UNDERSTANDING DEPRECIATION IN BUSINESS INTERRUPTION INSURANCE: A MISUNDERSTOOD CONCEPT

By

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Executive summary

Depreciation per se is neither a Fixed Cost nor a Variable Cost. In essence, Depreciation is an Optional Cost, insurable as an item of the policy, at the sole discretion of the Proposer/Insured.

Main stream insurance practitioners would be horrified to regard Depreciation other than a Fixed Cost because many, if not all, have been programmed to believe, like their predecessors, including those living in a bubble, the mantra that Depreciation is part of the Standing Charges.

The prerogative to insure Depreciation, or not, as an Optional Cost rests with the Proposer/Insured. Depreciation can be insured as an item on a limit of liability basis much like, inter alia, Additional Increase in Cost of Working and Accountants' Charges/Fees[2] which are not subject to underinsurance.

Depreciation, as an Optional Cost, is a novel and innovative concept in Business Interruption insurance, has never been explored at all.

Introduction

This technical paper on UNDERSTANDING DEPRECIATION IN BUSINESS INTERRUPTION INSURANCE: A MISUNDERSTOOD CONCEPT is a study of the meaning, practice,

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[1] LF Ong is a pioneer in the Malaysian Loss Adjusting circles. He was the former Chairman of the Association of Malaysian Loss Adjusters (AMLA) and the Chartered Institute of Arbitrators (CI Arb) Malaysia branch, and a former Director of the Malaysian Insurance Institute (MII) (now known as the Asian Institute of Insurance (Aii)). He was an Examiner and also a Question & Answer Setter of the CII/MII Business Interruption insurance examinations at the Associateship level. He had held the position of Deputy Managing Director of an international Loss Adjusting Practice and later, joined a substantial local Loss Adjusting Practice. Currently, he is a practicing Arbitrator and Mediator and is a member of the Advocates & Solicitors Disciplinary Committee of the Malaysian Bar.

[2] Additional Increase in Cost of Working and Accountants' Fees/Charges are actually Optional items insurable at the discretion of the Proposer/Insured.

process and application of depreciation as an Optional Cost in the Business Interruption insurance.

It is appreciated that the concept of Depreciation as an Optional Cost is totally against the norm of the Business Interruption insurance practice and would likely face considerable challenges from all angles.
An open mind is what is required for an understanding of this concept of Depreciation as an Optional Cost for the learning curve.

The awakening that Depreciation is an Optional Cost stemmed from an actual Business Interruption insurance claim dispute following a fire outbreak at a manufacturing plant complex managed by a public listed corporation (the Claimant) against the Underwriter (the Respondent) under a Business Interruption insurance policy (the BI policy) arbitrated by a 3-man arbitral Tribunal[3] (the Tribunal) whose Award was in favour of the Claimant,

For reasons of confidentiality and privacy, the identities of the parties and Tribunal members as well as the date of fire and location of the palm oil mill could not be divulged.

In a nutshell, the Tribunal, after hearing lengthy and protracted testimonies of expert witnesses and reviewing voluminous documentary evidence including bundles of authorities, held ipso facto cognizance to the fact that Depreciation is not a fixed cost[4] (hereinafter referred to as standing charge), for the purpose of the Gross Profit[5].

The short story is that by including Depreciation to the standing charges, the rate of gross profit by definition would be inflated up to an unrealistic level which was not cogently reflective of the Business insured. For this purpose, Depreciation was regarded as an item suitably located in the Specified Working Expenses ("SWE").

It has to be mentioned here that an Arbitral Award[6] is a private alternative dispute resolution (ADR) settlement between the contractual parties in dispute and is not regarded as a *stare decisis* (legal precedent), notwithstanding, due process of law had been fully complied with, throughout the proceedings, in accordance with the Malaysian Arbitration Act 2005 (Act 646) by three eminent jurists whose grounds of decision are worth its weight in gold.

What is Depreciation?

