Loss of gross profit: the high cost of getting your sums wrong

At a glance

- Establishing an accurate gross profit sum insured is essential to the correct operating of a customer's cover
- Miscalculating gross profit has increasingly led to brokers facing costly negligence claims with market reputational issues
- This guidance can help Clients' identify factors to consider in calculating gross profit and, in turn, help to identify where prospects have a defective gross profit sum

One of the difficulties in establishing a sum insured is that the definition of 'gross profit' in an insurance policy is different from accountants and other business people.
For clients', there are a number of key elements to consider when setting a gross profit sum insured as shown in the box out opposite.

In accountancy: Gross profit is widely understood to mean:

Gross Profit = Sales − Cost of Production

However, this is not correct for insurance purposes.

Most policy wordings will specify the following calculation:

Insurable Gross Profit = (Turnover + Closing Stock + Work in Progress) − (Uninsured Working Expenses + Opening Stock + Work in Progress)

Turnover, work in progress and opening and closing stock are easily determined in accordance with normal accountancy methods. But Uninsured Working Expenses is an insurance term that brokers and customers might not be aware of.

It actually refers to costs, sometimes called 'specified working expenses', which vary in direct proportion to turnover. So, if turnover is reduced by 30%, the costs will also reduce by 30%.

An accountant's gross profit calculation will subtract any cost that varies in proportion to production; but for insurance purposes they must vary in direct proportion. This is a key distinction and the source of much underinsurance.

For example, a cheese maker, who regularly contracts with a local milk co-operative to take regular supplies at a fixed price over a period of time, will eliminate the risk of variable market prices of supply.

However, should a loss occur and resultant turnover reduce, these costs will not be reduced, as they are fixed under contract. It might therefore be best to ensure the purchase costs for fixed price materials is not deducted from the gross profit sum insured.

A common pitfall – wage roll

Following a major loss, a business will still retain key staff. These wages will still be incurred and the business will rely on its business interruption policy to help meet these ongoing costs. Therefore, subtracting these from the gross profit calculation would result in underinsurance.

A distinction must, therefore, be made between wages that vary in direct proportion (such as non-essential production staff) and those that do not (such as key personnel).

Considering partial losses

Another example is that of a business that makes cakes using egg yolks, and meringues using egg whites. Typically, such a business may uninsure the purchase of eggs, which is understandable for a total loss. But, imagine a loss that affected the meringue line only.

Uninsured working expenses examples

- Production wages
- Purchase of raw materials
- Maintenance and repairs
- Lighting and heating
- Packaging materials
- Postage and freight
- Printing and stationary
- Consumables
- Bad debts
- Credit card charges

Each insurer defines these expenses differently so reference to the policy wording should always be made.

The business would continue purchasing eggs to continue the production of cakes. In these circumstances, there would be no savings on egg purchases, despite the loss of all meringue-related turnover.

Most losses are partial and it is essential to consider this when determining uninsured working expense, and not just approach the question from a total loss perspective.

In the case of our cake and meringue factory, due to the way its raw material are used, it may, in fact, be more appropriate for the business to insure on a loss of revenue basis.

Setting the indemnity period

Setting the length of the indemnity period is very important, as all claims cover will cease at expiration. If the business's recovery is delayed for any reason, such as planning consent or the need to replace bespoke machinery, then it may not receive an adequate indemnity and will be underinsured.

Customers need to carefully consider the length of the indemnity period and ensure it is long enough to allow the business to fully recover to the same financial position after the indemnity period as they were on the day before the loss, taking into account worst case scenarios and all possible delays.

Adjusting for future business trends

A business interruption policy aims to place the insured in the same position they would have been had the loss not occurred.

Having chosen the indemnity period, the gross profit sum insured will need to be adjusted for that length of time. In doing this, account must be taken of future business trends.

For example, if the business is predicted to grow by 20% over the next 24 months, then the gross profit sum insured should reflect this growth, in order to put it in the same position it would have been. This could include securing a large contract or developing into a new country.

Taking proper account of future business trends helps to ensure a full indemnity in the event of a loss.

The gross profit calculation is a common cause of underinsurance, and brokers play a key role in guiding their customers towards a figure that will provide full indemnity following a loss.

Clients face a very real risk of additional losses due to inadequately covered due to underinsurance, so should ensure that they understand all elements of the gross profit calculation, and take a methodical approach to arriving at a figure with their customers.