



How to avoid underinsurance

A guide for small and medium-sized businesses



dpi-insurance.co.uk

Introduction to underinsurance

Insurance helps you recover from unforeseen events that impact your business financially, helping you get back on your feet so that you can continue to operate.

Although you don't always see the real-life, tangible benefits of insurance until you need to make a claim, it plays a major part in protecting the future of your business, preserving assets and jobs. As well as getting the right type of cover to meet your needs, it's equally as important to have the correct level (or amount) of cover. This guide explains how you can assess the amount of cover to arrange for your business so that it's properly protected, and you don't find yourself underinsured.



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What does underinsurance mean?

Underinsurance occurs when you have insufficient insurance cover that leaves you responsible for a percentage of a loss or expense and may lead to financial hardship.



It's a common problem: The Chartered Institute of Loss Adjusters estimates underinsurance to be present on over 40% of claims and the degree of underinsurance is typically around 35 to 45%.



Suitable insurance forms a vital part of your business continuity planning – but how can you be sure that you're buying the right **amount and type** of cover? Finding at the time of a claim that your policy is not enough to meet the financial losses you have suffered can have devastating consequences.



Why getting the right level of insurance cover is critical for your business

Insurers calculate their premiums in part on the value of the items they are insuring, which in turn is usually based on the information you provide. This is called the 'sum insured'.



If, when you suffer a claim, the sum insured is found to be **lower** than the assessed value of your assets at the time of the loss, then the insurer may seek to correct this.

They may ask for more premium to reflect what they would have charged if the sum insured had been correct, or they may make a proportionate reduction in the claim payment (which in some policies is called a condition of average).

You have a duty under the Insurance Act 2015 to make a fair presentation of the risk your business poses. If any underinsurance is found to be deliberate or reckless, an insurer may have the right to void a policy due to the breach of this duty.



For example, if your business was **underinsured by 50%** - meaning your insured items were worth twice the amount of the sum insured - and you had loss or damage costing £40,000, the insurers would reduce the claim payment to £20,000.

Importantly, even where a policy is average free, in the event of a total loss a policy will only respond up to the total sum insured shown on the policy schedule. If that amount is wrong, the insurance policy won't make up any shortfall.

Case study

The policyholder's business is a shoe shop. They are tenants of the building in a high street of a small town.

They took out contents and stock cover with an insurer. The stock sum insured was £300,000 which was a true reflection of the amount of stock they would have on the premises at any one time. The sum insured for contents was £200,000. Unfortunately, a fire occurred which caused extensive smoke damage throughout the shop. This required full cleaning and refurbishment amounting to £150,000. The damage to stock was relatively minor as most of the stock was in a separate room. The total stock claim was £20,000 bringing the total claim to £170,000.

The contents section included cover for the insured's own fixtures and fittings and decorations. This meant that the cleaning and redecorating was covered. However, unfortunately the insured had underestimated the

value of all the contents, decorations and shop fit-out, including the racking. The total value of the contents was £400,000 including the fixtures and fittings and decorations.

The policy was subject to average which meant that the contents claim was proportionately reduced. As the sum insured was only 50% adequate, the contents payment was reduced by 50% to £75,000. With the stock payment of £20,000 the total amount the insured received was £95,000. Had the contents sum insured been adequate, the insured would have received £170,000 which in this case, means there was a shortfall of £75,000.



**Shortfall of
£75k**



What causes underinsurance?

Underinsurance can arise as a result of a failure to:

- correctly calculate the amount of insurance cover you need.
- understand how to arrive at a suitable sum insured or limit of indemnity
- understand what a sum insured or limit of indemnity represents
- select an appropriate indemnity period for business interruption cover (it's widely agreed that most businesses need at least 24 months to recover their trading position)
- take account of the fact that accountancy definitions of gross profit are different from insurance definitions
- obtain up-to-date valuations.
- review sums insured year-to-year
- recognise that policy standard limits are not always enough
- appreciate that periods of high inflation also increase the risk of underinsurance.

