Insurance Claims

Introduction

A business enterprise normally gets itself insured against the loss of asset on the happening of certain events such fire, flood, theft, earthquake etc. Sometimes, an enterprise also gets itself insured against consequential loss of profit due to decreased turnover in addition to loss of asset. Hence this chapter deals with two types of policies.

- Claim for loss of asset.
- Claim for loss of profit.

Insurance contracts(except life insurance) are contracts of indemnity whereby one party, called the **insurer**, undertakes to indemnify the loss suffered by the other party, called the **insured**, on the happening of some unforeseen event in consideration of a fixed sum of money, called the **premium.**

Loss of Stock Policy

To determine claim for loss of asset, the value of asset **at the date of fire** is considered. The value can be obtained from accounting records. But in case of loss of stock, the value of stock is **to be estimated** if stock ledger are destroyed by fire or not maintained.

To estimate value of stock following procedure is adopted.

Step I – Prepare Memorandum trading A/c

- This account is prepared from starting date of accounting year till the date of fire to ascertain the closing stock for the purpose of claim.

Particulars	Amt (Rs)	Particulars	Amt (Rs)
To Opening stock	✓	By Sales	✓
To Purchases	✓	By Closing stock	✓
To Direct Expenses	✓		
To Gross Profit	✓		

- Closing stock comes as a balancing figure.
- Gross profit is calculated as:
  - Same as last year
  - Analysing trend and taking average or weighted average of past years gross profit ratios
  - Preparing last accounting year trading account.

Note: Before taking previous year gross profit rate one must consider that:-

1. Previous year opening and closing is valued at cost.
2. Any price level changes are eliminated in current year figures.
3. If there are any abnormal items, then they are separated and treated as:

Particulars	Amt (Rs) (Normal)	Amt (Rs) (Abnormal)	Particulars	Amt (Rs) (Normal)	Amt (Rs) (Abnormal)
To Opening Stock	✓	✓	By Sales	✓	✓
To Purchases	✓	✓	By Closing stock	✓	✓
To Direct expenses	✓	✓			
To Gross profit	✓	✓			

4. Sometimes goods are recorded as purchases but not received physically or recorded as sales but not yet dispatched. In such cases principle to be applied is that whether goods were there in godown at date of fire.

   Example: goods sold but not yet dispatched are deducted from sales OR Goods received but not recorded as purchases are added to purchases.

5. Goods not for sale such as withdrawn for personal use, theft of stock, free samples etc. should be ascertained and adjusted to derive a reasonable estimate of value of stock lost in fire.

Step II – Determine Claim for loss of asset

Particulars	Amt (Rs)
Value of stock on the date of fire	✓
Add: Cost of Abnormal stock (*if any)*	✓
Less: Value of salvaged stock	(✓)
Amount of loss of stock	✓

Step III – Application of Average clause

- Why and when it is applied?

  As general insurance is a contract of indemnity, claim for loss of asset is restricted to the value of asset destroyed by the fire. For this purpose value of stock on the date of fire is known as Insurable Amount and actual amount insured is given in the question. Therefore two situations may arise:-

1. Insured amount > Insurable amount, *i.e.,* Over - Insurance

   Claim is admissible to full amount of loss.

2. Insured amount < Insurable amount, *i.e.,* Under - Insurance

   Average clause is applicable as follows.

$$Amount\ of\ Claim = Loss\ suffered\ \times \frac{Sum\ Insured}{Actual\ Insurable\ Value}$$

Loss of Profit Policy

Besides, loss of asset, fire results in dislocation of the business. It affects production, sales and consequently profits during dislocation period. A normal fire insurance policy covers the material damage to the property like building, machinery and other plant against the risks of destruction by fire. However in the event of fire, it is not possible for him to erect new buildings and it may take months or years to do so. Moreover there are some fixed expenses known as standing charges which are to be paid irrespective of business activity. Thirdly to fulfill orders on time he may have to incur extra cost. For these purpose, a business enterprise takes a policy called "Loss of profit" OR "Consequential loss" policy to cover the following:

- Net profits before Taxation.
- Loss on account of standing charges. The standing charges to be covered as follows:
  - Interest on debentures, mortgages, loans & bank overdrafts
  - Rent ,rates & taxes
  - Salaries to permanent staff & wages to skilled employees
  - Company's contribution to the provident fund, gratuity fund
  - Director's fees , auditors fees, legal expenses
  - Traveling expenses, motor car expenses
  - Insurance premium, advertising
  - Office expenses
  - Postage, telegrams & telephone, printing & stationery
  - Electric energy and / or power charges
  - Maintenance of building, plant & machinery
  - Depreciation (excluding stocks and stores)
  - Miscellaneous standing charges not exceeding 5% of the amount of the standing charges specified.
- Increased cost of workings.

