

The Development of Business Interruption Insurance

There are relatively few businesses which, in the event of damage being caused by fire or other perils at their premises or possibly those of their suppliers or customers, would not suffer financially either through loss of trade or the additional expenditure involved during the period following the occurrence. Protection against such financial loss by means of Business Interruption Insurance – or as it was known Consequential Loss Insurance – has developed progressively during the last century until it may now be said that in South Africa and in other parts of the world it is taken out by practically all prudent business undertakings as the essential complement of their material damage insurance.

In this article I will attempt to provide a little insight into the development of Business Interruption Insurance. When buildings or their contents are damaged by fire or kindred perils the condition and value of the property before the damage and the cost of its restoration or replacement are tangible factors on which can be based as assessment of the amount to be paid under the insurance covering them. What method of general application is there to ascertain for the purpose of protection by insurance the intangible, often hypothetical, loss which commences when the fire engines have driven away – the loss of future earnings?

Experience shows that the proportionate effects of a fire upon the earning capacity of a business can be readily and accurately measured in most cases by comparing the turnover in the months following the damage with that in the corresponding period in the twelve months preceding it subject to the appropriate adjustments for special circumstances or trends of business. For example if a fire causes interruption of business throughout January, February and March the loss of turnover during those months can be found by means of a comparison with the turnover for January, February and March in the preceding year. In general, the loss of turnover during any other period of whatever length can be used as a yardstick for measuring the interruption of trading provided that provision is made for any necessary adjustments.

As turnover figures can usually be ascertained satisfactorily for each day or week, or at the outside each month, this period provides a sensitive index for measuring the proportionate effects of a fire without waiting until the end of the financial year. It also shows the loss sustained when the end of an insured's financial year falls within the period of interference, a loss which could not be ascertained by a comparison of the profit earned in each of the two years. For instance, if damage takes place three months before the end of the firm's financial year and the business is affected from that date until three months into the next financial year, there might be little or no difference between the profit earned in those two years although altogether something approaching six months profit may have been lost. In circumstances of that kind a comparison of the prior year profit with the loss sustained following the damage and the shortage of turnover throughout the period of interruption is an accurate basis for measuring the insured's loss.

Moreover, the use of turnover as an index provides for business of a seasonal nature in which sales are not constant throughout the months of the year and it is also suitable for business in which the turnover is either increasing or decreasing because trends can be assessed for calculating the loss of sales following a fire.

BUT LOSS OF TURNOVER IS NOT SYNONOMOUS WITH LOSS OF PROFIT

However, the yardstick of turnover can be used to assess the net effect of a fire upon the earnings of a business. Each rand of turnover may be assumed to bear an equal share of :

(a) prime costs, conventionally entered in the first section of a trading account, such as purchases, whether for resale or for use in manufacture, productive wages, consumable stores, fuel for trade purposes, power and other process charges. These may be described as variable or working expenses, that is, they vary proportionately with the rise or fall of turnover;

(b) overhead expenses such as administrative, selling and distributive costs which generally appear in the second section of a trading account and in the profit and loss account. Because they are not controllable as are prime costs they are for insurance purposes referred to as standing charges, a term which aptly describes their nature;

(c) the residual net profit.

Should turnover fall in consequence of damage by fire the prime costs will, by and large, be reduced proportionately and no loss will be sustained by the business under (a) above. Standing charges, however as they do not vary directly with turnover will not fall proportionately; therefore in the event of a reduction in turnover (b) above will bear an increased incidence beyond its normal ratio. This relative increase in the amount of the standing charges will have a corresponding inverse effect by reducing the residue (c) above, that is, the net profit. At the same time there will be a concurrent loss of net profit taking place due to there being a smaller volume of turnover on which it can be earned.

However, if compensation is provided by insurance during a period of interruption caused by fire, for the amount of (b) and (c) normally borne by each Rand of turnover, on every Rand of turnover lost, the revenue of a business will be restored to the extent necessary to cover the normal amount of standing charges and net profit.

The simple principle that reduction in turnover after a fire is a reliable guide to and a sensible index for measuring the proportionate effect of the fire upon the earnings of a business, and that the actual loss can be ascertained by applying to this reduction, the ratios in which standing charges and net profit together normally bear to turnover, is the basis of the business interruption.