Where to get help

Insurance brokers want to help you buy the right insurance for your business and can advise you on how to calculate the amount of insurance you need – your sums insured.



For your assets – buildings, stock, and machinery – they may advise that the best way to do this is to obtain a professional valuation by a RICS surveyor or similarly qualified expert. Such a professional can also work with you and your broker to consider an appropriate indemnity period if your business is interrupted following loss or damage to your property. A good rule of thumb is that this should be a minimum of 24 months.

Your broker can work with you to assess your potential liabilities to third parties and agree an appropriate limit of indemnity.

Finally, a broker can also advise you on what a comprehensive programme of insurance may look like so that you avoid the potential for uninsured gaps, including insurance against such threats / risks as a cyber-attack which could disrupt your business.

Calculating sums insured – buildings and other property

In general, the purpose of your insurance is to put you back in the same financial position after a claim as you were just before it happened.

You should not be able to profit from an insurance claim. The way the policy is set up will affect how to calculate a suitable sum insured. Essentially there are three ways in which a policy can operate:



Policies set up on an indemnity basis

Claims settlement will take into account the reduction in value resulting from the age and condition of the property at the time of the loss or damage, putting you to the same position as immediately before the loss.



Policies set up on a reinstatement basis

Claims settlement that will provide a replacement for property that is 'similar but not better than' – sometimes called 'new for old.'



Policies set up on an agreed value basis

Claims settlement is based on a value agreed at the inception of the policy, for example, for specialised or rare property.

An insurance broker can advise you on which option may best suit your needs.



Rebuilding costs

It's important to remember that the sum insured for buildings **is not the market value** of your premises.

It needs to be the expected cost to rebuild or reinstate it, including any driveways, garages and outbuildings etc. It's also important to note that during periods of rapid inflation the risk of underinsurance increases. The amount will need to include costs for:

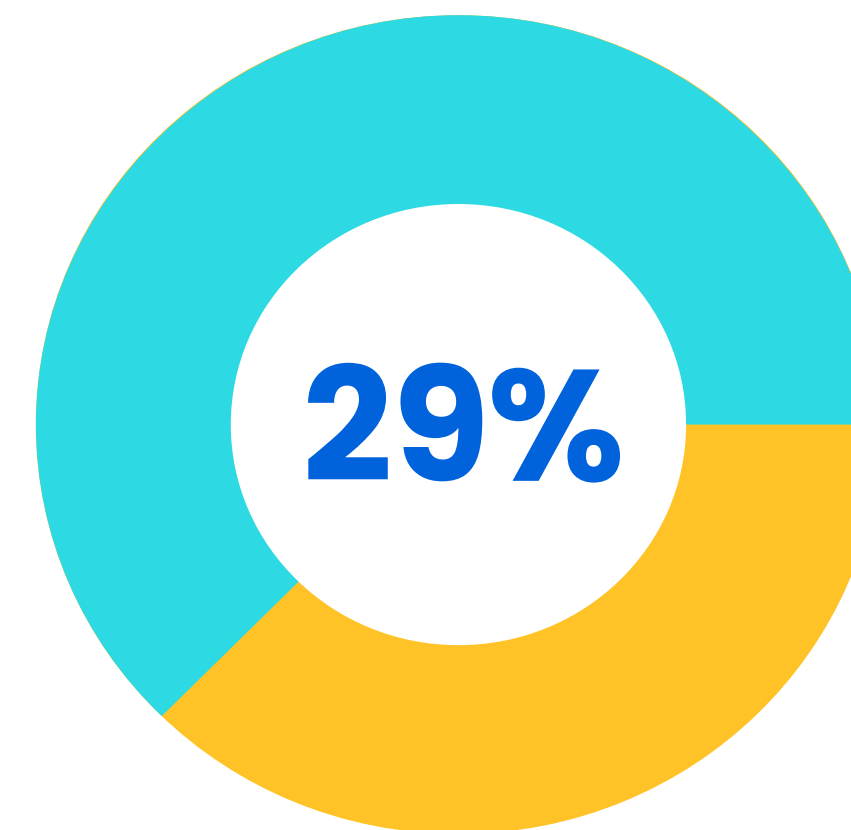
- materials
- labour
- architects
- surveyors and other legal fees
- the cost of demolition and debris removal
- VAT (as necessary)
- any public authority or planning costs and inflation or other increasing costs that happen during the policy period as well as any rebuilding period.

