To Helen, Susan, Lorna and Mary (my wife, daughter, mother and grandmother)
The four generations of women in my life who have meant so much to me.

Other titles by this Author
Understanding the ISR Policy – A Comprehensive Guide
Fidelity, Theft & Money Insurance & Claims
The Closure of the Bougainville Copper Mine – An Anatomy of a Major Claim
The Strategic Management of Crises in Small & Medium Businesses

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FOREWORD
By Roger Bancroft

Roger’s business suffered a major loss by fire on 21 December 1997 - his business survived!

Insurance is a nebulous thing - a grey area that for too long has been perceived to be a “lose-lose” situation. After all, if you do not claim, you have wasted your money, and if you do have to claim, you’re going to get a rough deal anyway. WRONG!

Think seriously about insurance and what its true purpose is. The real answer is “to offer you an opportunity to hold on to your assets”.

Many friends and associates think “the cheaper, the better” when it comes to insurance. They think all policies are the same, if they carry the same title. This, of course, is nonsense. You really need to understand the cover you are paying for. You owe it to yourself to make this a priority.

May I suggest that by not looking at insurance as you would other business decisions, you are doing yourself, your business, and those that rely on you, a great disservice. You come out the loser in such a situation, and the taxman is the big winner. Yes, that's right, the Australian Taxation Office. That is where the dollars move to, because the dollars saved in insurance drop through to the bottom line and are taxed.

Keep in mind that, like anything else in life, ignorance is not a defence for foolishness.

It is well worth the time and effort to re-evaluate your stock, plant, equipment, loss of profits and other insurances whilst preparing your tax returns, at the end of the financial year. All the information you need is at your fingertips, and replacement costs for the majority of items are really only a telephone call away. You really do have ‘a duty of care’ to yourself.

The biggest irony is that we choose to do this only after we have been affected. Think well on this. I know what I am talking about as I’ve been there!

Finally, if you are unfortunate enough to suffer a loss, not only to your physical assets but also resulting in a business interruption, get help! It is a complex area and you need an expert on your side. The best news is that the cost is probably covered by the policy anyway. I had great help, from great people - it paid great dividends!

Roger Bancroft
South Yarra, March 2002
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INTRODUCTION

Most individuals, business owners or those entrusted to manage a business have come to realise the importance of insurance. Fully insuring the assets of the business against fire and other events that may destroy or damage the income-earning property of the business, is simply good business practice.

Unfortunately, insurance is not taught as a subject in many business courses or at post-graduate level. Even high-level courses such as MBAs or DBAs do not address this very important aspect of risk management. Despite this lack of formal training, an enormous responsibility is placed on the business owner or finance director ‘to get it right’ when it comes to arranging the cover necessary to protect the business, and setting the correct Sum Insured. Assistance is available in the form of the insurance broker or adviser, and his or her advice can be invaluable. The ultimate decision, however, remains with the business owner or manager. Whilst under-insurance is a definite concern when insuring property, there are three areas of insurance which are not always given the attention they require, namely:

- Business interruption insurance;
- Fidelity insurance; and
- Liability insurance, including public liability, products liability, professional indemnity and directors and officers liability.

A recent study undertaken by Zurich Insurance Australia¹ found that in Australia, less than 40% of small and medium enterprises (“SMEs”) have business interruption insurance. What disappointed me the most in this study was that 23% of the SMEs surveyed responded that they had never heard of business interruption insurance. This is an indictment on the insurance industry and is one of the reasons behind this Guide. If those advising on insurance understand the product they are selling, they are more likely to be successful in their important role of advising on insurance protection.

A second study by the Insurance Council of Australia² suggests that of those that do not have full cover, around 70% do not survive a major loss such as fire, flood or significant storm damage. My own research³ suggests it is closer to 50%. Even at 50%, this is still a very alarming statistic. This same research indicates that for those businesses that have neither full cover nor business interruption insurance, the chances of their business surviving drops to less than 10%.

This text has been designed as a guide for business owners, business managers and those that arrange the cover and advise on insurance, as to how a Business Interruption policy works, the additional covers available, and the particular items that should be taken into consideration when setting the Sum Insured. Guides on the industrial special risks policy and fidelity insurance are also available in this series.

Whilst I have handled many thousands of claims, three have been the catalyst for writing this Guide. The first concerned a sign manufacturer in Perth. The business had recently been acquired by the grandson of the founder, and both the grandfather and the father worked in the business. In an effort to save costs and, no doubt, through the pressure of his new position, the newly appointed business manager reduced the Sum Insured, saving $10,000 in premium. Only 2 months later, the business was devastated by a major fire, resulting in disruption exceeding 10 months. The saving of $10,000 in premium resulted in the claim being adjusted due to under-insurance, costing the business $1.5 million. The look on the young business manager’s face when the ramifications of his decision to cut costs were known cannot be described.

