# Financial accounting

## Topic 9: INSURANCE CLAIMS

In the course of running the business, a businessman is exposed to a number of risks such as fire, burglary, accidents, etc. Out of all these risks, the fire risk is the most dangerous. In case it goes out of control, it may involve loss both in terms of property as well as human lives.

A prudent businessman secures himself against such losses by taking a proper insurance policy. Such policy is usually taken for two types of losses:

(1) loss to the property such as stock, plant, buildings, etc. and

(2) loss of profits on account of dislocation of the business.

## LOSS OF STOCK

• A fire insurance policy can be taken for indemnification against loss of stock on account of fire.

• The policy is usually for a year. The insurance company agrees to compensate the insured for any loss that he may suffer on account of loss of stock on account of fire, in consideration of a certain amount being paid as premium.

• The value of stock lost on account of fire can be ascertained by finding out the value of stock on the date of fire less the value of the salvaged stock.

# COMPUTATION OF LOSS OF STOCK

| | |
|---|---|
| Stock in the beginning of the accounting year | **XXXX** |
| Add: Purchases from the beginning of the accounting year to the date of fire | **XXXX** |
| Less: Cost of goods sold (from the beginning of the accounting year to the date of fire) | (XXXX) |
| Value of stock on the date of fire | **XXXX** |
| Less: Stock of salvaged | (XXXX) |
| **Value of stock lost on account of fire** | **XXXX** |

The value of stock can also be ascertained by preparing a **Memorandum Trading Account.** All figures relating to the opening stock, purchases, wages, sales, gross profit, etc., will be entered in the

Memorandum Trading Account. The balancing figure will be the value of stock on the date of fire.

The amount of claim for loss of stock to be filed with the insurance company depends on two important factors:

(i) Rate of gross profit

(ii) Average Clause

## (i) Rate of gross profit

For the calculation of the loss of stock, the information regarding cost of sales is necessary. This can be ascertained by deducting the amount of "gross profit" from, the "sales" made by the business. The rate of gross profit can be ascertained on the basis of the performance of the business during the preceding 3-4 years. While calculating such rate of gross profit, any abnormal factor affecting the rate of gross profit should be ignored

## (ii) Average Clause

In order to discourage under-insurance, usually the "average clause" is inserted in all contracts of fire insurance. The object of inserting such a clause is to limit the liability of the insurance company to that proportion of the actual amount of loss which the insured amount bears to the actual value of the property. bears

For example, stock worth 40,000 is insured only for $30,000 and if the loss amounts to 18,000, the claim admitted by the insurance company will be as follows:

**Average Clause=18000/40000*30000=13500**

A fire occurred in the premises of ABC Traders on 31st January 2021 where a large part of the stock was destroyed. Salvage was 15,000. They gives the following information for the period April 1, 2020 to January 31st 2021.

(a) Purchases Rs.85,000.

(b) Sales 80,000.

(c) Goods costing Rs.5,000 were taken for personal use.

(d) Cost price of stock on April 1, 2020 was Rs.40,000

Over the past few years, they have been selling goods at a consistent gross profit margin of 25%. The Insurance Policy was for ₹50,000. It included an average clause.

**Memorandum Trading A/c**

| | | | |
|---|---|---|---|
| Opening stock | 40000 | Sales | 80000 |
| Purchases 85000 | | | |
| Less: Drawings (5000) | 80000 | Closing stock (bf) | 60000 |
| Gross profit 25% on Sales | 20000 | | |
| | 140000 | | 140000 |



| | |
|---|---|
| **Closing stock** | **60000** |
| **Less: Salvage** | **(15000)** |
| **Loss by fire** | **45000** |

**Claim = Average Clause = 50000 / 60000 x 45000**
**= 37500**

## LOSS OF PROFIT

When a fire occurs, apart from the direct loss on account of stock or other assets destroyed, there is also a consequential loss because, for some time, the business is disorganized or has to be discontinued, and during that period, the standing expenses of the business like rent, salaries etc. continue.

Moreover, there is loss of profits which the business would have earned during the period. This loss can be insured against by a **"Loss of Profit" or "Consequential Loss"** policy

There must be a separate policy in respect of the consequential loss but claim will be admitted in respect of the policy only when the claim on account of fire is also admitted under other policies.

The Loss of Profit Policy normally covers the following items:

(1) **Loss of net profit**

(2) **Any increased cost of working,** e.g., renting of temporary premises

The amount payable as indemnity is the sum of

(a) In respect of reduction in turnover : The sum produced by applying the rate of gross profit to the amount by which the turnover during the indemnity period shall, in consequence of the damage, falls short of the standard turnover, i.e., gross profit on short sales.

(b) In respect of increase in cost of working : The additional expenditure necessarily and reasonably incurred for the sole purpose of avoiding or diminishing the reduction in turnover which, but for that expenditure, would have taken place during the indemnity period in consequence of the damage

## The following terms should be noted

- Gross Profit is the sum produced by adding to the Net Profit the amount of the Insured Standing Charges, or, if there be no Net profit, the amount of the Insured Standing Charges less such a proportion of any net trading loss as the amount of the Insured Standing Charges bears to all the standing charges of the business.

Gross Profit= Net Profit + Standing Charges

Gross Profit = Standing Charges - Net Loss

OR

Rate of Gross Profit = Gross Profit/Turnover x 100

- **Insured Standing Charges**: Interest on Debentures, Mortgage Loans and Bank Overdrafts, Rent, Rates and Taxes (other than taxes which form part of net profit) Salaries of Permanent Staff and Wages to Skilled Employees, Boarding and Lodging of resident Directors and/or Manager, Directors' Fees, Unspecified Standing Charges [not exceeding 5% (five per cent) of the amount recoverable in respect of Specified Standing Charges].
- **Rate of Gross Profit**: The rate of Gross Profit earned on turnover during the financial year immediately before the date of damage.

- **Annual Turnover**: The turnover during the twelve months immediately before the damage.
- **Standard Turnover**: Standard turnover means, turnover for the period corresponding with the indemnity period during the preceding accounting year.
- **Indemnity Period**: The period beginning with the occurrence of the damage and ending not later than twelve months thereafter

during which the results of the business shall be affected in consequence of the damage.

- **Short Sale**: It is the loss of sale resulting in dislocation of the business. This is the difference between standard turnover and actual turnover.

## Calculation of Claim to be Admitted

Short Sale Rs.20000
Increased working expenses Rs.1000
Rate of Gross Profit 20%
Sales during 12 months preceding loss Rs.100000
Amount of Policy Rs.15000
Sales showing an increasing trend of 10%



| | |
|---|---|
| Loss of Profit due to short sale (20000x20%) | 4000 |
| Increased working capital | 1000 |
| Claim for loss of profit & increased working capital | 5000 |
| Amount of policy should have been taken (110000x20%) | 22000 |
| Policy has taken for | 15000 |

*Thus, Average Clause is Applicable*

Claim to be Admitted by Insurance company = Average clause $= \dfrac{\text{Amount of claim x Amount of Policy}}{\text{Amount of policy should have been taken}} = \dfrac{5000 \times 15000}{20000} = 3409$