The rebuild cost may be higher if you have a specialised property, such as a listed building, or other

special features that may be more difficult, more costly, or take longer to rebuild or repair compared to a standard property.

Your broker or insurer can help you find a professional valuation service if you need more help with this. Online calculators, [such as BCIS](#), can be useful to give an estimate of the rebuild cost. Regular valuations could help you to keep your sums insured at an appropriate level. Annual valuations are a good idea.

Finding at the time of a claim that the policy you bought does not provide enough cover can have devastating consequences.



An Allianz survey showed that 29% of those who own a business property used the market value to calculate the cost of rebuilding.

2022 Allianz SME survey of 500 respondents.



Rebuilding cost vs market value

Costs and value can be very different. A building may be worth £1m on the property market because of the land it stands on but might cost only £500,000 to rebuild. Another premises in a different location might be worth only £200,000 on the market but because of particular special features might cost £350,000 or more to rebuild.

Market value should not be used as a sum insured.

Contents, stock, machinery, plant and equipment

Business insurance policies typically cover contents, machinery, plant and equipment at the premises and sometimes elsewhere.



The replacement 'as new' value of these items is the amount that should be insured, not the value stated on your balance sheet.

Your stock sum insured needs to represent the cost of raw materials, work in progress, plus finished goods. It should be calculated on the basis of the maximum amount of stock held at any one time, taking account of seasonal increases and peak trading periods.

An up-to-date list or inventory of all of your contents, machinery and plant etc, is useful when considering how much cover you need. If you have customer goods on site, the value of these should be included too. Smaller items can add up to

a significant amount and often these items are not included on an inventory or fixed-asset schedule.

If you have any specialised or complex machinery or equipment it may be useful to talk to your suppliers about the cost and availability of suitable similar replacements or repairs as these could take some time to replace. If you have equipment that is no longer manufactured, you might need to insure for the value of a new equivalent machine.

It's worth remembering that any economic or political situations might impact costs and delivery time for replacements that may come from overseas.



Assessing your business interruption insurance needs

Business interruption insurance covers you for loss of income during periods when you cannot carry out business as usual due to damage caused by a specific set of perils that are detailed in your policy.

It aims to replace certain financial losses sustained by the business during the period of the disruption when you may have reduced turnover. Cover includes losses following damage to your premises caused by incidents such as fire, flooding or other physical damage.

The amount of cover you need will depend on the amount of time you think it will take for your revenue or turnover to recover to the level immediately prior to the loss. This is called the indemnity period and it's very important to get it right.

Two years is likely to be the minimum indemnity period needed for a business to fully recover its trading level in the event of a serious loss.

It's wise not to be over-optimistic about your business recovery time and take into account how much control you'll have in any rebuild operation – for example, you may be dependent on landlords to manage any repairs which might delay matters.



44%

of SME businesses surveyed do not have an insurance policy in place to cover their business.

2022 Allianz SME survey of 500 respondents.

Think about what might happen if you are unable to trade for even longer than planned for

Think about all the possibilities that might stop you from beginning to trade again.



Will you need to apply for planning permission for any rebuilding work? Is your stock seasonal? Could damage to your suppliers, or customers' premises impact your business and cause delays for you?

If a claim payment for damage to your property is delayed or even rejected because of underinsurance, the resultant delays in repairing or replacing your property could cause knock-on problems for your business interruption insurance. You might want to think about what could happen if you are unable to trade for even longer than planned for. For example, is it possible that your customers would go elsewhere? Could there be additional costs to move back into the premises?

