



Technical Briefing Note

Potential double indemnity arising between business interruption and material damage policies.

1. Introduction

A potential overlap between the indemnity provided by a material damage policy and a business interruption policy can arise when stock (inventory) which has been the subject of some conversion process by, or on behalf of, the Insured, is damaged and a simultaneous claim is made for loss of gross profit.

Although there is little controversy over the principle that double-indemnity should not occur, the method of achieving this objective needs discussion. This is the purpose of this paper.

2. Policy wordings

Material damage

A fairly typical wording covering the stock indemnity will be “*Insurers will pay the value of the property at the time of its loss or destruction*” with little further explanation or help as to precisely how to establish “value”.

Some policies try to be more specific - e.g.

.....(d)In respect of raw materials, supplies and other merchandises not manufactured by the Insured, the replacement cost is applicable, but in respect of Stock in Process, the value of raw materials and labour expended plus the proper proportion of overhead charges is applicable



e) In respect of finished goods, the regular cash selling price, less all discounts and charges to which such finished goods would have been subject had no loss occurred or the market replacement cost whichever is the greater

---- or ----

“For the purpose of adjustment of losses the basis of valuation of:-

(a) Stock shall be replacement cost unless stated otherwise in the local policy or in accordance with local practice”

However, the key points to remember in most stock wordings are that the policy is neither a “valued” policy (i.e. there are no valuation rules set out in the contract), nor is it a reinstatement policy.

Business interruption

The typical wording encountered in the UK for indemnifying loss of sales applies the rate of gross profit to the loss of turnover resulting from damage. This rate of gross profit is determined by comparing the combined value of opening stock and specified working expenses, less closing stock with sales.

It is extremely rare for the specified working expenses to include all the variable, semi - variable and fixed costs that might be included in the stock valuation.

Indeed, the most common forms of business interruption policies list “purchases, discounts allowed, carriage and bad debts” - or something similar - as the specified working expenses to be deducted from sales value. By definition, everything else paid out of the number thereby arrived at is to be paid under the business interruption policy, with the exception of the calculation of savings in fixed costs (“standing charges”).



3. Accounting practice

In the UK and elsewhere around the world, accountants have been concerned with the correct measurement of stock in a balance sheet at the end of an accounting period. Agreement on a relatively standardised approach to accounting for stock was reached with the issue of Statement of Standard Accounting Practice 9 in 1975 (revised in 1988).

The standard states that stock should be valued at the lower of cost and net realisable value. Net realisable value being, effectively, sales value less costs necessary to achieve that sale.

The definition of “cost” is as follows: -

<p><i>Cost</i> is defined in relation to the different categories of stocks as being that expenditure which has been incurred in the normal course of business in bringing the product or service to its present location and condition. This expenditure should include, in addition to cost of purchase (as defined in paragraph 18), such costs of conversion (as defined in paragraph 19) as are appropriate to that location and condition.</p>	17
<p><i>Cost of purchase</i> comprises purchase price including import duties, transport and handling costs and any other directly attributable costs, less trade discounts, rebates and subsidies.</p>	18
<p><i>Cost of conversion</i> comprises:</p> <ul style="list-style-type: none">a) costs which are specifically attributable to units of production, eg, direct labour, direct expenses and sub-contracted work;b) production overheads (as defined in paragraph 20);c) other overheads, if any, attributable in the particular circumstances of the business to bringing the product or service to its present location and condition.	19
<p><i>Production overheads</i>: overheads incurred in respect of materials, labour or services for production, based on the normal level of activity, taking one year with another. For this purpose each overhead should be classified according to function (eg, production, selling or administration) so as to ensure the inclusion, in cost of conversion, of those overheads (including depreciation) which relate to production, notwithstanding that these may accrue wholly or partly on a time basis.</p>	20



SSAP 9 also addresses long term contracts, with which this paper is not concerned, but so far as valuation of stock is concerned, embodies the principles which are accepted generally and which will drive the valuation of any normal stock claim encountered in the UK (or indeed overseas).

4. Adjusting practice

Material damage

Most adjusters value work in progress and finished goods along the principle that “variable” costs should be allowed, but that “fixed” costs should not. This principle has to be defended against the charge from the Insured that they value their stock in accordance with generally accepted accounting principles (“GAAP”) and that they pay premium on the declared stock values.

The principle also has to be defended against charges of lack of realism in that the various fixed costs that are being excluded are entirely necessary to produce the stock, despite the fact that they may not directly vary with production.

Accordingly, the alternative principle of “direct” costs (as opposed to “indirect costs”) is often used for stock valuation. This is more in line with the accounting definition (SSAP 9 above) but may well be toned down to some extent by disallowing the more remote costs (such as buildings rent / rates, depreciation etc) which can more clearly be argued to be irrelevant to the “value” of stock (if it is being rebuilt).

If stocks are indemnified on the basis of purely variable costs (e.g. materials, variable power, variable labour etc) then it is possible that no overlap with a business interruption settlement will arise if the business interruption settlement



takes into account savings in such charges correctly. However settlement on this basis is not general market practice, which could be said to include, for instance, direct labour costs irrespective of whether they are shown to be variable or fixed.

In practice, adjusters are often relatively relaxed as to the valuation of stock where it is clear that there will be a large business interruption claim following - on the grounds that anything other than the specified working expenses paid for in the stock claim will simply be adjusted out as an overlap in the business interruption claim. This does not mean that this approach is correct (although the end result will be), and it is clearly wrong if there are different insurers involved, or if average applies to either the material damage or business interruption indemnities.

Business interruption

Following identification of appropriate trends, rates of gross profit to apply, and savings to be accounted for, the potential overlap between the two policies may sometimes be missed. In other cases the extent of the overlap may be unclear due to a lack of clarity within the settlement reached for stock, or indeed the savings calculation, or due to some special circumstance that renders it inapplicable.

However, in general, market practice is to calculate the double count (overlap) of costs that have been indemnified within the stock settlement and again in the loss of gross profit calculation and deduct the amount in the business interruption settlement.

This adjustment for overlap of costs has to be defended against charges that the costs included in the stock valuation arose before the loss, and are therefore historical and not ongoing (i.e. they are not the same as the costs occurring after the loss, which are being paid for under the business interruption settlement). There is apparent logic to this argument, which many Finance Directors find very persuasive.



Furthermore, it is important to note that there is no legal or policy basis for the practice of deducting a sum in the business interruption settlement which has already been paid within the stock settlement, other than the over-riding principle of indemnity. Thus, it is possible that it may one day be successfully challenged by an Insured.

5. The correct approach

Where possible, stock should be valued with the correct variable costs being included which means that the business interruption settlement, after deducting savings, should not result in any double counting of costs, and no overlap occurs.

Where, however, fixed costs are included in the stock settlement, care must be taken that costs which are intrinsically being paid twice are identified and excluded from the business interruption settlement. Although this is not justified in the policy (they are not savings in standing charges) an overall correct indemnity is achieved.

If this principle is resisted strongly enough by the Insured or their advisers, then reference should be made to Insurers showing the values involved and requesting further instructions. If this course of action is taken, the CIL A would be interested in any precedent being established for future reference.

6. Numerical examples

Different scenarios are attached as an appendix to this note to show how the overlap can, in practice, occur and be valued.