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[3] The Tribunal comprised a London-based practicing Queen Counsel/Senior Barrister who is also a Law Professor, a former Malaysian Court of Appeal judge and a former Malaysian High Court judge.
[4] Fixed costs and Standing charges are synonymous.
[5] Gross Profit comprised Fixed Costs (Standing Charges) and Net Profit.
[6] Similar decision on Depreciation was reached by the NSW CA in Mobis Parts Australia Pty Ltd v XL Insurance SE [2018]. see Ibid, 12

Before moving on, it would be necessary to understand the meaning of Depreciation.

a) BI policy definition

The Business Interruption insurance policy has no definition of Depreciation.

b) Dictionary definition

Oxford English Dictionary at page 221 defines 'depreciate' verb. (derivative: depreciation noun.) to mean "reduce in value over time".

Longman Dictionary of Contemporary English defines Depreciation, noun, to mean "reduction in the value or price of something" (at pages 367 & 368).

c) Malaysian Accounting Standards Board (MASB)[7] – Standard 14: Depreciation Accounting – Definition of Depreciation (at page 4 paragraph 4)

"Depreciation is the *allocation** of the depreciable amount of an asset over its estimated useful life. Depreciation for the accounting period is charged to net profit or loss for the period either directly or indirectly"

The keyword "allocation" is distinguishable from a Standing Charge[8].

d) International Accounting Standards Board (IASB)[9] – Definition of Depreciation

Pursuant to IAS 16 (replacing IAS 4), "depreciation is defined as the systemic *allocation** of the depreciable amount of an asset over its useful life. The standard requires the entity to recognize the cost of an asset as depreciation expense over the asset's useful life, reflecting the wear and tear, age or obsolescence of the asset".

Likewise, the keyword "allocation" is distinctive from a Standing Charge.

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[7] MASB was created by the Financial Reporting Act 1997 (FRA 1997) as a body of the Financial Reporting Foundation (FRF) on accounting standards for approved financial statements for the perusal of the Securities Commission Malaysia (SCM), Bank Negara Malaysia (BNM) and the Registrar of Companies (SSM).

[8] Standing Charges is synonymous with Fixed Costs and these are expressed interchangeably.

[9] London-based IASB was initially established in 1973 as the International Accounting Standards Committee (IASC) changed to its current name in 2001 under the International Financial Reporting Standards (IFRS) Foundation. IASB is an independent body of experts harmonizing IFRS Accounting Standards (IAS) adopted globally by 168 jurisdictions (2024). Needless to say, the IAS are impetus to attract foreign direct Investment (FDI).

*Longman Dictionary of Contemporary English (at page 36) defines "*Allocation*", noun, 1 [c] 'the amount or share of something that has been allocated to a person or organization. 2 [U] 'the decision to allocate something'.

Oxford Advanced Learner's Dictionary at page 30 defines "Allocation" as 1. (U) Action of allocating. 2 (C) amount (of money, space etc) allocated.

The International Financial Reporting Standards[10]' IFRS 17 applies to insurance contracts including reinsurers and other entities. The mandatory adoption of IFRS 17 began in 2023, additional rules and amendments came into effect on 1st January 2024.

e) <u>Malaysian Income Tax Act 1967 (Act 53) (the Act) (as at 29 December 2023)</u>[11]

(the Act). Schedule 3 (Section 42) (at pages 416-449)

The word, Depreciation, as is commonly regarded as a Standing Charge, in the insurance policy, does not appear in the Act, but for the lack of interpretation, is presumably its equivalent conveniently prescribed as Capital Allowance (CA).

Capital Allowance is provided for in Schedule 3 (Section 42) of the Act under the heading of **Capital Allowance and Charges – Qualifying expenditure.** (Emphasis in the original**).**

That said, Capital Allowance is similarly not defined under Section 2 – Interpretation, of the Act.

Moving on, hypothetically speaking, where there is a dispute in the matter of Depreciation and Capital Allowance, there would appear to be a lacuna in the statute for want of definition and based on the case of *NV Alliance Sdn Bhd v Director General of the Inland Revenue Board*[12], the ejusdem generis rule[13] would apply.

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[10] For full understanding and comprehension of the workings of IAS & IFR Standards, please read the "Conceptual Framework For Financial Reporting" issued by the International Accounting Standards Board in September 2010, revised in March 2018 (Copyright of IFRS Foundation).

[11] **A Word of Appreciation** on the matters of the Act is accorded to Mr Vincent Josef, a well-known and reputable Tax Consultant and Trainer in Tax Law and Practice., who had 35 years of distinguished and illuminating career with the Inland Revenue Board, rising through the ranks to the position of Assistant Director-General (now retired). Mr Josef's invaluable advice and learned views give a succinctly clear picture of the complex workings of Capital Allowance in the Act.

