History of Business Interruption Insurance

Business insurance is vitally important to ensure that the organization can be financially secured and be able to restore normal business operations and to avoid the loss of shareholders equity. It is the last line of defence to secure a business resilience.

There are many classes of insurance: property, business interruption, liability, personal accident, medical and so forth. Although insurance present the final line of defence in business survival, it is amongst the least understood business requirement by top executives. The majority would be contented when they have a document called “Insurance Policy” in hand that they procured at the least possible costs. Unfortunately, this usually only provide a false sense of comfort, but the reality of the protection they thought they had, would become known when trouble hits them.

One critical insurance cover is *business interruption*. Insuring just physical assets (e.g. plant & machinery, buildings, stocks, etc.) is not enough to fully protect a business from significant losses or often from financial ruin following a disastrous event. There are costs that will continue to have to be paid – rentals, wages and salaries, governmental dues. Additionally, the cost burden of restarting the business, which can include restoring goodwill, salvaging lost business, fines, claims and compensations, and other extraneous expenses can easily overwhelmed the financial capability of the company. It is said that only one out of 10 has the chance of ever surviving a business calamity without business interruption insurance (Manning, 2004).

Business Interruption insurance is designed to put the insured company back into the same financial position that which it would have enjoyed had the disaster not occur. This essentially means that the protection must return to shareholders the Gross Profit, intact, as much as possible. All extraneous costs of restore and put the business operations back to ‘normal’ i.e. the state that it should have been if not for the incident. The Gross Profit would fund the operational costs of the business including payroll and servicing loans and financing business projects.

Business Interruption insurance as Business Protection

(a) *Who needs Business Interruption insurance?*

Unless one has vast cash reserves to stomach and fund one’s own business recovery following a disaster situation, business interruption insurance policy is mandatory for survival. Anyone pf the following situations would require it:

- Owners of commercial property
- Businesses that are: manufacturer, wholesaler, retailer, or stockists
- Business that has high financial debts or financing costs are high
- Business would lose revenue if alternative work locations are required in an incident
- Businesses that require staff to be retained during a period of operational cessation
- When costs of transport to or from suppliers and/or customers are high
- When there are severe liability should business operations be disrupted

(b) *Indemnity Period*

This is the period of insurance cover from the date of the loss and remains applicable until the business’s turnover and profit levels are back to where they would have been if not for the incident occurring. The *Indemnity Period* is a realistic estimation by the Insured on when normal business operations could be achieved. This could vary from 3 months to as long as 24 months, depending on the complexities of rebuilding a new start-up.

(c) Insuring Gross Profit.

The budgeted gross profits or the previous year's gross profit is used as basis to set the limit of cover. Example: if gross profit is $12 million, and Indemnity Period is 9 months, then the gross profit to be insured under the business interruption is $ 9 million.

Insuring Additional Increase in Cost of Working (AICOW). This category concerns all other necessary costs that the company will incur to restore the business operations to normality. These are additional costs that would otherwise erode the Gross Profit if AICOW is not arranged. Examples of AICOW are:

- Additional rent for temporary premises
- Air-freighting of critical/urgent machinery or goods
- Higher costs of goods when purchased from alternative sources
- Outsourcing of manufacture to a competitor or contract manufacturer
- An advertising campaign to win back lost or disgruntled customers
- Hiring of temporary plant and or equipment
- Overtime payment to staff
- The temporary employment of additional staff

The past performance of the business is measured for levels of turnover and insured gross profit and these are adjusted as part of the estimation process to determine what level of turnover and insurable gross profit would have been generated but for the loss. The adjustments made are to take into account the trend of the business and any special circumstances that would have affected the business had the loss not occurred. From this estimate of the turnover that would have been earned but for the loss, is deducted any turnover that was actually generated. This determines the shortfall in turnover.

Additions and subtractions are made to the shortfall in turnover to take account of any savings in expenses the business has made and any additional costs that have been incurred in running the business during the period of disruption that normally are not normally covered.

Extra covers are available for claims preparation to have someone help you with this process. It is strongly recommended to take this cover and to use the services of a loss manager should a loss occur.

Another useful cover is additional increased cost of working which allows additional expenditure to get your business up and running as fast as possible so that your customers are inconvenienced as short a time as possible and you get on with your life.

