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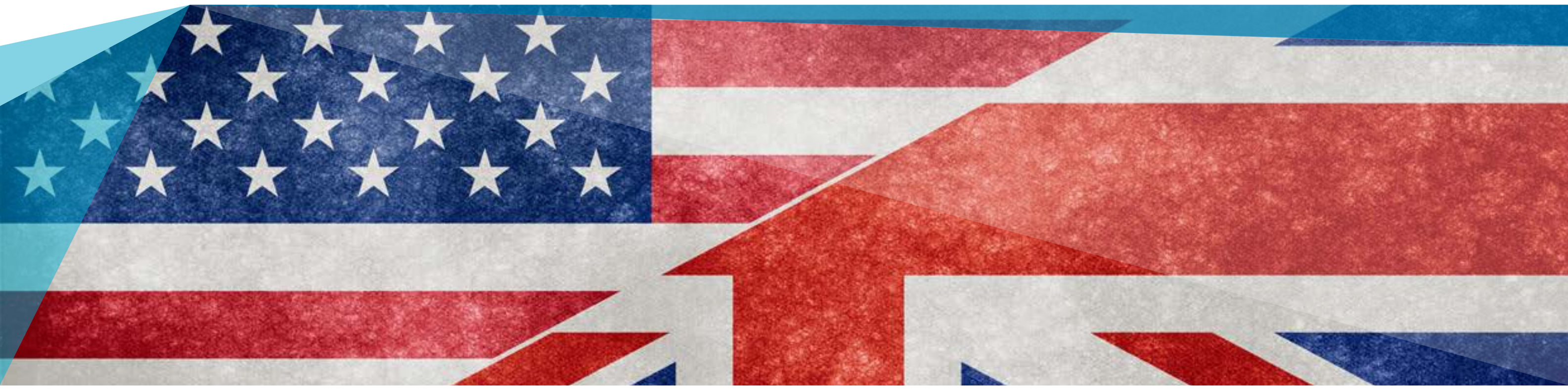
GROSS PROFIT - UK VS. GROSS EARNINGS - US



This document is part of a series of internal documents produced by the Forensic Accounting and Claims Service (FACS), which aim to help Marsh Risk Consulting employees understand technical terms, issues and processes when supporting clients insurance coverage and claims needs. These documents aim to provide an overview of each topic, with this first document covering the types of business interruption insurance around the world, more specifically a comparison of the Gross Profit (GP) and Gross Earnings (GE) policy form.

Business Interruption (BI) insurance is often misunderstood, partly because there is 'a fear of the unknown', but also because this type of insurance differs throughout the world. There are essentially two dominant forms of cover, known as the UK form and the US form. While similar, these two forms both have some stark differences that risk managers and their advisers need to take into account when placing cover. This document summarises the key differences between the two cover types rather than a comprehensive description of each, and offers guidance to the broker in coming to a decision on what type of cover is more suitable for the client.

ENGLISH FORM – GROSS PROFIT

Under the UK form, business interruption insurance should provide cover for a business to put them back into the 'financial' position they would have been in had an insurable event not occurred in the first place. This form of insurance covers the restoration of the business and aims to compensate the insured for any loss of profit suffered as a consequence of property damage suffered.

PERIOD OF COVER

The UK form includes a pre-determined maximum indemnity period covering consequential losses suffered as a result of damage, so covering losses suffered during any rebuilding or repair period, as well as those losses which continue as a consequence of the damage. In order to define how long policy cover is in force, a period of indemnity is set. Typically, this limit will be in the range of 6 to 36 months, in 6 month increments.

GROSS PROFIT

The UK form includes a loss calculation formula and uses turnover as the guide to measure a loss. The formula compares the turnover in the months following an incident to the corresponding period in the 12 months preceding the incident, subject to appropriate adjustments for special circumstances and trends to the business.

Under the UK form, Gross Profit (GP) is usually defined in the policy as turnover less purchases, stock movement and uninsured working expenses. The uninsured working expenses are true variable costs, i.e. costs that vary directly with turnover. This is therefore working from the top of the Profit and Loss account (turnover) downwards (also known as the "top down" approach or "deduction" method)[1].

PROXIMATE CAUSE

Indemnity provided to a business is qualified by the words "in consequence of the incident" such that any event which would have affected the business irrespective of damage will not be covered by insurers. For example, a shortage of raw materials would have an impact on the business irrespective of the insured event and the affect this has on reducing turnover would not be covered by the BI policy.

Taking this into account, under the UK form, if there was a strike in the building industry and this delayed the rebuilding of a property, this would be covered under the UK form because the strike would not have had an affect on the business but for the incident. This would seem to go against the time-honoured maxim of proximate cause whereby not the latest but the dominant cause of a loss must be regarded as the operative one.

INCREASED COSTS OF WORKING (ICOW)

UK form policy defines ICOW as "the additional expenditure necessarily and reasonably incurred for the sole purpose of avoiding or diminishing the reduction in sales caused by the physical loss". ICOW will also have an economic limit, in that an insurer will pay a pound to save a pound.