[12] In NV Alliance Sdn BHD v Ketua Pengarah Hasil Dalam Negeri (the IRB) (CoA judgment 4 November 2011), at page 6, where there is no definition of the word "hospitality" in the Act, the Court of Appeal applied the ejusdem generis rule in favour of the Appellant.

[13] Commonly called Lord Tenterden'S Rule; Evans v Cross [(1938) 1 KB 694]

Briefly, Depreciation is not recognized as a deductible expense[14] for tax purposes but on the other hand, the entity may compute a similar tax deduction known as "Capital Allowance" in line with the provisions of the Act.

On the premise that Depreciation is no longer regarded as a deductible expense, this would have an adverse impact on the Business Interruption insurance practice, in particular, the working process of the Difference Basis of the Gross Profit[15], for insurance underwriting and claims purposes.

Capital Allowance is computed under appropriate rates as Initial Allowance and Annual Allowance.

For the sake of easy understanding, four simplified Illustrations are shown below:

Illustration 1:

Qualifying Expenditure on Plant & Machinery $140,000

Capital Allowance –

Initial	28,000	
Annual	28,000	
Total Capital Allowance		(56,000)
Residual Expenditure c/f		$ 84,000

Illustration 2:

CA of the relevant year of assessment is deducted from the Adjusted Income as set out below:

Capital Allowance	$ (50,000)
Net Profit	$1,000,000
Statutory Income	$ 950,000

Adjusted Income is the result of making adjustment to the Net Profit/Loss where non-liable receipts are removed and non-allowable expenses added back.

[14] Depreciation as a deductible expense is deduced from either the straight-line method or Diminishing balance method of depreciation, the latter is much more popular.

[15] The Insurance Institute of London (IIL) in corroboration with the Chartered institute of Loss Adjusters (CILA) joint Research Study Group 265, suggested In their report "Business Interruption Policy Wordings" (2024 edition) at pages 12 and 25 that the term 'Gross Profit' should be replaced by 'Insurable Profit' or 'Insurance Profit' or 'insurance Gross Profit'.

However, in an Adjusted Loss situation, the CA, despite being a negative figure, does not increase the Adjusted Loss; rather, the CA is carried forward to be offset against the following year's Adjusted Income. (Paragraph 75 of Schedule 3).

Paragraph 75 read as follows:

> "Subject to paragraph 75A, where, by reason of an insufficiency or absence of adjusted income of a person from a business of his for the basis period for a year of assessment or by reason of the existence of an adjusted loss from the business for that period, effect cannot be given or cannot be given in full to any allowances or to the aggregate amount of any allowances falling to be made to him for that year in relation to the source consisting of that business, that allowance or that aggregate amount, as the case may be, which has not been so made (or so much thereof as has not been so made to him for that year) shall be deemed to be an allowance to be made to him for the first subsequent year of assessment for the basis period for which there is adjusted income from that business, and so on for subsequent years of assessment until the whole amount of the allowance or that aggregate amount to be made to him has been made to him".

For ease of understanding of Paragraph 75, Illustration 3 depicts the following picture.

<u>Illustration 3:</u>

Capital Allowance	$ (50,000)
Adjusted Loss	<u>(1,000,000)</u>

The Capital Allowance of $(50,000) is carried forward.

<u>Illustration 4</u>

In a hypothetical situation, where an admissible Business Interruption insurance claim on depreciation arises along the following scenario, the CA would operate within the ambit of the ITA 1967 as demonstrated below.

<u>Scenario</u>

- Company A purchased a machine (asset) for $100,000/-
- Company A effected a Business Interruption insurance policy on Gross Profit.
- In the First year, the Qualifying Capital Expenditure (QCR) of $100,000/- would be subjected to a deduction of $20,000/- for Initial Allowance and Annual Allowance.

- Subsequently there is a fire outbreak at the factory partially damaging the machine.
- Depreciation is listed as a standing charge in the BI policy.