This is but a short overview of the cover afforded by most business interruption policies. Please continue to explore this site or speak with your insurance **broker** or adviser to learn more about this vital of insurance covers.

What happens if I under-insure?

If you under insure you are penalised when it comes to a claim. Even in partial losses you may be deemed to be carrying some of the risk yourself and the Insurer will ask you to bear a portion of the claim yourself.

Business Interruption policies have one of the worst if not the very highest incidence of under insurance of all the classes of general insurance. It is estimated that over 70% of policies have some form of under insurance.

The following example will show the impact of under insurance. The formula on a policy with 80% co-insurance is:

$$\text{Adjusted Loss} = \frac{\text{Declared}}{\text{Value}} \times \text{Loss}$$

If we insured for $500,000 and the value at risk was say $1,000,000 with a loss of $200,000 the claim would be adjusted as follows.

$$\text{Adjusted Loss} = \frac{\$500{,}000}{\$800{,}000} \times \$200{,}000$$

$$\text{Adjusted Loss} = \$125{,}000$$

(Uninsured loss i.e. own insurer for $75,000)

When you consider the premium saving on $500,000 was somewhere in the region of $1,250 depending on the occupation of the business the loss of 60 times ($75,000 - 1,250) that figure on this moderate loss shows the complete folly of risking under insurance. You are really risking the very survival of your business. When you consider that one in 500 businesses suffer a loss every year, a prudent business person would never risk it.

Under insuring the Insurable Gross Profit is just one form of under insurance. Others are not having a sufficient Indemnity Period.

In summary then, Business Interruption Insurance is not a first loss cover. If you under declare your sum insured (sometimes called Declared Values) then you are deemed to be your own insurer for the proportion of any loss no matter how small or large. In reality the cost of insurance is not high, particularly when you consider the level of protection it can bring in the event of even a short disruption. The cost is tax deductible and unless your business has significant cash resources or you have the ability and are prepared to fund the recovery program yourself it is a product that we at Policy Coach Pty Ltd strongly recommend.

How long do I need to insure for?

The indemnity period is the period which the insurance policy will provide cover for disruption to your business. It not only covers the period which it takes to rebuild a damaged building or replace stock etcetera it is the period which you expect the business will take to be back exactly where it was at the time of the loss. This means getting back or replacing any lost customers and/or protection for any on-going increased costs of working to the business. A good example of this is that under many lease agreements the tenant is bound by the lease to maintain the lease if repairs are started within three months and completed within a time period sometimes 6 other times 9, 12, 18 or even 24 months. There is no use having a short indemnity period if a) you have to incur the costs of moving back into the finished building after the indemnity period has expired or b) you have to pay the lease out.

Other things to think about are:

Acceptance of the property claim

How long will it take the insurance company to accept your claim in respect of the loss of assets? In respect of a fire claim, this entails a thorough investigation into cause and in a major loss this process typically takes between 6 and 13 weeks. In some cases, the insurance company will consider granting an advance partial settlement of the claim when the claimant appeals for one.

Management of the claim

Getting the claim accepted is just part of the process. How proactive the loss adjuster, the consultants such as engineers, builders and the claims department themselves in getting things done, making all important progress payments etc. needs to be considered. Brokers and Insureds ought to give this much more consideration at the time they take out the insurance than they tend to do. Good quality insurers actively work to assist their clients. Others move the Insured from "customer" to "cost centre" the moment the claim happens. Having a longer indemity period can act as a second form of insurance as, realising that delays are really going to hurt them, it can force otherwise slow insurers/loss adjusters to keep things moving.

Alternative Premises

Let us assume you cannot occupy the building you usually do. There has been a fire, or perhaps an outbreak of disease. What alternatively premises are available to you? We find in many areas, such as shopping centres, retail shopping strips, country towns that there is a shortage of alternative accommodation available. This is particularly relevant in cases where your business has particular needs. Health department approval for food handling, particular requirements for electricity, gas, lifting, delivery, and storage facilities are just a few examples.

The Connection of Services

The connection or reconnection of electricity, gas, and or telecommunications, can be a problem for the original premises or to the premises to which you may relocate, temporarily or permanently, particularly to newer areas.