It is also possible under the UK form to have an "Additional Increased Costs of Working" (AICOW) extension to a BI policy. This extension will have the same basic requirements as ICOW, but without the economic limit.

The amount of cover available for ICOW can be either as a global limit with Gross Profit, or as a completely separate limit of liability. Further, ICOW and AICOW will have a set period of cover, usually of the same length as the Gross Profit period of cover. This would mean that any lease payments on temporary offices, which continue after the business has recovered, would continue to be covered until the end of the maximum period of indemnity.

FINISHED STOCK

Any Gross Profit loss resulting from loss or damage to an insured's finished goods inventory is covered under the UK form policy, in contrast to the American form where this loss type is excluded.

[1] The amount by which the sum of turnover, closing stock and work in progress shall exceed the sum of opening stock, work in progress and uninsured working expenses.

AMERICAN FORM – GROSS EARNINGS

(ALSO KNOWN AS BUSINESS INCOME)

The American form covers the period of restoration of the property following any damage, with any subsequent losses suffered by the business after the property has been repaired, not being covered.

PERIOD OF COVER

The American form has no pre-determined indemnity period, but instead uses the actual reinstatement period. This specifies that a business interruption loss ends once property construction and/or repairs are finished, with no limit to the period of indemnity during construction. However, once construction is complete, the BI cover ends even if the business continues to suffer a loss.

It is this primary difference between the two forms of cover that causes the most headaches for risk managers when making a decision as to the correct basis of cover for their business. This is great if there are unforeseen or unavoidable delays during construction, but this does not allow for ramp up, or true recovery.

It is possible to obtain extensions to a Gross Earnings policy to extend the loss of income provision beyond the reconstruction period. An "Extended Business Income" or "Extended Period of Indemnity" clause is usually for a period of 30 days after construction, or a multiple thereof and allows an insured a timeframe to restore its business – creating a form similar to the standard UK form of Loss of Profits. However, this highlights the importance of setting the correct indemnity period in the UK form – 12 months is rarely sufficient.

GROSS EARNINGS (GE)

The object of Gross Earnings insurance is to indemnify for "actual loss sustained" during the time it would take to rebuild the insured's property with "due diligence and despatch"[2]. This definition limits the insurance company's liability to the time period it feels is necessary to rebuild. If other events extend the rebuild time, insurers can limit cover for Gross Earnings to the time period it should have taken to rebuild.

Further, there is often no methodology to say how this "actual loss" is to be ascertained. That said, many American form insurance policies state that Gross Earnings should represent Net Income (Net Profit) plus continuing normal operational expenses (fixed costs or standing charges) , including payroll. This is working from the bottom of the Profit and Loss account (Net profit) upwards (also known as "bottom up" or the "additions" method)[3].

PROXIMATE CAUSE

The American form of cover limits the indemnity to the actual loss sustained "due to the necessary suspension of the Insured's 'operations' during the 'period of restoration'". American form of cover may also have a Special Exclusions clause whereby insurers state that they will not pay for any increase in loss caused by or resulting from a delay in rebuilding due to interference at the location of rebuilding caused by strikes or due to the cancellation of licenses. Proximate cause clauses reinforce the actual loss sustained definition discussed above.

This limitation of cover is in stark contrast to the cover and norms of the UK form of cover.

EXTRA EXPENSE (EE)

The American form EE is similar to ICOW discussed above and is defined as the "reasonable and necessary extra expense incurred by the insured during the period of liability". As with GE, cover will terminate when rebuilding has been completed, even if costs continue beyond the rebuild time period. For example, if an insured takes out a lease on new office space during the rebuild period and has to commit to a certain lease period, the EE will cover the costs incurred during the rebuild and not beyond.

FINISHED STOCK

Any GE loss resulting from loss or damage to an insured's finished goods inventory is not covered under the American form policy. This exclusion is based on the principle that GE deals with the future and this stock being "finished" is therefore a product of the past. As a result, GE policies often cover finished goods stock at Sales price less selling costs.

[2] Actual loss sustained by the insured resulting directly from such interruption of business for only such time as would be required with the exercise of due diligence and despatch to rebuild, repair or replace such property

[3] The amount produced by adding to the Net Profit the amount

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COMPARISON OF GROSS PROFIT AND GROSS EARNINGS

Characteristic	Gross profit	Gross earnings / Business income
Scope of coverage	Consequential loss (Open Boundaries)	Proximate cause (Precise Boundaries)
Indemnity principles	Restore operations as if no loss Had Occurred	Loss of production during repair Time Only
Period of cover	Indemnity Period (pre-determined)	Period of reinstatement (unlimited) – but not business recovery period
Increased costs	Increasing cost of working	Extra expense
Finished goods inventory	Included	Excluded
Method	Turnover less variable costs (top down)	Net profit plus standing charges (bottom up)

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