



Services sector in terms of changing environment

Risk management during work interruption

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Abstract

Insurance is economic and financial institution which functions in accordance with planning, economic, legal and technical bases and its aim is to provide coverage for any future needs of financial means. These needs have to be caused by harmful implications occurred against the will of the insured person and are independent and unpredictable in advance. For the insured person the insurance is an economical instrument which bears a very low cost (insurance premium) for an unpredictable financial loss that would exist if there was no insurance. The insurance is an economical instrument for lowering and eliminating the risk through a process of combining sufficient number of homogeneous exposures in a group, so the losses would become predictable for the group as a whole.

The purpose of this paper is to show the main task of each 'risk management', i.e. to take all the measures in order to manage the pure risks and insure the events.

Financial losses can be caused by variety of reasons and mostly by incorrect business decisions. However, they could also be caused by insuring different hazards to which the company is exposed because of the risk of fire, breaking of machines and earthquake, which can cause a stop in the process of production and sales and a complete stoppage of the work for a longer period. The stoppage of work, i.e. production and sales, can lead to losses of income.

A reasonable management of the company which wants to achieve income even in situations like these will protect its interests by insurance.

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1. Introduction

*What is precaution?
It is impossible to study the risk!
Johan Wolfgang Goethe*

There are a great number of risks caused by natural disasters or by men with which the business entities can be faced. Fire, flood, terrorist attacks, hurricanes, are only part of the risks which have always endangered property, work continuity and also the survival of the business entities.

Thus, more attention is paid to the insurance of property, buildings, office furniture, computers, machines and other equipment. The unforeseen harmful effects do not only cause destruction of property, but also cause disruption of continuity in the working process, which leads to falling behind and not making positive financial results, and also occurrence of loss accompanied by additional financial costs. There was always a need that the company insured the continuity of its work and its business result.

The first forms of insurance from work interruptions after a fire as the most common form of insurance date since 1797 as an attempt of Minerva Universal from Great Britain (Multiple Contributors, 2010) to ensure the costs and the loss of the commercial income after work interruption. Since 1986, when the recommendations of Insurance Office Services from USA (<http://www.iso.com/>) are accepted, and those are to use the commercial income instead of the gross profit, and also the recommendations of the Association of British Insurers from 1989/91 (<http://www.abi.org.uk/> www.insurancefraudbureau.org), there have been no drastic changes in this type of insurance. The thing that has changed recently is the general image of the risk. The attack of the World Trade Center on September 11, 2001, the potential pandemic avian flu, is some of the risks that endanger the continuity of work recently.

Faced with new risks, increased demands for protection, globalization, “just in time” delivery, and bigger and bigger occurrence of risks, the necessity for insurance of commercial entities becomes bigger and bigger.

The insurance from the danger of work interruption because of fire and some other risks (“Chomage insurance[†]”) (Kocovic, 1999) is set as additional insurance, if the same insurer contracted, before that or simultaneously, insurance of fixed assets, as well as non-cash working assets.

The insurance premium is calculated in advance from the planned amount of profit and the costs, if the insurance is concluded at fixed amounts. The essence of this type of insurance is to compensate the damage to the insurer that would have happened if there was a work interruption (halt in production) due to one or more basic or additional hazards that are mentioned in the insurance contract against fire and some other hazards.

The obligation to legal redress of the work interruption is sustainable if there is obligation of the insurer to compensate the material damage in the case of fire or some other hazards. (www.continuityinsights.com) If the basic insurance contract against fire and other hazards expires, the insurance contract against work interruption because of fire and other hazards expires automatically.

2. Subject to insurance from hazard work interruption

With the concluded insurance from hazards during work interruption because of fire (Chomage insurance), the property interest of the insured is covered, such as profit, earnings and different business expenses of the insured if work interruption occurs.

In the context of this subject of insurance, profit is only the gross profit realized through the principal activity for which the commercial entity is registered. The following items are not treated as profit: business activity in circulation of funds, sales tax on products and services, revenue from business units abroad, profits derived from interest and correction of the financial result, incomes from grants and subventions, extraordinary income etc.

Operational costs are overheads of working, either fixed or variable, and depreciation costs. It is important to mention that the insured person decides which costs will be taken for insurance. Special

[†] It originates from the French word *chômage*- stoppage, resting=stoppage of production

attention should be paid to insurance costs in the final account of the insured and they should be taken in the synthetic records. (Andrijanić, 2002)

All this is done to simplify the identification of the extent of possible damage. Every operational cost that might affect the regularity of determination of the amount of damage should be eliminated. The following items are not considered as operational costs: those which are not necessary during the work interruption and consequently are not mutually related to supplying costs of goods and raw materials, propulsion and auxiliary materials, unless they are in function of maintenance of the plant for production services etc.