¹ Zurich Financial Services Australia, 2007.
The second case involves a similar story. In this instance, the Insured’s broker refused to allow the Insured to reduce the Sum Insured as he knew that the Insured would be significantly penalised for under-insurance in the event of a claim. As a compromise, the Insured insisted on reducing the indemnity period from 12 months to 6 months. Again, the business was the subject of a major fire. Much to everyone’s amazement, the business in fact did better than planned in the 6 months following the fire. This was due to the fact that the service centre where the fire occurred, contained equipment belonging to many customers, which had been left with the business for servicing. As a result of the fire, all this machinery required major repair, and the business won the contracts to carry out those repairs. As a result, Turnover increased, as did profits. Therefore, the insurer paid out no monies as there was no loss during the 6-month period of cover provided by the policy. However, once this work was completed, the Turnover of the business dropped by over 50% when compared to the Turnover prior to the fire, and remained at this level for some time. In fact, it was more than 18 months after the fire before the business was back to normal. In hindsight, the Insured realised that instead of reducing their period of disruption from 12 months to 6 months, they should have increased it by 6 months (ie. from 12 months to 18 months) in order to be fully insured. Again, the result was an uninsured loss in excess of $1.5 million.

The third claim involved a drycleaner in Melbourne - Bancrofts Dry Cleaners - who suffered a fire in 1997. It was Roger Bancroft who kindly wrote the Foreword to this Guide. Although they had experienced a fire previously and were more than fully insured, it was clear they were unsure how the policy would operate. I sat down with a foolscap pad and attempted to explain just how the policy would respond, setting out the formula contained in the policy and the very flexible way adjustments could be made to reflect how the business was performing. For the first time in my career, the rough notes and calculations I used to help describe the process, were given back to me at the end of the claim. Worse than this, these notes were used by the Insured in a presentation at an industry function, in which the Insured explained how the major crisis in their business-life was overcome.

It was at this point in time I realised that business people, having just suffered a major crisis in their life, required more than just a quick lesson with rough notes on business interruption insurance. Hence, the Practical Guide to Business Interruption Insurance was born.

While every business owner and manager is cost-conscious, the saving in premium pales into insignificance when compared to the amount deducted from the assessed loss due to under-insurance. With increasing responsibility associated with corporate governance, coupled with an ever-increasing competitiveness in business, it is more important than ever to ensure that all salaries and wages, along with the insurable gross profit of the business, are fully insured. To assist in this regard, entire sections of the Guide have been devoted to explaining what is meant by insurable gross profit and why insurance of wages is so important.

‘Package’ insurance policies are being used more frequently for the insurance of businesses, and modifications to the traditional cover have been introduced. The 3rd Edition of this book included a new chapter on this subject, which was expanded even further in the 4th Edition. The 4th Edition also included two new chapters; one providing a schedule of indicative rates of gross profit for over 1,100 different business types, and another which takes a close look at the Instant Profits Policy, which differs significantly from the traditional cover and is finding more and more support from insurance brokers and authorised representatives.

It has now been 6 years since the 1st Edition of this Guide was published, and the book continues to be extremely popular. As such, it is timely for a ‘makeover’ in this, the 5th Edition of the Guide. Every chapter has been thoroughly reviewed and expanded, and 8 completely new chapters have been included. In the earlier editions, my intention was to explain the cover in a non-technical manner. The new chapters take the subject to a higher level, and have been included as reference material to answer some of the questions that I am frequently asked about business interruption. A Glossary of Terms has also been added as the final chapter. Therefore, while this edition is still an introductory text, the reader also has the ability to gain a more detailed understanding where appropriate, but all in the easy to read style that has been the hallmark of the Guide.
Introduction

As you progress through the Guide, you will find that our case studies refer to years using the following format: 20XX-1, 20XX, 20XX+1, and so on. The purpose of this format is to ensure that when the reader returns to the Guide a year or so from now, they can readily identify the current year’s, previous and forecast data, as 20XX will always refer to the current year at the time of reading, while 20XX-1 refers to the preceding year, and 20XX+1 refers to the following year. This ensures that the reader will not mistakenly confuse current or forecast data as being historic, which could easily occur if the actual years were displayed (eg. 2007, 2008, 2009 and so on).

Another enhancement to this edition is the inclusion of revision questions at the end of each chapter, to assist the reader in testing their understanding. The answers for each chapter are provided in the matrix at Chapter 24 of this Guide. I thank my son, Steven, for drafting the majority of the questions and model answers in this Guide.

Included with your purchase is a bookmark specifically for use with this Guide. The bookmark may be closed into a standard bookmark arrangement to hold your place in the Guide and, when required, opened into an ‘L’ shape to enable you to quickly and accurately locate the answers in the matrix. That is, by placing one edge along the column for the appropriate question number and lining up the other edge along the row for the relevant chapter, the answer will be easily determined where the two inner edges of the bookmark meet.

Lastly, the logic behind the answers is available to all readers via a link in the Publications area of the LMI Group website (www.LMIGroup.com/Publications). Please note that while the revision questions are available to all visitors to our website, in order to access the logic behind the answers you will need to enter a password. For your convenience, the password is the last 6 digits of the number displayed beneath the barcode on any edition of our Practical Guide to Business Interruption Insurance publications. For example, readers with this 5th Edition of the Guide would enter 094856, being the last 6 digits and easily identified as the last ‘group’ of numbers in the barcode. This will enable readers with earlier editions of the Guide to also utilise this valuable resource. The barcode is not only displayed on the back cover of the Guide, but also at the bottom of the dedication and information page just inside the front cover.

Sincere thanks also goes to many of my colleagues at LMI Group, who have offered valuable comment based on their many years of experience in the field, with particular thanks to Steve Smith, Paul Johnson, Steve Manning, Gordon Lum, Angus Stewart, and Phil Burn. Valuable assistance was also provided by Victoria University; many of the case studies used in this Guide were developed as part of my Doctoral thesis. Finally, I wish to thank Wendy Hunter of Secretaries on the Move for her assistance in the presentation of this Guide.