A claim for loss of profits can be established only if:

1. The insured's premises, or the property therein, are destroyed or damaged by the peril defined in the policy; and
2. The insured's business carried on the premises is interrupted or interfered with as a result of such damage.

Terms used

Period of claim: It is the indemnity period or dislocation period whichever is earlier.

Loss of turnover (Short sales): Standard turnover – Actual turnover

Standard turnover: It is turnover for the corresponding period in the preceding year and generally adjusted for the trend of business by including "Special Circumstances Clause"

Steps to calculate claim for loss of profit

Step I – Ascertain Period of Claim

Step II – Calculate gross profit ratio based on the trading results of last year

$$G.P.Ratio = \frac{\text{Net Profit(loss)} \pm \text{Insured Standing Charges}}{\text{Turnover of last A.Y.}}$$

Give due regards to any "Special Circumstances Clause".

Step III – Calculate turnover lost in claim period.

Particulars	Amt (Rs)
Turnover for the corresponding claim period in the preceding year	✓
Add/less: Special Circumstances Clause (*if any)*	✓
Less: Actual turnover during claim period	(✓)
Turnover lost during the claim period	✓

Step IV – Calculate Gross profit during claim period

$$Gross\ Profit\ = Turnover\ Lost\ during\ claim\ period \times Agreed\ GP\ ratio$$

Step V – Calculate sum insurable

Particulars	Amt (Rs)
Turnover for the 12 months preceding the date of fire	✓
Add/less: Special Circumstances Clause (*if any)*	✓
Adjusted Turnover	✓
Agreed GP ratio	✓
Sum Insurable	✓

Step VI – Calculate amount of net claim for increased cost of working

Particulars	Amt (Rs)
Gross claim	✓
Less: Savings in insured standing charges	(✓)
Net claim for increased cost of working	✓

Gross Claim is Lower of following:-

- Actual expenses
- Proportionate increased cost of working

$$Increased\ cost\ of\ working = \frac{GP\ on\ adjusted\ turnover}{GP\ as\ adjusted\ turnover + Uninsured\ standing\ charges}$$

- Maximum saving of liability of the insurer

$$= Reduction\ in\ turnover\ avoided\ \times Agreed\ GP\ ratio$$

Step VII – Calculate total claim by adding

- Gross profit lost during claim period (step 4)
- Net claim for increased cost of working (step 6)

Step VIII - Application of average clause

$$Amount\ of\ Claim = Total\ Claim\ \times \frac{Sum\ Insured}{Sum\ Insurable}$$

Notes:

1. Unless otherwise stated, all standing charges should be treated as insured standing charges.
2. Unless otherwise stated, actual turnover in the claim period should be deemed to be reduction in turnover avoided.

Comprehensive Policy

Normally when fire occurs, both asset and profits are affected. In order to prevent it an enterprise generally takes a comprehensive policy which is combination of both the policies. Calculation method does not change in any way here.

Amount to be insured under loss of profit policy

The amount to be insured should be the estimated specified standing charges plus the estimated net profit for selected period of indemnity based on the actual figures for the last financial year modified in accordance with the trend of business and market conditions. The various steps involved in the determination of the amount to be insured under a loss of profit policy are given below:

Step I – Calculate the estimated Turnover for the period for which policy is to be taken.

Step II – Calculate the estimated Gross Profit thereon

Step III – Calculate the estimated increase in the amount of Insured standing charges.

Step IV – Calculate the amount of uninsured standing charges

Step V – Calculate the amount of Policy as follows:

Particulars	Amt (Rs)
Estimated Gross profit (Step 2)	✓
Add: Estimated Increase in Insured Standing charges	✓
Less: Uninsured Standing charges	(✓)
Amount of Policy	✓