The sum insured for the business interruption section of your policy

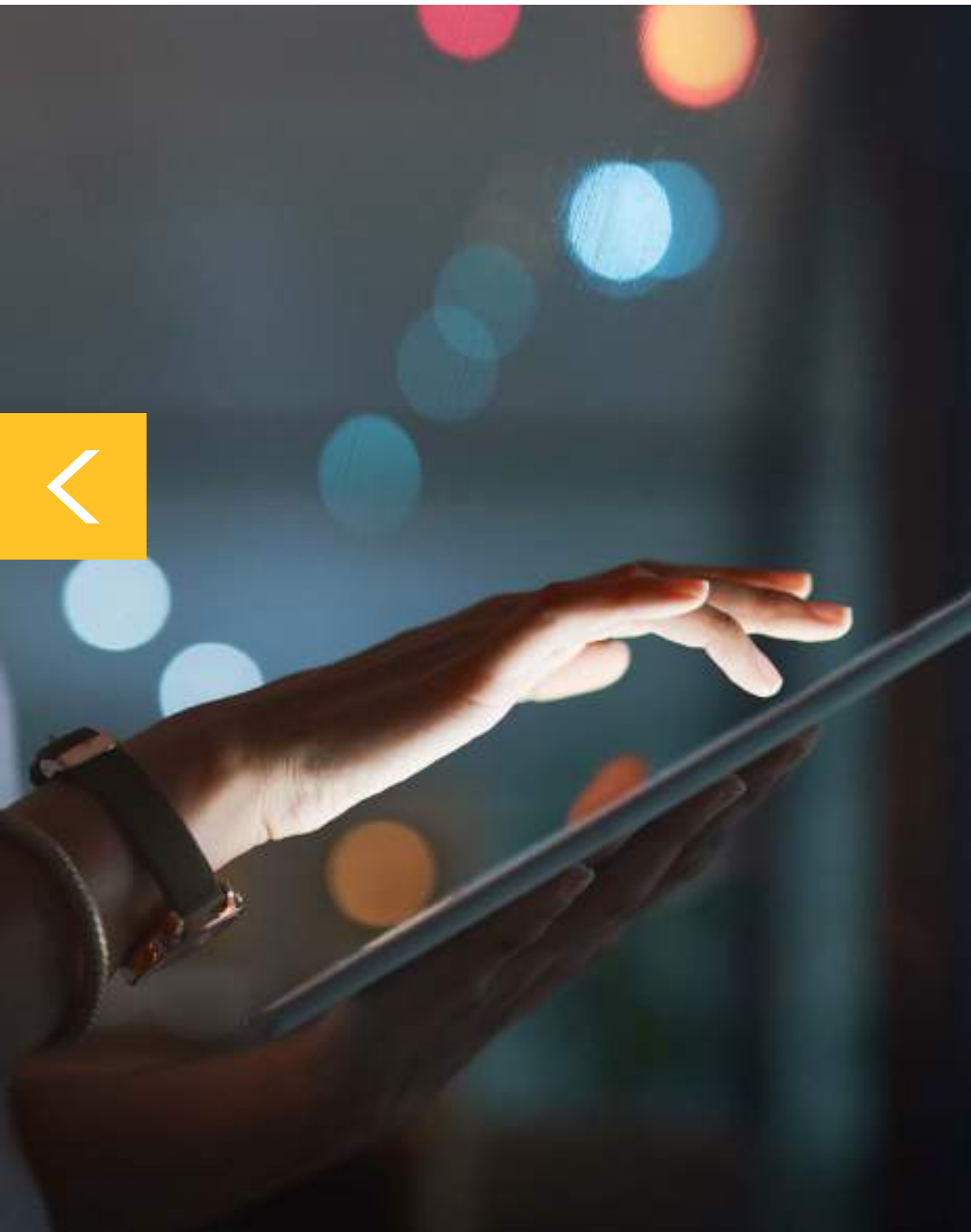
should reflect your anticipated 'gross profit' during the indemnity period you have selected. Insurers define gross profit in a different way from accountants and this is important to remember when doing your calculations. For insurance purposes, the general definition of gross profit is calculated as turnover minus purchases and variable costs during the indemnity period. Definitions can vary by insurer so it's important to check your policy. Again, an insurance broker can help you understand how the definition applies in your circumstances and calculate the right sum insured.