Capital Allowance under ITA 1967

Capital Allowance and Insurance Recovery are separate issues, thus, have to be viewed separately, then, merged at the end against the Residual Expenditure along the following scheme of arrangement:

Qualifying Capital Expenditure		$ 100,000
First Year		
Initial Allowance	RM20,000	
Annual Allowance (20%)	20,000	(40,000)
Residual Expenditure		60,000
Second Year		
Less; Insurance Compensation		(10,000)
Residual Expenditure carried forward		50,000
Less: Annual Allowance		(20,000)
Residual Expenditure carried forward		30,000
Third Year		
Less: Annual Allowance		(20,000)
Residual Expenditure carried forward		10,000
Fourth Year		
Less: Annual Allowance		(10,000)
		NIL

Annual Allowance is a statutory fixated amount designed for granting Capital Allowance and is not based on the life span of the asset.

Basically, the CA is a specie of "clawback" deduction or systemic allocation of depreciable amount of the capital expenditure investment of the material assets over its useful life, a period set by the Act.

The Business Interruption insurance policy takes no cognizance of the term "Capital Allowance'. Hence, the BI insurance policy's meaning of 'Depreciation' is estranged from the MASB and IASB Accounting Standards Practices worldwide as well as the Act.

The shortcoming of the BI insurance policy has to be appropriately addressed by incorporating the technical words "Capital Allowance" expressly defined therein as Depreciation to mean to be in tandem with Schedule 3 of the Act, the MASB and IASB Accounting Standards, in order to avoid the rule of contra proferentem. Any ambiguity will be resolved against the party who framed the contract.

In all the circumstances, Depreciation, which is no longer regarded as a deductible expense, as mentioned above, may be insurable as a Capital Allowance or a selected portion thereof or not insured at all, pursuant to the Fundamental Principle of Indemnity.

It is suggested that the policy schedule of the BI Insurance policy can be appropriately written, with Depreciation as an Optional charge, as set out hereunder:

Illustration 5

Item	Interest Insured	Sum Insured
1	On Gross Profit	$ 10,000,000
2	On Additional Increase in Cost of Working	1.000,000
3	On Accountants' Fees/Charges	100,000
4	On Depreciation[16]	1,000,000
	TOTAL SUMS INSURED	$ 12,100,000

It is wishful thinking to include Optional charge as part of the standing charges. Firstly, standing charges are, strictly, speaking, fixed costs. Optional charge is not so simply because such an expense is contingent upon circumstances rendering it to arise.

Secondly, IF Optional charge were part of the standing charges, it would be subject to the proportionate reduction condition.

Thirdly, Optional charge as a standalone item outside the standing charges obviates the underinsurance factor as it is on a limit of liability basis.

Suggested policy definition of Capital Allowance

"Capital Allowance shall be synonymous with Depreciation so defined as the Allocation of the depreciable amount of an asset over its useful life in the audited financial statements".

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[16] The word, Capital Allowance, may not be expressly provisioned in the audited Financial Statements, in its place, Depreciation is generally provided for in the financial statements. On a Difference Basis of Gross Profit calculation, Capital Allowance/Depreciation may be listed as a Specified Working Expense (Uninsured Working Expense) (SWE/UWE).

It could well be that, mindful of the International Accounting Standards in practice globally, the ITA 1967 and the Income Tax statutes in the British Commonwealth of nations, and other similar jurisdictions, are *in pari materia.*

f) <u>The Authorities</u>

i) <u>Riley on Business Interruption And Consequential Loss Insurances And Claims</u>
First edition by Denis Riley. (Riley)

RIley is conceivably the most renowned, widely acclaimed and foremost authority on Business Interruption insurance, with its first edition by Denis Riley, launched in 1956.

In the preface to its fifth edition of Riley, the learned author averred, among other things, "There are many diverse circumstances in the world of industry and commerce, **accountancy practice varies considerably in the treatment of company accounts**, (emphasis added) and above all it is impossible to visualise all the unpredictable conditions which after a fire materialise in connection with any individual business. Hence, **it is essential to consider any such insurance in the context of the circumstances of the particular business and to apply the accepted principles in the ways which seem most appropriate, which may mean that one cannot always "go by the book**"'[17] (Emphasis added)

Reference is made here to the sixth edition to Riley updated and edited by David Cloughton BA (Hons); FCII, published in 1985.