I would be extremely pleased to receive feedback regarding the relevance, ease of understanding and usefulness of the material contained herein, and any suggestions for improvement. You may reply via email to allan.manning@LMIGroup.com. It is through such feedback that the Guide continues to grow with each new edition.

Allan Manning
Melbourne, July 2008
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CHAPTER 7 - IS THE BUSINESS EXPENSE TRULY VARIABLE?

As explained in Chapter 5, it is necessary to insure every expense of the business that is not truly variable in direct proportion to sales. This chapter provides a brief commentary on 54 of the most common business expenses. No two businesses are the same, and the following must of necessity be a generalisation and should be treated as such.

While not the only aspect to consider, the amount of the expense should be looked at. That is, 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.

7.1 Accountants’ & Auditors’ Fees

Accountancy work in connection with an Insured’s audit, financial and management reporting, taxation and/or other matters, will not change dramatically as a result of a Reduction in Turnover due to a disruption to the business. While some saving may be negotiated, the expense certainly will not fall in proportion to the Reduction in Turnover. As such, it should be insured in full.

The fees for extra accountancy work that may arise in the production of information required by insurers in connection with a claim following an insured loss, is typically payable by insurers under the terms of the Claims Preparation or Professional Fees item of the Business Interruption policy. As the external accountant to the business does not prepare business interruption claims on a day-to-day basis, it is considered prudent to obtain specialist advice to prepare claims. Even accounting firms themselves engage loss management experts to prepare their own business interruption claims.

Having said this, some additional financial reports may be necessary during the claims preparation process, which the Insured’s usual accountants can most easily supply. The costs for these additional reports would be claimable if Claims Preparation fees are insured.

7.2 Advertising

Advertising expenses, exhibitions and trade show expenses, as well as sports and other sponsorship expenses, can be included in this category.

Advertising expenses are typically not directly variable to sales. In the event of a short-term loss, the advertising expense may in fact increase. Even in the case of a long-term disruption, the business will usually require advertising to keep the brand and/or products in the public eye. Therefore, it is recommended that this expense be insured.

7.3 Annual Leave Provision

See Wages in Chapter 9.
7.4 Bad Debts

As bad debts can only accrue on sales transacted or services rendered, they are typically not insured. However, I am not sure that this is good practice. Bad debts are not necessarily accrued by a business in direct proportion to sales. During boom times, sales may increase and, due to this general period of prosperity, bad debts may not be a problem.

On the other side of the coin, during periods of recession or following a disruption, Turnover may be reducing and the business may relax their criteria for providing credit. As a result, their bad debts may increase despite falling revenue.

Another factor to consider is that for many businesses, bad debts are only relatively small and, as such, I tend to recommend insuring the expense.

I am aware that some insurers and/or broker cluster group policies nominate bad debts as a standard Uninsured Working Expense. For many businesses this is quite acceptable.

7.5 Bank Charges

The rate of charges, which in reality is relatively minor, does not vary with Turnover. As such, these charges should be insured in full.

7.6 Bonuses

Bonuses are typically treated as part of Payroll/Wages. See Chapter 9 for a comprehensive discussion on this topic.

7.7 Carriage (shipping, freight container and container-base services)

Carriage is, in general, a charge of a variable nature. In some industries, however, it can be that carriage is under contract, at a fixed price per month or year irrespective of the quantity of goods carried. This is the exception, however, rather than the rule. Where a fixed contract does apply, it is a fixed charge that should be insured. Otherwise, if it is truly variable as a proportion of sales, the charge need not be insured.

Shipping and freight expenses for goods sent overseas (trucking, warehousing, insurance, lighterage to the loading tackle of a ship, stevedoring and shipping charges) including air freight, are a form of carriage. If they are a charge that will vary proportionately with any reduction in the quantity of goods transported, there is no necessity to insure them.

Similarly, where the transport of goods overseas is in containers with use being made of the services, equipment, cranes and containers of a container-base firm, and the charges relate to the quantity of goods transported, they may be regarded as a variable expense and therefore not insured.

7.8 Commissions

If commissions are paid to agents or staff, the first reaction is to treat them as an expense that does not require insuring. However, it is wise to review any contracts to ensure that the business can reduce or suspend commissions in the event of an insured loss.
In addition, the long-term relationship with the company or individual reliant on the commission income, needs to be considered. Will they abandon the insured firm to a competitor that may, in the long-term, cost the Insured more than if they had continued to meet a fair or negotiated level of commission? If this is the case, then it is recommended that commissions be insured.

7.9 Computing Expenses

This expense can include the cost of hosting a website or webmail, to providing regular maintenance to the business for all types of computing services. In most cases where I have examined the expense for a client, I have determined that the cost is not directly variable to sales and, as such, is an expense that needs to be insured.

7.10 Courier Charges

For most businesses, this cost is insignificant and should be treated the same as postage, which is discussed later in the chapter. If, on the other hand, the costs are significant and do vary in direct proportion to sales, for example in a mail order business, then the expense need not be insured.

7.11 Credit Card & EFTPOS Charges

The vast majority of these costs are charged as a fixed percentage of sales. As long as the level of credit or EFTPOS sales transactions (as a percentage of sales revenue) to cash sales remains the same after a loss as before, then this expense need not be insured.