You could consider buying cover that is adjusted based on the declarations you make about your anticipated gross profit. It's standard for such policies to provide an automatic

uplift of 33% in your sum insured providing it's correctly calculated at the start of your policy. The other advantage is that normally such policies don't have the average condition clause. You can also buy business interruption insurance that's simply based on your estimated gross profit. These estimates will be checked against actual figures if you do have a claim and if the estimate is less than the actual figure, the claim might be reduced by the same proportion – check with your broker to think about ways you can reduce the risk of this difference occurring. This is particularly important if your business is going through a period of rapid growth.



The difference in gross profit calculation



Insurers define what they expect gross profit to represent in the policy. For example they may define it as:



The difference between the sum of turnover, closing stock and work in progress and the sum of opening stock, work in progress and uninsured working expenses.

In the event of a claim a loss adjuster will deduct variable costs and deduct uninsured working expenses, often defined in the policy as, 'purchases less discounts received, bad debts, rent and any other item described in the schedule'.



Accountants define gross profit as:



The residual profit after selling a product or service and deducting the costs associated with production and sale - and deducting all direct costs.

These are examples of gross profit definitions; but it's imperative to base your calculation of gross profit on the definition in your own policy wording.

Your broker will also be able to discuss the various extensions to business interruption cover that are available including:



Advanced profits, where you have expansion or research and development plans which will generate profits in the future which might be affected by an insured loss at your premises.



Increased cost of working for additional costs incurred to keep the business running after a claim.



Loss of rent.



Denial of access where there is no material damage to your own premises.



Suppliers and customers where there is a dependency on them.



Failure of public utilities.



What about underinsurance of liability risks?

Few businesses can afford to defend a legal liability claim without sufficient insurance.

Liability policies are intended to pay the costs of defending an allegation of legal liability against your business together with any settlement or award of damages. They include employers' liability cover, public and products liability covers, as well as more specialised insurance such as directors' and officers' liability, environmental liability and professional indemnity insurance.

To work out the liability risk for your business you need to think about any potential claims that might be brought against you or your business because of something you've done. Making an estimate of the value of awards that might be made against you and their frequency will help you to request a suitable level of cover, which in liability policies is referred

to as a 'limit of indemnity'. Often insurers may offer limits of £5 million to £10 million which can seem plentiful; however, even these amounts may not be enough if there's a serious incident or substantial connected claims. If your insurance cover is not sufficient to meet a claim against you, your business assets might be at risk. If you have employees there's a legal obligation to have at least £5 million of employers' liability cover while most insurers provide and recommend £10 million.

Calculating the right amount of liability cover is not completely straightforward and an insurance broker can provide advice here and help you with a liability risk assessment.

There are a number of factors that can help you feel comfortable with the limit of indemnity you arrive at including:

- the number and value of claims previously made against you - or against similar businesses
- the risk of an incident where your property causes loss or damage to a third party - such as spreading fire
- the known sources and triggers for claims against you
- the likelihood of significant number of employees being affected by the same event
- the costs of defending an allegation of legal liability, irrespective of the outcome and whether these costs are included in the limit of indemnity or in addition to it
- whether your trading contracts impose any additional liabilities (known as liability assumed under contract) which are not normally covered by a standard insurance policy
- additional factors such as economic loss, legal defence costs, environmental liabilities and cyber liability
- whether there are likely to be multiple claims from multiple claimants
- the effect of future inflation on claims made years after the policy has expired, as well as increasing court awards
- the risk of claims coming from overseas, where personal injury awards can be much higher than in the UK.