At paragraph 174[18], David Cloughton asserted, inter alia, **Depreciation** "**often gives rise to the argument that it is not a standing charge** because if building and plant are destroyed depreciation will either cease altogether or be reduced in proportion to the amount of damage done. But as explained in the preamble…'

In the preamble at paragraph 121[19], David Cloughton added "….**some charges** may be termed borderline and some **are definitely optional**" (Emphasis added).

Back to paragraph 174, the learned author echoed Denis Riley that "There is a further **reason for insuring depreciation**. **There is no uniformity in the accountancy practice in the method of calculating depreciation"** (Emphasis added).

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[17] Sat paragraph 5 of Preface to Fifth edition of Riley (1981).
[18] At page 145 of Riley.
[19] At page 111 of Riley

It is rather preposterous that the reason for insuring depreciation is attributed to inconsistency in the accounting practices on depreciation.

Moving on the same paragraph 121, Riley asserted that the "the fundamental principle that in order to protect the net profit of a business it is essential to insure net profit plus those charges which will not fall proportionately with a drop in turnover. From this a working definition can be drawn, namely, that ***an insurable standing charge is one which might not diminish proportionately with a reduction in turnover if there is interruption of or interference with the business by any of the contingencies insured against***. to which an important addition must be made – *or any* ***variable charge which it would be desirable to continue in the interest of the business***. (emphasis in italics) **Those in the latter category are referred to as <u>optional charges</u>**" (emphasis in italics).

In a nutshell, it is irrefutable, there are such expenses termed as **optional charges,** (emphasis added) but for reasons unknown, these charges are not heard of in the Difference Basis of Gross Profit calculation. Where did it go wrong?

The advent of the International Accounting Standards (IAS Standards) worldwide[20] has thus demolished the proposition that the reason for insuring depreciation is that the accountancy practice varies or no uniformity of accountancy practice.

As mentioned above, Riley recognized the existence of optional charges.

ii) <u>Principles and Practice of Interruption Insurance.</u>
First edition (1982) by GJR Hickmott MBE, FCII, FCI Arb. (Hickmott)

On Depreciation[21], Hickmott averred "what may be termed as ***normal depreciation*,** (emphasis in italics added) which in other words may be defined as:

> A **charge against income** of that portion of the cost of fixed assets deemed to have been consumed during the period under review" (emphasis mine)

Hickmott added "it is an accepted accounting standard that the appraised **charge** for depreciation must be made **against revenue** before the determination of net profit."(emphasis mine).

By way of an illustration, Hickmott referred to the Addition Basis policy on the subject-matter of depreciation, with a particular reference to the definition of Net Profit:

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[20] Latest report indicated 168 countries use the IASs globally.
[21] At page 138 of Hickmott

> "Net Profit. – The net trading profit (exclusive of all capital receipts and accretions, and all outlay properly chargeable to capital) resulting from the business of the insured at the premises after ***due provisions have been made for all standing and other charges including depreciation***" (emphasis in italics).

It can be seen that, firstly, the word "Depreciation" is purposely set apart from **standing and other charges** (emphasis mine). And secondly, Hickmott's assertion that "… the charge for depreciation must be made against revenue" corresponded with the provisions of the ITA 1967 (see Illustrations 1, 2 & 3).

The learned author went on to add[22]:

" **The definition does not say that depreciation is a standing charge,** but it observes the accounting standard that there must be charged against gross income "due provision ….for….depreciation" before the net profits is determined"(emphasis mine).

However, subsequently[23], there is a contradiction by Hickmott that "**Depreciation of fixed assets is a standing charge".** If Depreciation were a standing charge, the definition of Net Profit ought not to extend the wording " .**including depreciation**,"(emphasis mine) as depreciation per se would be already all inclusive in the standing charges.

It is trite law that where a definition did not expressly define depreciation is a standing charge, it would be presumptuous to say so.
Additionally, there would be confusion that on one hand, to say,"the definition does not say that depreciation is a standing charge" and on the other hand, adding "depreciation of fixed assets is a standing charge".

In fairness, First edition of Hickmott pre-dated the IFRS Accounting Standards (IAS).

Summarily, it has to be mentioned that it is most disconcerting to observe, notwithstanding the advancement of IFRS Accounting Standards, there are schools of thought still subscribing to the notion "Depreciation is a Standing charge'.