Removal of Debris

How long will it take, allowing for the environmental protection authority and work safe rules and regulations to clear the damaged property ready for replacement?

Another point to consider is, in the case of a landlord, just how many of the tenants are insured adequately if at all. Under insurance or worse still no insurance can certainly delay the rebuild process, particularly if the tenants go bankrupt and abandon their debris to the landlord.

Council Requirements

The time frame to obtain council permission to rebuild to current standards sometimes requiring a new planning permit can take several months. This is why most commercial leases now allow the landlord a minimum of three months before they have to start repairs otherwise the lease is at an end. Please check your own lease as part of your planning process.

Environmental Issues

This is certainly becoming an issue in more and more cases and should be carefully considered when setting the Indemnity Period.

Tender Phase

There is the tender phase of obtaining quotations for the reinstatement of the building, machinery and plant etcetera. It takes time to prepare an adequate scope of works and then evaluate the tenders that are received.

From our experience, Insurers are less and less inclined to go down the "cost plus" methodology today which has proved to be so much quicker in the past. As all the costs are verified as part of the verification process with the overhead and profit margin is agreed in advance, the cost of reinstatement is traditionally lower and the reinstatement done faster. As such I cannot see why it is not used where appropriate. In any event, the tender phase does add considerable time to the process and needs to be factored in to the Indemnity Period.

Lead Times on Replacement Equipment

If your business relies on product or machinery that is imported from overseas or is otherwise not immediately available then you need to factor this into your calculations. The more complex the machinery: typically the longer the lead time.

Fit out, Testing, and Commissioning

It is one thing to rebuild a building but then it has to be fitted out. Partitions may have to be built, telephone cables laid, computer networks installed etcetera. For some risks this can be many weeks of work.

Similarly, any new equipment needs to be installed, tested and commissioned. What reasonable time is required here?

The Time to Relocate back into Your Premises

If your business has temporarily relocated after say a fire, you will need to return to your original premises. This can be a time consuming and disruptive period.

Winning back new customers

This is the major point that most or many people overlook. Even when all your property is reinstated you are entitled in many jurisdictions, United Kingdom, Australia, New Zealand and the like to continue to claim under an interruption policy until your turnover has returned to normal as has your expense rate. In the United States the policy typically limits this to a nominated period, independent of your indemnity period.

Add more for Catastrophe Situations

If the business is in an area where a catastrophe is possible such as a hail storm, flood, cyclone, earthquake then at minimum of 25% to 33% increase in the length of the Indemnity Period should be considered as the reestablishment process will take longer after a large catastrophe.

Regardless of the type of insurance, the time taken to win back your customers should be carefully considered when determining what level of indemnity period is required.

It is important that a 3 month cover, i.e. a 3 month indemnity period is not 25% the cost of 12 months. The reason for this is the frequency of short disruptions compared to longer ones. You will find that the cost difference is so small it is better for you to insure for at least 12 months as a minimum.

We strongly suggest you take a longer indemnity period if you feel that 12 months is even the slightest bit “skinny”. Twelve months may sound a long time, but from our experience, it goes far too fast and many a business is only just started rebuilding after a major event let alone fully recovered.

How should Wages be Insured?

The only way to provide a company with all the flexibility possible is to insure Wages 100%. If you intend to insure wages fully, you can leave all those items that make up the definition of Payroll, as part of the Sum Insured for Insured Gross Profit. To do this, you do not show Payroll or Wages as an Uninsured Working Expense.

As has been previously stated, total flexibility is only achieved by insuring Wages in full for the entire Indemnity Period. If Pay-Roll is to be insured separately using the Dual Wages Method, 100% of Pay-Roll should be shown as an Uninsured Working Expense as Pay-Roll is insured separately as a separate item.

Should I insure every expense?

It is necessary to insure every expense of the business that is not variable in direct proportion to sales but the cost benefit of not insuring an item should always be kept in perspective. When you consider the consequences of getting it wrong, compared to the comparatively inexpensive cost of coverage, the recommendation is that if you are in doubt, insure it.

How a claim is Calculated

Arguably the best way to learn how a claim is settled under the policy is to run through a claim scenario and see just how a business interruption policy responds. By taking this approach you will learn why you insure the way you do and the importance of getting the sum insured/declared value right.

