Loss of profit insurance policy

What is consequential loss policy?

At present it is very common for a firm to its assets by insurance against damages caused by fire, Etc. practically the loss which is sustained as a result of such fire is not confined only to material damages But the same affects the firm as a whole

We know that an ordinary fire policy is designed to make Good "capital" losses due to assets being wholly or partly destroyed. However, it is apparent that the Loss to a business in event of a severe fire involves for more than the actual loss of capital assets .This is because the business will be restricted in its trading operation and reduced turnover results in a loss of net profit. At the same time the greater part of the ordinary working cost will continue and this may prove a considerable drain on the finance of the firm and could results i its winding up. As a results insurance companies encourage businessmen to protect themselves against these losses by taking out policy for loss of profit technically known as consequential loss policy or profit insurance policy.

Some important terms in respect to loss of profit insurance policy:

1) **Indemnity under policy** : Subject to fire, light explosion the insurance company would cover the insured against the following :

a) Loss of net profit.
b) Standing charges.
c) Increased cost of workings

2) **Standing charges** : It includes fixed charges which continue irrespective of reduction in turnover as opposed to variable charges which fluctuate with the turnover . Some of the examples are noted below :

a) Wages and salaries of permanent staff & employees.

b) Rent, rates, taxes and insurance.

c) Director's fees and Auditor's fees.

d) Interest on loan, Mortgages and debentures.

e) Depreciation of fixed assets (excluding depreciation of stock).

f) Lighting and heating (not always)

3**) Non standing charges** : It includes the following:

a) Lighting and heating where not selected as standing charges.

b) Unskilled wages in some cases.

c) Legal expenses unless there is a retainer.

d) Discount and commission on sales.

e) Depreciation on stock.

4**) Increased cost of workings** : This includes the additional expenditure necessarily and reasonably incurred for the sole purpose of avoiding or diminishing for reduction in turnover, which but for that expenditure would have been taken place during the period of indemnity as a result of the damage. For example, Premises taken temporarily as hire to carry on production.

Increased cost of working can be computed as follows:

a) (i) when all insurable standing charges are insured the aggregated amount of different components of increased cost of workings would be taken as actual I.C.W.(increased cost of workings).
(ii) when all insurable standing charges are not insured by the policy then actual I.C.W. is to be reduced proportionately as follows :

{[N.P.+ I.S.C (insured standing charges)] / [N.P.+A.S.C.(all standing charges)]}* Actual I.C.W.

b) The I.C.W must be limited to the amount of gross profit on actual sales due to I.C.W. Thus the least amount between [a) and b) above] would be taken into consideration for the determination of claim under loss of profit insurance policy.

5) **Indemnity period :** This is the period that commences at the date of damage and ends not later than the stated one of months thereafter. Thus it is the period from the date of damage upto the date when the business begins its normal functions, subject to the number of days or months mentioned in the policy.

6) Risk not covered: The following items are not covered under the scope of loss of profit insurance policy:

a) A third party liability due to damage.

b) Loss of goodwill

c) Depreciation of stock

d) Bad debts

e) Legal charges in relation to dispute arising out of damage.

7) Average Clause: All forms of profits insurance are subject to average clause. This clause states that if the company which took out this policy is under insured, then the assessed claim would be proportionately reduced by applying the following formula to reach the net claim:

Net Claim = [sum insured/sum for insurance] * assessed claim

Where sum for insurance is equal to the Gross Profit on the adjusted annual turnover. Thus this clause only be applied when sum insured is less than the sum for insurance.

8) Adjustment Clause: It provides for adjustments which may be necessary for the settlement of losses as regards turnover and rate of gross profit in the event of exceptional circumstances affecting the business either before or after damage. Adjustment may therefore be necessary to provide for :

a) if the trend of the business (either increasing or decreasing may affect on the tendency of the sales or rate of gross profit)

b) Variations in the business which may affect the turnover on the rate of gross profit.

c) Special circumstances affecting the business either before or after the fire which could have affected the business has the insured event not occurred. Eg. A strike or Lock Out.

9) A STATEMENT SHOWING DETERMINATION OF CLAIM UNDER THE LOSS OF PROFIT INSURANCE POLICY

Indemnity Period -- ###

Dislocation period--### (Date of fire to date of recovery)

Dislocation period and indemnity period whichever is less should be taken into consideration for the determination of claim under loss of profit insurance policy.

FORMAT

STEP 1

G.P.= (N.P. + INSURED STANDING CHARGES)

Net profit as per P/L	###	
Less: Non trading incomes	###	
	###	
Add: Expenses on non trading activities	###	
NET TRADING PROFIT	###	
Add: Insured standing charges	###	
GROSS PROFIT		####

STEP 2

RATE OF GROSS PROFIT = (GROSS PROFIT *100) / SALES DURING LAST ACCOUNTING PERIOD x%

STEP 3

REDUCTION IN TURNOVER DUE TO FIRE

(Standard turnover – Actual turnover)

Standard turnover (unadjusted)	###	
Add/ Less: Trend sales on it	###	
	###	
Less: Actual Turnover	###	
REDUCTION IN TURNOVER		####

STEP 4

REDUCTION IN GROSS PROFIT DUE TO FIRE

(Reduction in turnover* x/100**)** ####

Add: Increased cost of working (I.C.W.)

Least of the following:

a) Actual I.C.W (When all standing charges are insured)
OR,
(N.P + I.S.C*Actual I.C.W.) /(N.P.+ A.S.C.)[When all st. Charges are not insured] ###

b) G.P. on actual sales due to increased cost of working	###
Least amount from above a) and b)	####
GROSS CLAIM	####
Less: savings in standing charges (If any)	####
ASSESSED CLAIM	#####

{IF SUM INSURED IS GREATER THAN OR EQUAL TO THE SUM FOR INSURANCE, THEN NET CLAIM= ASSESSED CLAIM}

{IF SUM INSURED IS LESS THAN SUM FOR INSURANCE, THEN NET CLAIM= (SUM INSURED * ASSESSED CLAIM)/ SUM FOR INSURANCE}

NOTE:

CALCULCULATION OF SUM FOR INSURANCE

Annual turnover (turnover 12months preceding from the date of fire)	###
Add/ Less: Trend sales (if any)	###
Adjusted annual turnover	###

SUM FOR INSURANCE = (Adjusted annual turnover * x)/100= ######