Cyber insurance cover



Look out for more detailed guidance on cyber insurance from BIBA.



Cyber incidents is ranked as the UK's top risk in the [2022 Allianz Risk Barometer](#).

You are more than likely to rely on information technology (IT) to some degree in your business. If so, you'll be exposed to the risks of business interruption, income loss, damage management and repair, and possibly reputational damage if IT equipment or systems fail or are interrupted following a cyber-attack. It's therefore important to consider purchasing adequate cyber insurance to protect your business from the financial consequences that can follow a cyber incident.

Cyber insurance is a vital consideration. The Department for Digital Culture Media and Sport's 2021 Cyber Breaches Survey suggests that only four out of 10 businesses have some sort of cyber insurance cover but only 6% of firms have specific specialist cyber cover.

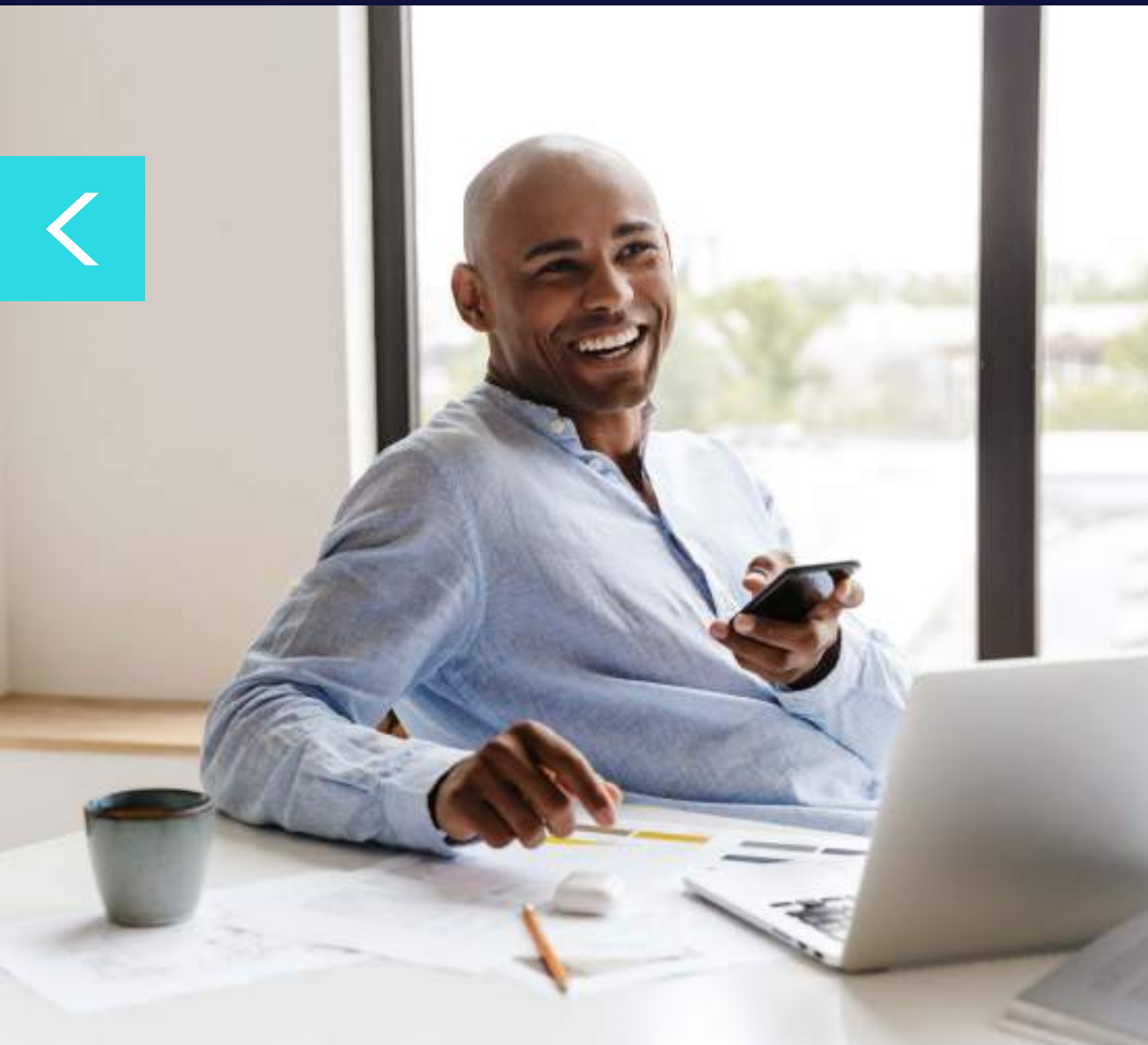
It's important to seek advice from an insurance broker for the level and type of cover best suited for your business, but as a minimum consider the following features:

