



## **Technical Briefing Note – Purchases**

### **1) Introduction**

‘Purchases’ is a term that carries a technical meaning for many Insurance Practitioners but is not a technical term with a specific definition in general everyday usage. The term ‘Purchases’ (and other related costs) now frequently replaces the generic ‘Uninsured Working Expenses’ seen in many wordings. Misunderstandings can arise where a Policyholder interprets the term Purchases in a different way to the technical meaning inferred by Insurers and/or Brokers and significant Policy considerations can arise. Significant under-insurance can have a particularly significant impact for a non-declaration linked Policy where an Insured has deducted more cost captions as purchases than is apparent to the Insurers.

### **2) Policy Calculation and Gross Profit**

Some policies do not contain the word “Purchases”, instead referring to uninsured working expenses representing a deduction from turnover in calculating gross profit. Where the term “Uninsured Working Expenses” has capital letters to denote a defined term, the definition in the Policy can be imprecise, referring to the Schedule which may, in turn, not be sufficiently precise.

More importantly, the wording of an annual declaration showing the calculation of the insurable amount may use different wording and terminology from the policy.

Even where the word “Purchases” is absent, Insurers will still be interested to see that only variable uninsured working expenses are deducted from turnover. It has been argued in the past that an Insured is entitled to deduct whichever costs are considered appropriate (by them) to define a bespoke gross profit for their particular business. There are two reasons why the detail of that calculation is relevant.

Firstly, it may be relevant to Underwriters when calculating estimated maximum loss and exposure. Secondly, it is necessary to fully appreciate the calculation when a claim is made, not merely to calculate the Rate of Gross Profit correctly, but also to consider the application of the Uninsured Standing Charges clause.



This clause essentially reduces reimbursement of Increased Costs to the proportion that the insured element of the fixed costs bears to the total fixed costs. Where an Insured has uninsured fixed costs, they have elected not to invite Insurers to carry risk in respect of those costs. The relevant proportion of increased cost expenditure to protect that element of the Profit and Loss account should, likewise, equitably be excluded.

The CILA notes that there have been a number of instances where the Uninsured Standing Charges Clause has been omitted from a Policy wordings, although Insurers generally perceive it as inequitable that 100% of the claimed increased costs should be payable if premium has been received on a gross profit sum that itself excludes some of the expense captions that the increased costs have been incurred to protect.

It is important to appreciate that the term “Standing Charges” is not a defined term in the policy. Additionally, it is not a term that accountants use or would understand. Practical difficulties are likely to arise in applying the clause as it does not reflect terminology in everyday business use.

### **3) Technical Meanings of Purchases**

The historic approach taken by Insurers and the market generally has been to interpret the term “purchases” as relating to raw materials/consumables only. Riley, at paragraph 7 (6<sup>th</sup> Edition) notes that *“for most businesses the first item in the list of variable charges to be excluded from the insurance and gross profit will be purchases and this is intended to refer to purchases of direct materials and indirect consumable materials”*. He proceeds to note that purchases of utilities by way of example would not constitute purchases.

Hickmott concurs with this, referring to purchases *“of raw materials and other incidentals associated therewith”*. The CILA is mindful that notwithstanding these technical references, the views of those authors are not enshrined in the Policy wordings.

Dictionaries define purchases as being anything that is bought, obtained by payment, *et al.*

The common everyday usage does not restrict the term “purchases” to one that technically only refers to physical raw materials as opposed to any other expense. Instances where a Policyholder has unwittingly captured a variety of expenses incurred under the caption “Purchases” in an insurance declaration can cause significant difficulty if the traditional interpretation of purchase is applied to calculate a rate of gross profit when a claim is made.



The Committee does not comment on whether a Court would allow the importation of a technical meaning to the term “purchases” but the issues noted above outline the possible debate that might be entertained.

#### **4) Books of Account**

Generally speaking, Insurers will allow the adoption of the treatment of a cost caption in the books of the Insured to be used consistently when considering a claim (assuming that the alternative possible considerations are all reasonable and the treatment of a significant expenses is not wholly inappropriate). This is provided within the Accounts Designation Clause. However, such clauses are infrequently included in the actual policy wording. Even where such a clause is included, the terminology in the policy may not be consistent with the books of account. The Insured may not use the term “Purchases” at all perhaps, likewise, the “difference” wording (calculating gross profit as the difference between the sum of turnover and closing stock/work in progress, and the sum of uninsured working expenses [or in some wordings just purchases and carriage] and opening stock) may not match terminology in the books.

#### **5) Which Accounts?**

An Insured will produce various sets of accounts, and even where the Accounts Designation Clause is to be applied, it is not always apparent which set of accounts should be adopted. Monthly Management Accounts may refer to “materials” for example. Annual Statutory Accounts may include the term “cost of sales” and even a detailed trading Profit/Loss Account provided to the Inland Revenue as part of a tax computation may identify purchases merely as “raw materials” but leave the key piece of terminology out.

In order to prepare any set of accounts, for internal management use or otherwise, businesses need to summarise revenue and expenses to know what totals the accounts should include. Expenses are typically summarised in a Purchase Day Book. More likely an electronic file rather than a physical book, this will include all expenses, from raw material purchases to utility costs, advertising expenditure etc. A policyholder might assume that any item included in the Purchase Day Book is a Purchase.

The purpose of making this observation is to illustrate that the Accounts Designation Clause, particularly where it is imported as a matter of goodwill by Insurers, may not always be helpful if different terminology (to that used in calculating the insurable amount or Rate of Gross Profit) is used in different sets of accounts that the Insured produce. It is also noted that a Policyholder



may be reticent to allow the importation of an Account Designation Clause that is not printed in the Policy Contract in those cases where a settlement would be reduced if it was imported.

#### **6) Issues in Un-insuring Purchases**

If purchases are to be equated with raw materials/consumables, it is frequently assumed that those costs can always be assumed to vary in line with turnover and should, thus, be un-insured. Whilst this is an issue of arranging cover rather than adjusting a claim, it is appropriate to note that a business can have contractual commitments to purchase materials (e.g. where food producers have committed to purchasing a farmer's crop even before it is planted) which will require the purchase still to be made even if the processing factory is burned to the ground. Likewise, commercial commitments, even to the extent of confirming the ongoing financial liability of a small but niche supplier may be required. If it has been assumed that such costs would reduce in line with turnover but do not, a shortfall in the insurance settlement compared to the loss actually suffered may arise.

#### **7) Conclusions**

In almost all cases of complication, difficulties with the acceptable definition of purchases may be avoided if there is a more explicit discussion or definition of the term in advance of a claim. Defining purchases as raw material and physical (other consumable) purchases would remove any uncertainty and reduce the possibility of unwelcome surprises when a claim is made.

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