On **<u>optional charges</u>**, Hickmott dedicated a paragraph[24] to mention "it is customary, however, to permit the insurance of <u>certain other charges</u> which <u>may be</u> <u>classed as optional……. charges</u>…the business might want to maintain or consider it politic or expedient to maintain undiminished….. during the interruption period, such as,…wages of certain classes of employees, advertising (except under contract),

[22] At paragraph 5 of page 138
[23] At page 140, paragraph 1 of Hickmott
[24] At page 128 of Hickmott

donations (except as pledged). It is **common practice to insure such expenses as standing charges** if the client so wishes...". (emphasis mine).

It is surmised that insuring optional charges as standing charges would be subject to the proportionate reduction (average) condition whereas insuring Depreciation, as a standalone item with a limit of liability basis[25] would escape this condition.

Going further, in order to avoid any confusion and misconception on the understanding of depreciation, it would be necessary to quote Hickmott[26] that

> "When the insured standing charge of depreciation is thus described it is not to be construed as meaning that the insured charge is merely that proportion of depreciation that remains to be charged in respect of assets not destroyed. The **insured charge is the full annual depreciation charge on the fixed asset as existing prior to the fire**. If the assets are destroyed or damaged, as a result the charge ceases or is reduced, the amount of **cessation of reduction** must **be treated as savings** in the insured standing charge"[27](emphasis mine).

iii) <u>Business Interruption Insurance; Theory and Practice</u>
First edition (1992) by Edwin H. Gamlen FCII, and John H.P. Phillips FCII
(Gamlen & Phillips)

The learned authors opined that Depreciation " in the Accounts is the writing down in value of the assets of the firm. ….it is a reduction in the amount of Net Profit and constitutes the creation of a reserve for the future purchase of replacement assets[28].".

The first limb of their statement is in line with the provisions of the Act[29] while the second limb is not so.

They concluded that "Depreciation[30] is treated as a standing charge" . Here, it is unclear as to why did the learned authors aver 'Depreciation is **treated** as a standing charge,' instead of simply stating 'Depreciation is a standing charge'? (emphasis mine). Notwithstanding the semantics, these are different connotations, for example, 'John is treated as Tom's son' as compared to 'John is Tom's son'.

Further, 'Depreciation is treated as a standing charge' would appear to be inconsistent with the narrative that depreciation" is a reduction in the amount of the

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[25] Ibid, 7
[26] At page 523 paragraph 1 of Hickmott
[27] Polikoff Ltd v North British and Mercantile Insurance Co, Ltd (1936) 55 L1. L. Rep. 279
[28] At page 14, paragraph 3.07 of Gamlen & Phillips
[29] Ibid 3, 4 and 5
[30] At page 15 of Gamlen & Phillips.

Net Profit and constitutes the creation of a reserve for the future purchases of replacement assets" (see the opening paragraph above).

According to Hickmott, the term "standing charge[31]" connotes something that is substantially invariable – a charge which must continue payable out of earnings while earnings continue and out of capital when earnings cease".

In any case, Gamlen & Phillips pre-dated the IFRS Accounting Standards.

iv) <u>All Risks Property Insurance</u>

Second edition (1999) by John Hanson M.A. (Oxon), and Christopher Henley LL.B, FCII. (Hanson)

Hanson at page 213 under the heading of 'Business Interruption' stated that

"Depreciation is charged as an expense or cost in arriving at the net profit of the business[32].

Where the depreciation of an asset is totally or largely dependent on usage, then, like raw materials, an interruption in the use of the asset will halt or substantially reduce its depreciation. Where this is clearly the case the insured may wish to regard depreciation as a variable cost to be deducted in arriving at the gross profit"[33]

v) <u>Company Accounts</u>

Second edition 1978 by J.O. Magee[34] FCA; Depreciation at pages 212-213

"Depreciation. When a business owns fixed assets it is the normal practice to write these off over their lifetime by means of a depreciation charge which is debited in the Profit and Loss Account. The corresponding credit will be made in the asset account concerned (or in a Depreciation Provision Account).