What is difference between Increase in Cost and Additional Increase in Cost of Working

Anyone in business knows that it is much easier and less expensive to look after and service an existing customer than to lose the customer and have to replace them. The insurance industry accepts this notion, and realises that in the event of an insured loss, it is, on the face of it better to incur some increased costs of working to minimise the period of disruption and/or the shortfall in Turnover during the period of disruption. In other words they allow the business to claim some additional expenses not normally incurred to retain its market share.

Increase in Cost of Working

When you declare a Declared Value and Limit of Liability under an ISR policy, (or sum insured under most business packs) you are selecting cover for loss of insurable gross profit.

Under the ISR this is referred to as Item 1(a) Loss of Gross Profit as a result of a Reduction in Turnover. Sharing this same Declared Value (sum insured) is Item 1(b) Loss of Gross Profit as a result of Increase in Cost of Working.

What this means is that the insurer does not differentiate between a financial loss to the insured business as a result of a loss due to turnover having fallen due to an insured disruption or as a result of the business incurring increased expenditure. It will meet losses suffered by the business in either form or a combination of both up to the Limit of Liability.

How the Policy does this is best explained by way of an example. Let us assume that a business has sustained fire damage to a machine worth $150,000. It will take 6 weeks for the machine to be sent by sea from Italy, its place of manufacture. For every week that the insured business is without the machine it loses $10,000 in revenue. This reduction in turnover results in a loss of insured Gross Profit of $4,000. If the Insured were to airfreight the machine from Italy to Australia it would cost an additional $25,000 but would reduce the disruption to the business by 5 weeks.

Under the terms of the Material Damage section of the Policy, the insurer will replace the machine, subject to a test for the adequacy of insurance. Replacement not only covers the cost of buying the machine in Italy but transporting to the Insured's premises and installing it. This claim will be based on the cost of sea freight, the most economical form of transport.

The owner of the business decides to pay the difference of $25,000 and air freight the machine to Singapore and eliminate the 5 weeks time delay and thereby minimise the disruption to his customers.

To determine what is claimable under Item 1(b) Increase in Cost of Working we need to review the wording. This is reproduced below:

*"**Item 1(b)*** [*Loss of Gross Profit in Respect of an Increase in Cost of Working*.]
"The additional expenditure necessarily and reasonably incurred for the sole purpose of avoiding or diminishing the reduction in Turnover which, but for that expenditure, would have taken place during the Indemnity Period in consequence of the damage, but not exceeding the sum produced by applying the rate of gross profit to the amount of the reduction thereby avoided."

The first issue to understand when considering whether an increased cost is recoverable under this section of the Policy is that the expense must be for the **sole purpose** of avoiding or diminishing the reduction in Turnover. In our case, the air freight was for the sole purpose of diminishing the reduction in Turnover as a result of the damage, and was successful in doing so.

Not all expenditure passes this test. An example that often arises is the employment of additional staff in the accounts department to catch up on issuing invoices and statements, and the collection from debtors. This may reduce the delay in the collection of revenue, but does nothing to reduce or avoid a reduction in Turnover. As such, the additional wages would not be covered under this wording. There is a wider cover readily available in the form of Additional Increased Cost of Working for this type of expense, and we address this later in this section. In our example case of the airfreight of the machine, the expenditure passes this first test.

The second test is known as the **Economic Limit Test**. In simple terms, it means that you cannot claim more as an Increased Cost of Working item than was saved by way of avoiding a claim for loss of insured Gross Profit.

We test this by comparing the expenditure incurred (here $25,000) to the loss of insured Gross Profit avoided. In this case it was $20,000 ($4,000 x 5 weeks). This being the case the Insured is able to claim $20,000 as an Increase in Cost of Working. This test is based purely on a cost benefit analysis with the limit being the amount of insured Gross Profit saved.

Any amount not paid as an increased cost of working may be considered under the wider cover of Additional Increased Cost of Working, which we discuss later under the next sub-heading.
One final point needs to be made about Increased Cost of Working cover. Under the vast majority of ISR and business pack policies any amount payable as in Increase in Cost of Working claim is subject to the test for under insurance. If there is under insurance then the amount paid by the Insurer will be reduced in a proportion based on the terms of the under insurance clause.