7.12 Depreciation of Buildings, Plant & Machinery, Fixtures & Fittings, Office Equipment, Vehicles etc (excluding stock)

Depreciation is an item that often gives rise to argument. It is sometimes suggested that it need not be insured because if buildings and plant are destroyed, depreciation will either cease altogether or be reduced in proportion to the amount of damage sustained. However, Turnover can be adversely affected out of proportion to the amount of property destroyed, and so the reduction in the depreciation charge will not necessarily be proportionate with the fall in earnings.

Further, when new buildings and plant replacing those destroyed are still not fully productive, depreciation will be taking place and the expense accounted for. The need to insure depreciation is even more obvious when the business interruption insurance is extended to include Loss of Turnover resulting from disruption arising out of an event away from the premises, such as prevention of access to the Insured’s premises, damage at a customers’ or supplier’s premises, or failure of a public utility.

Another argument is that as depreciation is a non-cash expense, there is no need to insure it. Although it is a non-cash expense in the Profit & Loss Account (as the actual expenditure occurred at an earlier time, ie. when the asset was first purchased), it is a legitimate charge against the trading income of a business. Depreciation is the amortisation of the cost of that asset, less its estimated residual value, over the useful life of the asset. The value of the amortisation is properly a cost of earning revenue that is no different to any other operating cost charged against revenue. It is strongly recommended that this expense be insured in full.

Given the significance and complexity of this topic, a chapter has been dedicated solely to depreciation. The reader is directed to Chapter 20 for a more detailed analysis of this expense item.
7.13 Depreciation of Stock

Depreciation of stock, whether it be raw materials, consumable stores, work in progress or finished goods, generally arises through market fluctuations, the aging of stock, changes in designs and fashions, or obsolescence. Typically, in the company’s annual accounts, depreciation is not debited as a charge, but is reflected in the reduced amount of the closing stock figure according to the stock valuation.

It is a trading loss attaching to the amount of stock held and, in general, would arise irrespective of damage occurring. Consequently, it is not regarded as insurable as part of Gross Profit, and is excluded by the use of opening and closing stock figures provided that due provision has been made for depreciation.

Given the significance and complexity of this topic, a chapter has been dedicated solely to depreciation. The reader is directed to Chapter 20 for a more detailed analysis of this expense item.

7.14 Director’s Remuneration & Fees

It is obviously desirable that whatever effect the damage may have, the directors of a business should continue to receive their normal remuneration. It often happens that the directors work longer and harder during a crisis, and it would be unreasonable for them not to be compensated. By insuring Directors Remuneration & Fees, you protect the directors’ income stream.

7.15 Discounting Charges

Although paid to a third party rather than being given to a customer (those given to customers being referred to as ‘discounts allowed’), discounting charges are in effect an expense of the same category. They reduce the amount received for goods sold, and typically vary with the volume of trade transacted. If they do occur at a fixed rate to Turnover, then they need not be insured.

7.16 Discounts Allowed

Whether shown as a debit in the accounts or deducted from the sales figures before the amount is recorded in the accounts, ‘discounts allowed’ (being a cash discount allowed to customers for settlement within a credit period) is a charge that will, on average, vary in direct proportion to the value of goods sold or services rendered. Therefore, it need not be insured.

7.17 Discounts Received

Unless the rate of discount received is not directly proportional to the Turnover of the business, this item need not be considered when calculating the Insured Gross Profit.

7.18 Donations

Although donations may be largely an optional expense, it is the general practice to insure them fully.
7.19 Electricity

This expense is sometimes linked to power and light and/or water and/or gas. In any form, it does not necessarily vary directly with Turnover and, as such, should be insured in full. There has been a tendency in the past to insure only part of the expense, say 50%, but the other 50% may or may not vary directly with Turnover. As a result, the Insured may be contributing to part of the expense if a claim is made. Where a percentage of electricity is insured, the endorsement (refer section 7.55 of this chapter) is recommended.

If the expense is a significant proportion of Turnover, resulting in a closer examination being required, the reader is referred to section 7.27, titled Lighting & Heating, for further commentary.

7.20 Fringe Benefits Tax

Refer to Wages in Chapter 9.

7.21 Gas

Gas can appear as an expense item, particularly in those States where piped natural gas is readily available. The cost can sometimes be linked to light and power and/or water.

Where the expense is not significant, it is recommended that it be insured. However, where the expense is significant, a closer look is required, including reviewing the contractual obligations of the supply contract; where there is a large variable component, this need not be insured. Where a percentage of gas is insured, use the endorsement included as section 7.55 in this chapter.

7.22 General Expenses

It is recommended that general expenses be insured in full. These may include petty cash disbursements for such items as staff amenities, minor repairs, stationery, specialist photocopying, and the like. It can cover minor marketing expenses and other day-to-day costs of running the business that are too small in their own right to justify an account of their own. These costs are typically not directly proportionate to Turnover and, as such, should be insured in full.

7.23 Goods & Services Tax

The Goods & Services Tax ("GST") is charged by the majority of businesses as a flat rate of sales. The amount collected is then payable to the government. As the GST is payable as a flat rate of sales, it is truly variable with sales and is therefore not required to be insured. The insurer is said to be indemnifying the Insured for loss of Gross Profit, not lost sales. Therefore, the payment made by the Insured does not include GST.

The GST charged to the business is able to be offset by the business in their return. If the amount paid is greater than the amount collected, the shortfall can be claimed back. As a result, it is not necessary to include GST in the Gross Profit calculation.
7.24 Hire Purchase or Hire Contract Charges

Hire purchase and hire contract charges do not necessarily vary with Turnover.