Insurance can be concluded only by legal entities which according the law, independently, regularly and permanently, realize income and expenses. As a rule, insurance is concluded for the whole asset of the legal entity. With exception, parts of the legal entity which are dislocated production facilities may be insured with extra charge, but if only there are adequate records.

The basis for calculating insurance premium is determined by the contractor, on insurer's special forms. The agreed amount on accounts is the maximum commitment of the insurer when the insured event is created. Special attention should be paid not to include costs that do not result from work interruption.

3. The necessity of integral approach to risk management if interruption of work

Risk management is nothing new. Large numbers of companies adequately implement the risk management and this contributes to reduction of losses caused by realization of risk.

However, on one side there are companies that do not implement adequate way of risk management, or do not implement risk management at all, and on the other side the modern conditions, the working practices and the more recent experience regarding realization of risk, lead us to the necessity for complete approach to risk management.

Firstly, we should point to the new developments which affected the big losses during work interruption. The most important event, from the risk of work interruption's point of view, is the terrorist attack of the USA. The total expenses of insurance, which indicate the significance of the work interruption risk of this event, were about 40.2 billion dollars. 11 billion dollars and that is 27%, were expenses for the insurance industry on the basis of reimbursement of lost earnings and costs caused by work interruption. (www.iso.com)

Another major impact to the insurance industry was the season of hurricanes in 2005. The three hurricanes Katrina, Rita and Wilma caused losses estimated to 170 billion dollars. The insured losses were 45, 2 billion dollars according to the estimation of Insurance Services Office. (<http://thelongestlistofthelongeststuffatthelongestdomainnameatlonglast.com>) Although the fees were on basis of work interruption, their calculation cannot be precisely determined because of its complexity and it is considered that, because of the length of the hurricane season and the work interruption that follows and is unpredictable, they will be the major part of the total loss.

Beside these crucial hazardous events, something should be said about the potential danger for the work continuity in the future period of the pandemic avian flu. The World Health Organization regards that this pandemic, based on the former experiences, can lead to reduction of the available labour force for 25% any minute. The AON study, brokers in the area of insurance and reinsurance show that the risk management during work interruption should be the key question in the following period. (www.uksoftware.ltd.uk) If we take into consideration the data of the Asian Development Bank, according to which it is clearly seen that the SARS virus has caused losses in the form of absence of operating profit and current costs of work interruption in the amount of approximately 60 billion dollars in the countries of east and south-east Asia, it is clear why the risk management is so important lately. (www.adb.org/documents)

Many companies took protective measures to protect their property. However, integral approach is necessary in order to protect the normal functioning. Companies must take care of their employees, for the responsibilities towards third parties, as well as for the business profits. The business profits can be endangered either by internal or external factors.

There are *internal* and *external* reasons. **The internal** are connected to the company itself. The sensitivity of the company to work interruption depends on the type of production, the product and the conditions for production. In parallel production for example, the work interruption of one machine means work interruption of all the others. **External reasons** for work interruption can be delay or interruption of power delivery or raw materials and the problem is additionally complicated if the company practices “just in time” delivery and uses only one supplier. Hazardous actions, such as fire, will directly cause problems in the cash flow. So, if the company stops the process of production, it will not be able to generate revenue from sales. Besides that, some time is necessary for the company to return to normal business operations. Regardless of the work interruption the company will have to pay certain fixed costs, such as salaries, rent, amortization of equipment, etc.

The variable expenses will not affect the decline of the profit, which is exactly the reason why the insurance of the work interruption covers only the fixed costs. Because of the things mentioned above, the business entities must apply integral approach to risk management and there are three forms for that: (Andrijanić, 2002)

- ✚ Avoiding risk with primary objective to limit probability of occurrence and size of damage
- ✚ Transfer of risk with primary objective to alleviate the burden with transfer of risk to third party, i.e. through insurance
- ✚ Readiness with primary objective for the company to be in position to regain its operations into normal

If we take into consideration the risk of work interruption after fire, which is the most common example of continuous work of the business entities, then the measures for fire prevention – fire extinguishers would be avoiding the risk. There is a risk of fire to one or more buildings or installed systems in the open which are not separated from one another, but are separated from the surrounding buildings. It is necessary to separate the objects, of the installed systems in the open, inside the building and separation from other risks of fire. The separation is adequate if the distance between two buildings is at least as the height of the higher building.

The distance or the height above 20m is not taken into account. Spatial separation in open warehouses, flammable materials is 20m, between buildings storing flammable materials is 15m, but the most common spatial separation is 10m. Measuring of distance is done at spots where buildings and warehouses are mutually the closest. (Insurance Company AD “Qbe Macedonia”)

4. The role of insurance at work interruption

The most common risk which leads to work interruption is fire, according to the number of concluded insurance contracts, immediately following the risk of breach of machines.