Additional Increased Cost of Working
The cover provided by Additional Increased Cost of Working is much broader than that provided by Increase in Cost of Working as is clear from the following definition, which again has been taken from the ISR Mark IV wording.

Item 4 [*(Additional) Increased Cost of Working*]
"The insurance under this item is limited to increase in cost of working (not otherwise recoverable hereunder) necessarily and reasonably incurred during the Indemnity Period in consequence of the damage for the purpose of avoiding or diminishing reduction in Turnover and/or resuming and/or maintaining normal business operations and/or services."

This wider cover allows increased costs that maintain the business or service, but which do not necessarily reduce or avoid a Loss of Turnover during the Indemnity Period. For example, with the example of an Insured employing additional accounting staff to ensure debt collection is maintained at the normal rate then this would now be covered under the Policy. In other words there is no "sole purpose" test.

Further, the Additional Increase in Cost of Working cover is not subject to the Economic Limit Test, which can be a great advantage, particularly if the expenditure ensures the retention of customers well after the expiration of the Indemnity Period. The costs, however, must be reasonable and incurred in consequence of the damage.

In the example of the Insured that air freighted the machine out from Italy, if this company demonstrated that it was a prudent course of action for the business to take and that they would have met the expenditure even if they were not insured, then the Insurer would meet the difference between the amount incurred of $25,000 and the amount paid as an Increase in Cost of Working Item $20,000.

From experience we find this to be a very valuable cover. It allows an insured to make quicker decisions as they do not have to justify expenditure before incurring it. If it is prudent and reasonable then it should be covered by the Policy.

One final benefit is that the Additional Increased Cost of Working cover is not subject to any adjustment for under-insurance. In all policies where you can insure for it, the sub-limit or sum insured is a first loss limit.. However, it is important that the cover is adequate to allow the businessperson to take all reasonable steps to protect their business during the period of the crisis.

The inclusion of Additional Increased Cost of Working cover can, in some policies, assist in recovering the portion of the under-insured loss of an Increase in Cost of Working caused by under insurance. But please understand that the primary purpose of Additional Increased Cost of Working cover is not as a backstop for under-insurance, but rather as an extra cover in its own right for the reasons described above. Adequate insurance on both Gross Profit and Additional Increased Cost of Working is strongly recommended.

Besides air freighting, Additional Increased Cost of Working has been used to fund:

- Additional rent for temporary premises
- Outsourcing of manufacture to a competitor or contract manufacturer
- An advertising campaign to win back lost or disgruntled customers
- The hire of temporary plant and or equipment
- Overtime payment to staff
- The temporary employment of additional staff

This is just a short list that immediately comes to mind. It is really an invaluable cover that every Insured should have.

Additional Increased Cost of Working Cover only

Some Insureds believe that they do not require full business interruption insurance as they will not lose any sales but may incur some additional expenses to maintain sales and customer service. This may be true for some service companies. They claim that they can quickly relocate or have their staff work from home. If this is true then this cover, purchased as a stand alone cover may be appropriate.

We would certainly not recommend this for a manufacturer or retailer. In most cases, it is found that the cover does not adequately indemnify a wholesaler.

If the office or service risk involves specialised equipment such as a dentist, again we would recommend the business take out full business interruption cover.

Before making the decision, the business owner is strongly encouraged to discuss the pros and cons with your insurance broker or adviser.

Sub-Limiting Increase in Cost of Working and Additional Increased Cost of Working on a ISR Policy

Now that we have gone through the cover, we wish to provide commentary on the increasing tendency of sub-limiting Increase in Cost of Working on an ISR policy.

As has been just described, the cover is quite valuable to an Insured in that it allows them to incur costs that maintain sales and thereby protect the survival of the business. It has been designed so that the Sub-Limit for Gross Profit is shared fully with the Increase in Cost of Working cover.

It should always be borne in mind that there is a Policy Condition that requires the Insured to minimise any disruption. As such it could be argued that an Insurer would prefer to pay out an Increase in Cost of Working claim rather than a claim for Loss of Gross Profit due to a reduction in Turnover. From the business owner's perspective it is certainly better as it usually means they have retained their customer.