It is sometimes suggested that as destruction of the items would mean recovery of the value under the material damage section of the policy or a Fire & Perils policy, discharge of the hire agreement would cause the cessation of the charge. As such, it is not necessary to insure it. However, this logic is flawed for a couple of reasons:

1. What happens if the Insured needs to continue to hire equipment to complete or re-do the work affected by the event giving rise to the disruption. If turnover is affected at a different rate to the hire charge, then the expense needs to be insured.

2. Damage may occur that interferes with production without destroying the particular plant or machinery that is the subject of the hiring agreement. To cover this possibility, the hire purchase or hire contract charges should be insured in full.

7.25 Insurance Premiums

Insurance cover is still required in the event of damage in all but the most severe cases. Even then, as soon as insured property is replaced, insurance will be required to protect it. As such, insurance should be insured in full.

Liability, D&O, PI, Accident & Health etc continue to be required regardless of the extent of damage.

Workers’ compensation insurance premiums are included in the definition of Payroll/Wages, as they will reduce in proportion to the reduction in Payroll. It should therefore be treated the same as Wages. See Chapter 9 for further commentary.

7.26 Interest Payments

Examples of interest payments include interest on debentures and loans, bank overdrafts, mortgages, and interest or trade accounts. Some part of the total interest payments may cease after damage if the money obtained from the material damage insurance on the leased property destroyed, is used to repay the principal on which interest is payable. However, as replacement equipment, stock etc is acquired, fresh financing (and therefore interest expenses) will be payable. Other interest expenses will continue throughout the period of disruption. Either way, all interest payments should be insured.

7.27 Lighting & Heating

The necessity to include these charges in full is sometimes questioned, but to omit them could leave an Insured open to loss in a variety of circumstances. In fact, in many cases, the costs of lighting and heating increase during a period of interruption due to usage that is required at times when they would not normally be necessary. As such, it is highly recommended that lighting and heating be insured in full.

This may need to be reviewed for a large manufacturing business where the cost of lighting and heating is grouped with electricity or power, and can be substantial. In such cases, the truly variable component need not be insured, and I would refer the reader to section 7.55 of this chapter, for an endorsement that should be included in the insurance policy.
7.28 Long Service Provisions

Refer to Payroll/Wages in Chapter 9.

7.29 Motor Vehicle Expenses

Where this expense item includes vehicles collecting or delivering goods, it might be argued that if a firm is running a fleet of delivery vans, some of these could be laid up after damage at the premises if there is not sufficient work for all of them. In such a case, some suggest that it is a variable charge that does not need to be insured - I do not support this view.

In most cases, the vehicles are on lease. As such, registration costs, lease payments and third party insurance expenses continue even if the vehicles are temporarily off the road. It is also my experience that such vehicles often do more deliveries to accommodate shorter production runs and, as such, the cost increases rather than decreases. To be certain of full protection against possible loss, it is recommended to insure motor vehicles expenses in full.

Petrol or other fuel, oil and tyre costs and, to some extent, vehicle repairs, can be classified in another accounts code/category. As they do vary in proportion with mileage, they could be reduced if mileage was reduced, but it is again unlikely to be in direct proportion with Turnover for the same reasons as set out in the preceding paragraph. As such, it is again recommended that they be insured in full.

Often the operating costs of management or business owners' vehicles are included in this category. These costs will certainly continue regardless of the level of Turnover and, as a result, should certainly be insured in full.

7.30 Office Expenses

It is recommended that office expenses be insured in full. These may include petty cash disbursements for such items as staff amenities, minor repairs, stationery, specialist photocopying and the like. It can cover minor marketing expenses and other day-to-day costs of running the business. These costs are typically not directly proportionate to Turnover and, as such, should be insured in full.

7.31 Other Expenses

Obviously, there are many other expense items not mentioned. However, it is hoped that from those listed, you will have gained an adequate understanding of the principles involved, which will enable you to decide whether a particular expense should or should not be insured (ie. whether it is a Fixed Cost or a Variable Cost in relation to Turnover).

7.32 Payroll Tax

Refer to Payroll/Wages in Chapter 9.

7.33 Postage

The cost of postage may be less than normal during a period of disruption. However, the reduction would normally not be in the same rate as the Reduction in Turnover. Postage and courier expenditure can increase due to the extra correspondence that is inevitable after serious damage. As such, this expense should be insured in full.
7.34 Power

Power can be a significant manufacturing cost in some industries, none greater than in the production of aluminium. In the vast majority of businesses, it is only a minimal expense, and does not vary in direct relationship with Turnover. As such, except in some rare cases where power consumption is a truly variable expense as a proportion of Turnover, it is recommended that this expense be fully insured.

This may need to be reviewed for a large manufacturing business where the cost of lighting and heating can be grouped with electricity or power, and can be substantial. In such cases, the truly variable component need not be insured, and I would refer the reader to section 7.55 of this chapter, for an endorsement that should be included in the insurance policy.

7.35 Printing & Stationery

An item referring to expenses of this kind will appear in one form or another in every set of accounts. As it is not typically directly related to Turnover, it should be insured in full.

7.36 Purchases

Purchases are one of the true variable expenses and, as a result, need not be insured. In some service industries, such as accounting, legal practices etc, there are no purchases. In effect, this means such businesses may need to insure their full revenue.

