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INSURANCE BROKERS

KNOWLEDGE SERIES 03

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CONSEQUENTIAL LOSS INSURANCE (FIRE) OR LOSS OF PROFIT INSURANCE OR BUSINESS INTERRUPTION INSURANCE

As in the past in our knowledge series, we shall endeavor to present the above insurance in the simplest possible way with a view to elicit interest and also to exemplify its importance.

When a fire occurs at premises used for the purpose of conducting a business, whether industrial, mercantile or Professional, the owner of the business will usually be insured against damage to his property by fire etc and will in due course be able to recover his material loss. With the proceeds of his claim he can, in time, replace his lost or damaged property and resume his business but, until this can be done, the profits which he was previously earning will have ceased, wholly or in part.

In addition, there will almost certainly be fixed expenses arising from the business e.q. salaries, rent, municipal taxes, which be will have to continue to meet, even if his profits have entirely vanished.

Faced with the situation, he may find means to reduce or even eliminate the loss of his profits but this will call for expenditure perhaps substantial – which he may not have the funds to meet. It is to meet this situation that loss of profits insurance have been devised and subject to a suitable type of policy and an adequate sum insured, it affords an insured complete protection against the reduction or cessation of profits following a fire and place him in the same position as though the damage had not occurred.

In these circumstances, a loss of profit insurance should appeal to any businessman as an essential complement to Fire Insurance.

We shall proceed ahead to give a brief idea of important definitions and ingredients which needs to be understood before obtaining a policy:

a) Net Profit:

The net trading profit resulting from the business of the insured at the premises. This does not include all capital receipts and accretion. Provisioning for all fixed charges shall be made including depreciation but shall not include taxation chargeable on profits.

b) Standing Charges:

These are the fixed expenses which will nevertheless continue to accrue to the insured despite the cessation of business e.q. Rent, Municipal taxes, fixed interest on capital, Advertising etc

c) Indemnity Period:

The period commences when the damage by fire occurs, and ends when the business ceases to be affected there by, subject to the maximum period specified in the policy.

d) Turnover:

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

e) Rate of Gross Profit:

The Gross Profit explained above divided by turnover during the financial year immediately before the date of the damage.

f) Annual Turnover:

The turnover during the twelve months immediately before the date of the damage.

g) STANDARD TURN OVER:

The turn over during that period in the twelve months immediately before the date of the loss which corresponds with the Indemnity period. This mean that if a fire occurs on 1st January and the business is affected during the following three months, January to March, then in ascertaining the shortage in turn over, the figures for those months are compared with January to March in the preceeding year. This is fairness personified

especially in case of seasonal trades.

MEASURE OF INDEMNITY:

With the aid of the above stated definition, it would now be possible to state in simple terms how the insured would be compensated in the event of a loss. The amount payable shall be under two heads, which are described as below:

(I) Reduction In Turn Over:

It shall be he sum produced by applying the rate of gross profit to the amount by which the turn over during the indemnity period shall, in consequence of the damage, fall short of the Standard Turnover.

(II) Increase In Cost of waking:

It shall comprise the additional expenditure necessarily and reasonably incurred for the sole purpose of diminishing the reduction in turnover but the amount shall not exceed the sum produced by applying the rate of gross profit to the amount of reduction there by avoided. We shall go ahead by giving you a very simple accounting applicability of this policy and make you clearly understand how it fully compensates an insured. By this example, you will able to appreciate that all the aspects are duly taken care of by insurers.

	Before Fire (Rs.)		After Fire (Rs.)	
Turnover	50,000,00		25,000,00	
Production Costs	35,000,00	70%	17,50,000	70%
Standing Chiafrges	10,000,00	20%	10,000,00	40%
Net Profit	5,00,000	10%		
Net Loss			2,50,000	10%

The sum insured under the profits policy is fixed at

Annual Net Profit	Rs. 5,00,000
Plus Annual Standing Charges	Rs. 10,00,000
Gross Profit	Rs. 15,00,000

The ratio of Gross Profit to turnover is $\frac{15,00,000}{50,00,000}$ = 30 Pre Cent

The shortage in Turnover = 50,00,000 – 25,00,000 = Rs. 25,00,000

Thus, Loss of Gross Profit = 30% of 25,00,000 = Rs. 7,50,000 - (1)

The Policy also pay s the additional expenditure, say = Rs. 1,00,000 - (2)

The Policy in total pays = Rs. 7,50,000 + Rs. 1,00,000 = Rs. 8,50,000

What happens to the insured account now can be understood like this

Gross Profit before fire	= Rs. 15,00,000	- (3)
Gross Profit earned on reduced turnover	= Rs. 7,50,000	
Less increased cost	= Rs. 1,00,000	
Net Amount	= Rs. 6,50,000	
Add Claim under consequential loss policy	= Rs. 8,50,000	
Total Gross Profit after fire	15,00,000	- (4)

Comparing 3 and 4, we find that the insured is placed in the same position after the fire loss as he was before the loss had taken place.

In the next issue, we shall dwell upon some important policy conditions as well as various extensions offered by the various insurers. The idea would again be to make the policy easily comprehensible and equally easy on application.

Suggestions would always be welcome

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