified working expenses which are variable, i.e. they increase or decrease correspondingly with increase or decrease in turnover. Examples are packing materials, freight, carriage charges and marine insurance. You must deduct such charges from the Gross Profit because they will not be incurred during the period of interruption to your business.

Q: If I am starting a new company how do I insure the Gross Profit if I do not know what that the amount is?

A: You can either make a projection of the Gross Profit or alternatively you can insure the standing charges plus the estimated netprofit.

Q: What are standing charges?

A: Standing charges are fixed expenses which you will have to incur regardless of your turnover and which you must continue to incur even after a loss/damage. Examples of standing charges are rent, property tax, telephone bills, property and vehicle insurance, interest and directors' fees

Q: If my company is making a loss, can I still buy a Consequential Loss Policy?

A: Yes, you can. You can still insure the Gross Profit. .

Q: How can I insure wages?

A: Normally following a fire, you may not need to retain all the workers, e.g. daily rated employees who can be laid off. However, you may also wish to retain those monthly paid employees or those employees who are critical to your operations. You can include the wages of these workers in the Gross Profit (i.e. you do not list them as Uninsured Working Expenses). Alternatively, you can insure Wages/Payroll separately from Gross Profit.

Q: Must the indemnity period necessarily be 12 months?

A: No, it can be more or less than 12 months, depending on the nature of the business and how quickly the business can revert to normal in the event of the business being totally destroyed. Hence you can insure for as short as 3 months to as long as 36 months.

Q: If the indemnity is shorter or longer than 12 months, what will be the sum insured for Gross Profit?

A: For periods less than 12 months, the sum insured will be the 12 months Gross Profit. However, for periods longer than 12 months, the sum insured will have to be increased proportionately.

Q: My business could be adversely affected because of a loss occurring at my supplier's or customer's premises. How do I protect my gross profit against such events happening?

A: The policy can be extended to include such events as well as other events on the payment of additional premium. The common extensions are:

- Suppliers' Premises
- Customers' Premises
- Public Utilities

Q: What do I have to do in the event of a loss?

A: You need to:

- act with reasonable speed in dealing with the loss or damage, e.g. notify the fire brigade immediately
- take all reasonable measures to avert or minimize the loss or damage
- notify the insurance company the same day of the loss or damage occurring
- preserve rights of action of recovery against third party who may be responsible
- co-operate with the adjuster in his investigations if one is appointed by the insurance company
- complete and return the claim form supported by relevant documentation, e.g.
- accounting and financial report such as the Profit and Loss Accounts, wage records, etc. (ensure that this is done within 30 days)
- stock records
- a statement of claims

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