

Insurance Claim: - An Easiest Approach to Understand

- By Mr. Praveer Kumar

Introduction:

There are various risks attached today with business, whether it is small, medium, or large. One of the major risks is losses suffered by businesses due to fire, theft or earthquake.

Insurance companies ready to bear these losses if the business takes the insurance policies to cover the loss arises due to fire, theft, and earthquake and pay the insurance premiums as determined by the insurance companies within the due dates.

In this article I will discuss, How to calculate Insurance claims for the losses suffered by the business, in easiest way.

Types of losses and claim thereon:

When a business is affected by Fire and Earthquake etc. the businesses suffered by

- (a) Loss of Stock and
- (b) Loss of Profit or Consequential Losses

Loss of Stock means losses arises due to destruction of stocks in such a way that those are not saleable in the market ,or saleable at the nominal price, and Loss of Profit or consequential losses means losses in form of profit which can be generated during indemnity period, if business runs smoothly in that period. Loss of Profit Policy normally covers following items:

- (i) Loss of Net Profit
- (ii) Standing Charges
(It means all administrative expenses and finance charges. It is of two types Insured and Uninsured. That part of standing charges for which Insurance Company is agree to provide cover under their policy is called insured standing charges, and remaining standing charges are called uninsured standing charges)
- (iii) Any Increased Cost of working
(For example, renting of temporary premises)

Thus an accountant has to calculate **Claim for loss of Stock** and **Claim for Loss of Profit** to submit their overall claim to the insurance company for its realization.

Calculation of Claim for Loss of Stock:

We can divide the process of calculation of Claim for loss of stock in five steps:

Step 1: Prepare **Memorandum trading A/C*** of previous financial year to know the Normal Rate of Gross Profit (NRGP)

Step 2: Prepare **Memorandum trading A/C*** of Indemnity Period (*period during which business is disturbed*) with available information and apply G.P. Rate on estimated sales (*as calculated in step 1*) to find out Gross Profit.

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Step 3: Deduct the estimated sales from the total of amount appearing in the debit side of Trading A/C (*Opening Stock + Purchase + Other Direct Expenses + Gross profit*) to get the value of **Estimated Stock** at the date of Fire.

Step 4: Deduct the Salvaged Value (*if any*) from the Value of estimated Stock (*as calculated in Step 3*) to get the value of **Adjusted Estimated Stock**

Step 5: Apply the **Average Clause** ** (*if applicable*) to get the **Net Claim for Loss of Stock**. In other case value of **Adjusted Estimated Stock** (*as calculated in step 4 above*) will be value of **Claim for Loss of Stock**.

*Memorandum Trading A/C (Format)

Particular	Amount (Rs.)	Particular	Amount (Rs.)
To, Opening Stock	XXX	By, Net Sales	XXXX
To, Net Purchase	XXX	By, Closing Stock	XX
To, Direct Expenses	XXX		
To, Gross Profit	XXX		
Total	XXXX	Total	XXXX

$$\text{Normal G.P. Ratio} = \frac{\text{Gross profit}}{\text{Sales}} \times 100$$

****Average Clause:** When value of estimated stock at the date of fire is greater than the value of stock insured for loss of stock policy with the insurance company then **Net Claim** shall be proportionate to the Stock insured.

So when the average clause applies, the **Net claim for loss of stock shall be calculate** by applying following formula:

$$\text{Net Claim} = \left(\frac{\text{Adjusted Estimated Stock or Gross Value of Claim}}{\text{Step 4}} \right) \times \frac{\text{Policy Value}}{\text{Closing Stock at the date of Fire (value of Step 3)}}$$

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Calculation of Claim for Loss of Profit:

Before calculating claim for loss of profit, we must have to know some terms to be used in the calculations.

- (i) **Indemnity Period:** A period during which the business is disturbed due to fire. It shall not be more than twelve months.
- (ii) **Standard Period:** A Period equal to indemnity period, in corresponding previous year from the year in which fire occurred.
- (iii) **Annual Period:** A period of twelve months, immediately preceding the date of fire occurred.

For example: If a fire has occurred dated **30th March 2012**, having indemnity period of **three months**. Than

Indemnity Period: Starts from 30/03/2012 to 30/06/2012

Standard Period: Starts from 30/03/2011 to 30/06/2011

Annual Period: Starts from 01/04/2011 to 30/3/2012

- (iv) **Actual Turnover:** Turnover made during Indemnity period is called Actual Turnover.
- (v) **Standard Turnover:** Turnover made during Standard period is called Standard Turnover.
- (vi) **Annual Turnover:** Turnover made during annual period is called annual Turnover.

Steps to calculate claim for loss of profit or consequential loss:

Step 1: Calculate Gross profit Ratio of previous year by applying following formula

$$\text{G.P. Rate} = \frac{\text{Net profit} + \text{Insured Standing Charges}}{\text{Turnover}}$$

Step 2: Calculate Short Sales

Standard Turnover	XXXXXX
Adjustment regarding increasing or decreasing trend	XXX
+ Increasing trend in Turnover	XXX
- Decreasing trend in Turnover	(XXX)
Adjusted Standard Turnover	XXXXXX
(-) Actual Turnover	(XXXXX)
Short Sale	=

Step 3: Calculate G.P. on Short Sale by multiplying G.P. rate (**step 1**) with Short Sale (**Step 2**)

Step 4: Calculate adjusted annual turnover and gross profit thereon

Annual Turnover	XXXXXX
+ Increasing trend in Turnover	XXX
- Decreasing trend in Turnover	(XXX)
Adjusted Annual Turnover	XXXXXX
G.P. on Adj. Annual Turnover	= Adj. Annual Turnover X G.P. Rate (Step 1)

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Step 5: Calculate Allowable Additional Expenses or increased cost of working
Least of following three amounts is allowable as additional expenses,

- (a) Actual Additional Expenses or Increased cost of working.
- (b) Gross profit on **(Additional Sales)*** due to additional expenses, by multiplying additional sale with G.P. rate (as calculated in Step 1).
***If Additional Sale** due to **additional expenses** is not given clearly, than we will consider **Actual sale** for this purpose.
- (c) Result of following calculation

$$\text{Additional Expenses} \times \frac{\text{G.P. on Adj. Annual Turnover (as calculated in step 5)}}{\text{G.P. on Adj. Annual turnover} + \text{Uninsured Standing Charges}}$$

Step 6: **Calculation of Claim for loss of Profit**

Gross Profit on Short Sale	XXXX
(+) Allowable Additional Expenses or increased Cost of working	XX
(-) Salvaged Value (Saving in insured Standing Charges)	<u>(XX)</u>
Gross Claim*	<u>XXXX</u>

***Gross Claim is subject to average clause**

Step 7: Applicability of Average Clause and calculation of net claim

When G.P. on adjusted annual turnover is more than the policy value (or sum insured) then average clause will be applicable. In that case Gross Claim is reduced by proportionate value of policy by applying following formula.

$$\text{Net Claim for loss of Profit} = \text{Gross Claim} \times \frac{\text{Sum Insured or Insurance Value}}{\text{G.P. on adjusted annual Turnover}}$$