7.37 Rates

Local authorities continue to charge rates regardless of the level of revenue earned at the site. Therefore, rates should be insured in full.

7.38 Rent

Rent, as an overhead charge, should always be insured. This is true even where there is a lease in place with a ‘cessation of rent’ clause for total non-occupancy or a reduction in rent in the event of partial loss. There are two reasons for this. First, alternative premises will need to be secured, and if Turnover is down, then rent as a percentage of sales will increase. Secondly, there are occasions where disruption to the business can occur although there is no damage to the building. As such, no saving in normal rent occurs. Examples of this are prevention of access, damage at customers’ or suppliers’ premises, and disruption due to a failure of public utilities.

Other rental payments such as ground rent, rent for wharves or railway sidings, space and power, advertising signs, office machinery, computer leasing, telephone systems etc, and fire and/or burglar alarm systems, should similarly be insured.

In cases where an insured entity owns the building and leases the building or part thereof to another company within the group, it may be necessary to insure rent twice. For the ‘tenant company’, the expense should be insured as part of Gross Profit; that is, an expense that is not deducted as an Uninsured Working Expense. This will allow the tenant company to rent alternative premises while the building is being reinstated. The ‘landlord company’ may well be out of pocket with no revenue being received from the tenant company, particularly if there is a rent abatement clause. In cases where the landlord company (which, as I say in the case under discussion, is part of the one insured group) would still like to receive rental income despite the tenant moving out temporarily, it is necessary to insure this revenue as Turnover or, preferably, as a separate rental income cover under the business interruption section of the policy.

As the insurer could pay out a claim twice - once for the tenant part of the group, and another as loss of rent for the landlord - the item should be insured twice.
7.39 Repairs & Maintenance

Repairs and maintenance is another of those items that often gives rise to argument. It is sometimes suggested that it need not be insured due to the fact that if buildings and plant are destroyed, repairs and maintenance will either cease altogether or be reduced in proportion to the amount of damage suffered. However, Turnover can be adversely affected out of proportion to the amount of property destroyed, and so the reduction in the repairs and maintenance charge will not necessarily be proportionate with the fall in earnings.

The need to insure repairs and maintenance, like several other business expenses, is even more obvious when the business interruption insurance is extended to include Loss of Turnover resulting from disruption away from the premises, such as the prevention of access, damage at the premises of a customer or supplier, or failure of a public utility.

I have seen claims where the maintenance expense goes up during the period of disruption, although the loss involved damage to only one part of production machinery. The reason being that the maintenance team used the forced closure of the factory to undertake a full maintenance program on the undamaged machinery and plant, so that when the damaged section was repaired, the factory could operate for as long as practical without a further maintenance shut.

It is therefore strongly recommended that repairs and maintenance be insured in full. Where the cost is considerable, particularly in a large manufacturing concern, the truly variable component of this expense may not need to be insured. In such a situation, I would direct the reader to section 7.55 of this chapter, for an endorsement that should be included in the insurance policy.

7.40 Royalties

If royalties are payable regardless of Turnover, say as an annual fee, then royalties should be insured in full. Where they are payable as a fixed percentage of sales or as a ‘per unit’ rate, they need not be insured.

Care should be taken to read the contract, as proceeds from an insurance policy may be deemed as Turnover and, in such cases, royalties would need to be insured in full. Special care also needs to be made when the royalty is paid to a parent company that is also named in the policy. In this scenario, the expense or revenue stream needs to be insured.

7.41 Salaries

Refer to Payroll/Wages in Chapter 9.

7.42 Sick Leave Provisions

Refer to Payroll/Wages in Chapter 9.

7.43 Storage Handling Charges

The cost of manual and mechanical handling of an Insured’s goods in store by employees at an outsourced warehouse should vary in ratio to the quantity of goods moved in and out. Before making a final decision on whether to insure this expense, the contractual conditions should be reviewed. If the expense is truly variable with Turnover, then it need not be insured. If, on the other hand, it is a fixed or semi-variable expense, it should be insured.
7.44 Storage Rent

This should be insured in the Gross Profit item if the expense is for space, that is, for specific buildings or portions of warehousing premises. In such circumstances, the expense will not decrease proportionately with a reduction in the quantity of goods passing in and out of store, particularly where the rent is paid on a monthly or annual basis.

Where the rent is paid according to the quantity of goods stored and/or the length of time they are in storage, the charge is more controllable. Even so, the question as to whether it is a Fixed or truly Variable Cost can vary with each business. It could well be that the expense increases due to the fact that the onsite storage utilised normally by the Insured is lost due to the insured peril and alternate premises need to be sourced. As such, it is recommended that this expense be insured.

7.45 Subscriptions

Often business operators claim before a loss that they would discontinue such payments in full in the event of damage. They are usually only thinking of a total loss situation. As has been stated earlier, most losses are only partial. Either way, such payments would almost invariably be continued in full, particularly subscriptions to trade associations and trade journals, which are considered essential in many industries.

While some may argue that this is an optional expense, it is recommended that it be insured in full. It is typically an expense that, in the scheme of things, is very small. As such, the cost of insurance is negligible, while the benefit of continual subscription can be high in comparison to the premium saving.

7.46 Taxation

Taxation in this area does not include GST, Payroll Tax or FBT, all of which are discussed separately in this Guide. The question of how taxation on profits is to be dealt with does not arise because only the Uninsured Working Expenses are mentioned as being deducted from the amount of Turnover to arrive at the Insured Gross Profit. Consequently, there is no definition of net profit. Therefore, any taxation on trading profits is automatically included in the insurance, and is payable.