The important point to be appreciated here is that a double entry of this kind does not involve any payment, i.e. there is no reduction in the amount of cash held by the business. It is simply a book-keeping entry. All that happens is that the book value of a fixed asset is arbitrarily reduced and profits are reduced by the same amount. It follows, therefore, that the working capital is not reduced because depreciation only affects fixed assets and not current assets."

vi) <u>Mobis Parts Australia Pty Ltd v XL Insurance Company SE</u>[35]

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[31] At page 128 of Hickmott.
[32] At paragraph 1 of Hanson
[33] At paragraph 2 of Hanson
[34] Formerly Principal Lecturer in Accountancy at the Polytechnic of North London.
[35] Mobis Parts Australia Pty Ltd v XL Insurance Company SE [2018] NSWCA 342.

The New South Wales (NSW) Court of Appeal held, in a landmark judgment, that **depreciation is not a charge or expense** "payable" out of Gross Profit, according to the formula of the Industrial Special Risks (ISR) policy, as such, **not a saving,** unanimously overturned the decision of the trial judge at first instance. (emphasis mine).

The trial judge's decision was premised on a UK High Court's decision in the Synergy[36] case (which was misguided) holding depreciation, being no longer an expense in the accounts, was a saving, therefore, to be deducted from the Gross Profit claim.

The NSW Court of Appeal thoroughly explored the actual meaning and correct interpretation of depreciation on profit, defined depreciation as

> "the systemic allocation of a tangible asset's cost (less its anticipated scrap value) as a series of expenses over its expected useful life…Each depreciation expense appears in the income statement as an expense deducted from gross profit for the purpose of calculating net profit but the process of depreciation has no direct impact on cash flows."

It can be seen that the learned Lordships had taken a leaf out of IAS 16[37] and the Company Accounts[38] in reaching their decision as a leading authority[39] on depreciation in business interruption insurance practice.

The NSW Court of Appeal decided that the word "payable" in the policy wording "payable out of Gross Profit" contrary to the word "deducted" suggested the exclusion of charges and expenses that are not liable to be paid away, such as depreciation.

In the process, the Appeal Court specifically drew attention to the language used in method of determining the loss as coloured by its immediate and commercial context.[40]

It is interesting to note that contrary to the norm on the principle of indemnity, the NSW Court of Appeal held that the indemnity in the ISR policy is not against "actual loss", rather it contains a formula and there was nothing in the context of the clause which required any departure from the language used.

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[36] Synergy Health (UK) Ltd v CGU Insurance Plc [2010] EWHC 2583

[37] Ibid, 3

[38] Ibid, 11

[39] In Malaysia and other countries practising English Law, Mobis case is a persuasive authority.

[40] Mount Bruce Mining Pty Ltd v Wright Prospecting Pty Ltd (2015) 256 CLR 104

vii) <u>Business Interruption Policy Wordings (Research Study Group 265's Report</u> (2024 edition)

The RSG's report on definition of Depreciation[41] succinctly stated:

> "The policy usually allows the insured to select the costs (variously described as Specified Working Expenses, Variable Costs, or Uninsured Working expenses) to be deducted from turnover (or Revenue, Takings, or Sales) in defining Gross Profit. This is intended as a benefit rather than a complication, because it means that the **purchaser** of the insurance (who **has the best understanding of their own business**) **can decide** on what will make **the cover most meaningful** to them." (emphasis mine).

Moving further, the RSG report proposed a potential solution[42] that "the term 'standing charge' should be abandoned because it is not a term in general use and thus has no generally accepted meaning." On this note, those, who advocate "Depreciation is a standing charge, no doubt, would take exception to this viewpoint.

The better alternative solution is to insure Depreciation as an Optional charge on a standalone item basis with a discretionary minimal sum insured, devoid of the underinsurance factor, as shown in Illustrations 5 and 8. In this order, all or any risk of the policyholder receiving more than a full indemnity is eliminated.

In a matter of comparison, the example of the leasing equipment company[43] in the RSG's report is analogous to the manufacturing plant described in the Introduction[44] and in Illustration 8 at Column II,[45] where, in all instances, the sum of depreciation is disproportionate in the Gross Profit.