- ransom
- cyber crime or 'phishing'
- restitution of IT systems and data
- the costs to notify customers of an attack and loss of their personal data
- your liabilities that might be owed to third parties following loss of their data.

You can also protect your business against business interruption losses that might flow from a cyber-attack. For example, you have a production line that is halted because your systems are compromised. There's no physical loss or damage, but you have suffered a financial loss. If you suffer a cyber breach, having cyber insurance can make the recovery process as straightforward and rapid as possible. Many insurers include technical assistance with managing a breach as part of the insurance policy – if so, get in touch with them immediately after the breach is discovered.

Top tips to help you avoid underinsurance

These may help you to get the basis of your insurance right and reduce the risk of underinsurance.



01.

Use a professional insurance broker to help you understand what breadth and level of insurance protection best suits your needs.

02.

Use professional valuation services to help you decide on your sums insured – useful information can be provided by your broker or insurer, or via abi.bcis.co.uk or www.rics.org/bcis. Regular valuations will help ensure the sums insured are correctly assessed.

03.

Getting the numbers right when you buy your insurance policy will help avoid any insufficient sums insured becoming even less adequate year-on-year. In this way, you also avoid the risk of an insurer reducing a claim payment through applying the average condition.

04.

Sums insured for buildings should be based on the cost of rebuilding, not the market value, and particular features of your premises might affect the cost of reconstruction.

05.

When looking at business interruption insurance remember that accountancy and insurance policy definitions of annual gross profit are different. Make sure your assessment of gross profit matches the one in your policy so that you don't understate it.

06.

When thinking about an indemnity period for your business interruption insurance, remember that 24 months is likely to be the minimum period needed for a business to fully recover its trading level and to rebuild its customer base.



07.

Liability policies are complex. Make sure that you have considered the risk of claims against you and check whether you have taken on any liabilities under your terms of business contracts. Are the limits of indemnity on your policy sufficient to meet these liabilities? £5 million could be considered as a sensible minimum.

08.

For business interruption, consider buying declaration-linked insurance because it provides an uplift of 33%, providing that the sum insured and period of indemnity are both correct initially and declarations are made when requested by insurers. Again, ask an insurance broker to help you decide on the policy that best suits your business.

09.

If you buy a simple online package policy, check that the liability limits of indemnity, business interruption indemnity periods and other standard policy limits are sufficient.



10.

New risks sometimes emerge. Consider how the risks to your business change, including areas such as cyber risk or data protection.

11.

Check your policy documentation; your insurance broker and many insurers will make every effort to draw your attention to the important conditions of your policy, but it's always important to check to make sure there are no errors.

12.

Make sure that your disaster recovery or business continuity plans are up to date since they may help you recover more quickly after a loss.

13.

The costs of claims preparation, such as the costs of instructing an expert or an accountant to help with the claim, are not usually included in your insurance cover and may be costly; discuss with your broker whether you need to buy additional insurance to cover this.





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