7.47 Telecommunications (including telephone, facsimile, mobile, internet)

Rental and, where applicable, hire charges for telephones, answering services and data lines should be treated as Fixed Costs that will not vary in direct proportion to Turnover and, as such, should be insured in full. Similarly, fixed contracts on usage should also be insured. In fact, in most businesses, the entire expense is best insured.

7.48 Trade Levies & Export Promotion Levies

Expenses of this kind call for special consideration as there are different methods of charging them, and they can be very substantial amounts. Where they are fixed charges, irrespective of production, they should be insured in full. On the other hand, where the cost is incurred in direct proportion to sales, it need not be insured.

Any contracts covering the payment of such levies should be read as it may be that insurance proceeds under a Business Interruption policy could be deemed as sales revenue which, in turn, creates an expense payable by the business. In such cases, trade levies should be insured in full.
7.49 Travelling Expenses

This expense can cover a variety of expense types. It can, for example, cover the cost of sales representatives. In such a case, there may be a shortage of goods available for sale from a manufacturer, wholesaler or retailer as a result of damage to a factory or warehouse. In such a situation, the sales representatives who have a round of regular clientele will usually find it necessary to call on them just as frequently as before the loss, in order to maintain their goodwill and/or to sell those goods that are available. As such, it should be insured in full.

On the other hand, where salespersons are selling entirely by ‘cold canvas’ with no repeat custom, their expenses may fall with a reduction in the volume of goods available for sale. Whether such costs would fall in direct proportion to sales, particularly where the company supplies company vehicles etc, is very unlikely. If the drop in expense would not be in direct proportion to sales, then the expense should be insured.

When a firm’s traveling is done by one or more of the principals or directors of the company, the accounts item of traveling expenses usually covers the principals’ and directors’ use of motor vehicles for social and pleasure purposes as well as their journeys for marketing. In these cases, it is obviously a charge to be included in the insurance.

7.50 Uniforms, Work Clothing, Protective Clothing etc

In a business where the Insured provides uniforms or working clothing for employees, the expenses should be insured at least to the same relative extent that the payroll of such employees is covered. See Chapter 9 for commentary on Wages. However, please note that this expense does not normally fall within the definition of Payroll.

7.51 Wages & Salaries

Insurance of Payroll, which includes salaries, wages and associated costs such as payroll tax, FBT, overtime, commissions, bonuses, holiday pay, sick pay, workers’ compensation insurance premiums and/or accident compensation levies, superannuation and pension fund contributions, long service leave and the like, call for individual consideration. In view of the complexity, Chapter 9 is devoted to this subject. For most SME clients, I recommend wages and salaries by fully insured. This provides the greatest level of protection for the survival of the business.

7.52 Water

In the majority of businesses, this cost is not great and rarely is it strictly variable with the level of Turnover. As such, in the majority of cases, it should be insured in full. Only in cases where it is truly proportionate to Turnover, should it not be insured. Where a percentage of water is to be insured, the endorsement reproduced at section 7.55 of this chapter, is recommended.

7.53 Workers Compensation Insurance/WorkCover

See Payroll/Wages in Chapter 9.

7.54 Wrapping Materials, Packaging, Boxes & Other Containers of All Kinds

These are all items of expense that are typically related to the quantity of goods sold or produced. Therefore, they are not insured in the majority of cases.
7.55  Recommended Endorsement

If the Insured elects to insure only a proportion of an expense, it has been the practice to show the percentage that is not insured on the Schedule as an Uninsured Wording Expense. For example:

"Uninsured Working Expenses:  Purchases
30% Electricity"

The problem often arises when the claim is being adjusted, as not all loss adjusters know how the calculation should be performed as it is not clearly set out in the policy. To avoid confusion and to allow adjustment in an equitable way, in line with the Dual Wages methodology, whereby the percentage acts as a sub-limit, the endorsement provided at Figure 9 (overleaf) is recommended\(^\text{50}\).

7.56  Conclusion & Implications

If an expense need not be insured and it is, then the worst that can happen is that any reduction in the expense during the period of disruption will be deducted as a saving. The Insured will have paid a premium on something that cannot be claimed.

If on the other hand, an expense that continues after a disruption is not insured, it is an expense that the business has to bear out of the reduced Turnover. The cost here is much greater than any premium that was payable.

7.57  Summary of Chapter

There are two rules of thumb involved in making a decision as to whether an expense should be insured.

Firstly, for consistency, if the expense is not truly variable as a fixed percentage of Turnover, regardless of the level of Turnover, it should be insured.

Secondly, if in doubt, insure it!

For the revision questions attaching to this chapter, please head to page 116.