The above mentioned results two issues: (Insurance Company AD DDOR Novi Sad)

- ✚ If you want to have a risk coverage with the insurance, it is necessary to conclude a basic contract with which the property of the business entity is protected from fire, breach of machines, and the following conditions have to be fulfilled: the property of the company occurred within the premises of the company (so, if work interruption occurs after lack of capital, this will not be covered with this insurance)
- ✚ The obligation of the insurance company towards the business entity, subject to insurance is compensation of the lost profit, as well as additional expenses for damage repair, temporary lease of business premises and machines).

Hazard insurances covered by work interruption insurance are: (Law of insurance supervision, 2002-2010)

- ✚ Fire or lightning strike
- ✚ Explosion
- ✚ Storm

- ✚ Hale
- ✚ Impact of motor vehicle in insured facility
- ✚ Fall of a flying object
- ✚ Events and demonstrations

The insurance coverage may arrange for risks: flood, high waters, spillage of water from the installation, landslides and landfalls, snow avalanches, leakage of working fluid from containers and installations, combustion of stock materials, and spillage of liquid burning metal.

Therefore, in the developed countries, especially in the USA, it is possible to conclude various forms of additional coverage, such as: (www.iso.com), (www.continuityinsights.com)

- ✚ Stoppage of work continuity after interruption of the computers (maximum compensation amount of 2,500\$)
- ✚ Extended coverage of business profit(if there was a fire in a restaurant after reopening)
- ✚ Stoppage of work continuity caused by civilian authority. This type of insurance was activated in the USA after the terrorist attack on September 11
- ✚ Stoppage of work continuity to: **the supplier** (if the company depends on only one supplier and that supplier was hit by hazardous action); **crucial customer**(if hazardous event stopped the hotel from working, then the specialized cheese supplier will be indirectly endangered);crucial facility or location (after the damage of the trading center, a small store does not have to be damaged, but it cannot work full time)
- ✚ Various kinds of specialized insurances from work interruption such as coverage of the lost revenue from tuition fees, in case the school doesn't work during one semester, weather insurance that covers damages caused by weather conditions- rain, snow

This type of insurance does not cover: nuclear explosions, military dangers (civil war, riots, revolutions) other political risks (expropriation, confiscation, nationalization), pollution and contaminations with fundamental risks (SARS). When it comes to the duration of compensation, the warranty period in these areas is usually 3 to 12 months with the possibility of surcharge for extended fee to 24 months. If work interruption was for three days or less, the insurer is not obliged to pay compensation.

Globally, there are two applicative solutions for damage compensation: (Marović, 1997)

- ✚ **British**, which is present in many countries, and with which the insurer's obligations last until the moment of commercial capability;
- ✚ **USA** with which the insurer's obligations last until the moment of technical capability

Finally, besides the damage compensation, the role of the insurer is to provide professional assistance in the field of risk management.

5. Compensation from work interruption insurance

Determining the amount of damage because of work interruption caused by fire or some other dangers is considered a very complicated task, especially with companies which have a complex production process.

When solving damages like these, besides economists, other experts can be engaged, for instance technologists. Considering the fact that each Chomage damage is specific, there is no way to determine a method or steps for solution in advance. Many elements have to be taken into consideration. In theory and practice of insurance activity, adequate solutions for problems like these can be found. It is necessary to determine earlier whether there are grounds for compensation. It is completely important, to state the period of delay, i.e. date and time of work restart. The period of delay cannot be longer than the guaranteed period- the shortest is three months and the longest is 12 months. According to the stated so

far, the insurer is not obliged to compensate the damage if the production stoppage was 72 hours or less[‡]. (Gancheski, 2000), (Company Law, 2004)

Determining the extent of damage is one of the most complex stages in the procedure. A lot of analysis has to be done: scheduled production volume, realized physical volume of production by month, dynamic production plan, 2 or 3 shifts possibility, and so on. If the production process is with lower quality, this adds to the problem. All circumstances that would influence the business result of the insurance company, either positive or negative, have to be taken into consideration.

Considering the price, it is clear that the retail price is used. At last, at liquidation of these damages it is obligatory to apply the franchise.

6. Conclusion

The numerous risks that endanger the work continuity of the social subjects indicate that the need for business profit protection is more expressed. In the risk management from work interruption, the leading role in all aspects has the insurance, i.e. the insurance company. A close cooperation between the insurance company and the insured is necessary, as a high level of mutual trust would be realized.

However, the insurance is not and cannot be the only way of risk protection. The business entities cannot rely only on insurance as a form of risk management. They should manage the risk internally, through avoiding and preparing in case damage happens.

Considering all this, we come to a conclusion that the business entities have to manage the risk of work interruption and the absence of business profits integrally.

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[‡] If the stoppage of the production process takes three or less days, the insurer is not obliged to compensate the damage. If the stoppage of the production process takes more than three days the ascertained Insurance is lowered for 10% (repulsive franchise). Work interruption because of fire hazard less than three days is covered by the insured person. It is supposed that the insured can independently, with small engagement, compensate the possible unfulfilled profit or generated cost

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