\(^{50}\) This endorsement was drafted by Max Salveson and David Goodlad, and I offer my sincere appreciation for their allowing me to reproduce the endorsement here.
Basis of Settlement Provisions
Insurance of Variable Charges for a Percentage or Fixed Sum

When calculating the Insured's claim entitlements, it is agreed that the Rate of Gross Profit calculation shall exclude figures for the specified Variable Charge. The claim relating to the Specified Variable Charge will be calculated separately in accordance with the following example:

a) Rate of Gross Profit for the particular charge multiplied by Loss of Turnover $ \[\text{[A]}\]
b) Less savings in the Variable Charge during the Indemnity period, ie.
   1. Pre-damage payment value in the corresponding period $ \[\text{[C]}\]  
   2. Less post-damage payment in the Indemnity Period $ \[\text{[B]}\]

c) Actual Gross Loss applicable to the Variable Charge $ \[\text{[A - B]}\]

**Insured Limit:** Amount payable not to exceed the insured percentage of (a) or the fixed set sum _____

---

**Example**

*(After application of the Adjustment Provisions to provide for trends and other circumstances affecting the business during the Indemnity Period)*

Annual Turnover = $1,000,000  
Turnover in Indemnity Period = $1  
Specified Variable Charge = $200,000  
Turnover lost = $900,000  
Rate of Variable Charge = 20%  
Expenditure on Specified Variable Charge = $35,000  
Variable Charge insured amount = 10%

a) Rate of Variable Charge multiplied by Loss of Turnover (20% x $900,000) = $180,000

b) Less savings in the Variable Charge during the Indemnity period, ie.
   1. Pre-damage payment value in the corresponding period $200,000  
   2. Less post-damage payment in the Indemnity Period $35,000

   \[\text{[B]}\]  
   \[\text{[A - B]}\]

c) Actual Gross Loss applicable to the Variable Charge $15,000

**Insured Limit:** Amount payable not to exceed 10% of (a) or the fixed set sum $18,000

Loss of $15,000 falls within the Insured Limit of $18,000 and payable in full

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Figure 9
Recommended Endorsement
7.58 Revision Questions

The following questions are designed to both test and reinforce your understanding of the areas covered in Chapter 7 of this Guide. The answers are available at Chapter 24.

You can also review the logic behind the answers, using the link in the Publications area of the LMI Group website (www.LMIGroup.com/Publications). While full details are provided towards the end of the Introduction, which is located at the beginning of this Guide, for the purpose of quick reference, the following password should entered online when prompted for a password: 094856

Q7.1 To be fully insured, it is necessary to insure every expense of the business that is not truly variable in direct proportion to sales.

Answer:  
A True  
B False

Q7.2 No two businesses are the same and, as such, any advice on an expense category must, of necessity, be a generalisation and should be treated as such.

Answer:  
A True  
B False

Q7.3 While not the only aspect to consider, the amount of the expense should be looked at. If the cost to insure an expense is too high, you should not insure that expense.

Answer:  
A True  
B False

Q7.4 Advertising is a variable expense and therefore need not be insured.

Answer:  
A True  
B False

Q7.5 There is no need to insure Directors Fees under a Business Interruption policy.

Answer:  
A True  
B False

Q7.6 It is prudent to insure interest and other financing costs.

Answer:  
A True  
B False

Q7.7 If an expense need not be insured and it is, then the worst that can happen is that any reduction in the expense during the period of disruption will be deducted as a saving. The Insured will have paid a premium on something that cannot be claimed.

Answer:  
A True  
B False

Q7.8 An expense that continues after a disruption and is not insured, is an expense the business has to bear out of the reduced Turnover. The cost is much greater than any premium that was payable.

Answer:  
A True  
B False
THE AUTHOR

Professional Qualifications

Doctor of Business Administration
Bachelor of Commerce
Master of Business Administration
Fellow Certified Practising Accountant
Fellow Aust & NZ Institute of Insurance & Finance
Fellow Chartered Insurance Institute (UK)
Fellow Chartered Loss Adjuster
Fellow Chartered Institute of Loss Adjusters (UK)
Chartered Insurance Practitioner (UK)
FUEDI European Loss Adjusting Expert

Professional Experience

After 11 years experience with General Accident Insurance, Allan joined Robins MBS Loss Adjusters in 1981. In 1987, he transferred to Papua New Guinea, as Managing Director. During this time, Allan handled one of Australia’s largest claims, which surrounded the closure of the Bougainville Copper mine. This claim had a reserve of US$1,000 million. Allan returned to Australia in 1990 as State Manager, Western Australia and, in 1991, was appointed Regional Manager for the Southern Region, as well as head of GAB Robins’ Large Claims Team.

In 1999, Dr Manning founded the LMI Group Pty Ltd, a firm dedicated to providing a high level of customer service and technical expertise in pre- and post-loss insurance services. Since forming the company, Allan has been instrumental in developing a number of online knowledge-based research and technical services, including PolicyComparison.com, BIcalculator.com, PolicyCoach, ContinuityCoach.com and RiskCoach.

For nearly 40 years, Allan has managed large and complex losses, involving major property and business interruption, including advanced consequential loss, fidelity, construction, and liability throughout Australia, Asia Pacific, Europe and North America. Assignments have been completed for multi-national and government organisations, as well as small and medium businesses. He has acted as an expert witness since 1983, primarily looking at quantum and policy response issues. Allan particularly enjoys the challenge of assisting companies to return to normal trading after a major crisis. His interest in the survival of a business following an insured loss prompted him to complete a Doctoral thesis, involving 6 years of extensive research.

Over the past 10 years, Allan has been engaged to review the insurance programs and the level of sums insured for businesses, including multi-nationals, to ensure adequate declared values, limits and sub-limits of liability, indemnity periods and extensions of cover.

Allan has lectured at RMIT on Claims Management, and has delivered over 350 papers at seminars on business interruption and other insurance-related topics. Dr Manning is the author of five books on insurance subjects.

Dr Allan Manning
DBA, B.Com, MBA, DBA, FCPA, ANZIIF (Fellow), FCII, FCILA

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