With the kind permission and approval of the IIL and CILA, as well as the RSG, and for the benefits of its members, associates and affiliates, for the sake of clarification, pertinent extracts relating to the Equipment Leasing Company are set out in the following box:

<u>Illustration 6</u>

<u>Business Insured:</u> Equipment leasing company

[41] At paragraph 1.1.1 of page 21 of RSG's report.
[42] At paragraph 1.2.4 of page 26 of RSG's report
[43] At pages 75 & 76, paragraph 4.4.2 of the RSG report
[44] Ibid, 2
[45] Ibid, 15

Nature of Trade: Rental of electronic testing equipment to the aviation and telecommunications industries. Uninsured Working Expenses: Purchases (largest item) not converted to stock for sale Rate of Gross Profit (RGP): Unusually high 90%, Depreciation 50% of Operating costs Claim for rental loss: £15m Loss of GP : £15m x 90% = £13.5m Depreciation: £7.2m Net Amount payable:: £6.3m (£13.5 - £7.2m) net of depreciation Recommendation: Amend savings clause whether saving should or should not include depreciation.

As indicated above, the RSG 265 report had suggested an amendment[46] to the savings clause, with a view to resolve the matter.
It is submitted that to all intents and purposes, there is no need to amend the savings clause, which is a sacrosanct, well-entrenched and infallible mechanism applicable across the board to all standing charges, not depreciation alone, but simply insure "Depreciation Charge," as a standalone item, under the Interests Insured, as shown in Illustrations 5[47] and 9[48].

The Insured's accountant would be in the best position[49] to advise a suitable figure for the insurable Depreciation charge on a limit of liability basis, thus, the Insured would be the self-insurer for any loss in excess of the policy limit.

Addition Basis v Difference Basis

At the outset, the Addition Basis of Gross Profit was the order of the day. In that era, depreciation expense crystal clearly stated in the financial statements were premised on an archaic accounting system.

Addition Basis is a simple process of adding selected standing charges to the net profit to produce gross profit. In a net loss situation, standing charges will exacerbate this net loss.

Standing charges were extracted from the audited accounts.

[46] At page 76 of the RSG's report.
[47] Ibid, 7
[48] Ibid, 18
[49] Ibid, 13 – paraphrase "The purchaser has the best understanding of their own business to decide the cover".

By its own volition, the Addition Basis is contractual and mandatory in law as evidenced from its definition of Net Profit.[50]

In essence, therefore, Depreciation is, by way of contract, formalised as a standing charge.

Both insurer and insured were bound by the contract of BI insurance policy. As such, there was no room for dispute or argument.

Fast forward, the Difference Basis of Gross Profit operates under a different protocol by way of a formula simplified Illustration 7 below:

Illustration 7

Turnover		$	xx,xxx,xxx
Closing stock			xxx,xxxx
		$	xx,xxx,xxx
Less			
Opening stock	xxx,xxx		
Purchases	x,xxx,xxx		
Specified Working Expenses	xxx,xxx		x,xxx,xxx
GROSS PROFIT AS DEFINED		$	x,xxx,xxx

The words 'Gross Profit as defined' is to distinguish it from the standard accounting statement Gross Profit which followed a different regime.

The Difference Basis "obviates a definition of net profit, and, in consequence, emphasizes that the profits Insurance is concerned with the gross profit as a whole and not with the individual standing charges or net profit separately. Thus, it deals with an exceptional charge automatically, whereas the addition basis always leads to difficulty in respect of such items"[51]

The Gross Profit Difference Basis wording is subject to the following provisions[52]

N.B. 1
The amount of the Opening and Closing Stocks shall be arrived at in accordance with the Insured's normal accountancy methods, due provision being made for depreciation.
N.B. 2
The words and expressions used in this Definitions shall have the meaning usually attached to them in the books and accounts of the Insured unless otherwise

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[50] Ibid 8
[51] At page 37, paragraph 4 of "Insurance of Profits' by A.G. Macken and G.J.R. Hickmott.
[52] Revised Fire Tariff, Section 3, Rule 9.1, at page 3-25

defined in this specification.

In the matter of normal accountancy methods, (N.B. 1) due provision being made for depreciation refers to the provisions of ITA 1967, vis-à-vis, Capital Allowance.

It is trite that normal accountancy methods would have to be in consonant with the ITA 1967 which regulates the insured's books and accounts, otherwise, such provision (N.B. 1) would be ultra vires.

As can be seen the word "Depreciation" is no longer a specified contractual standing charge.

In the Difference Basis of calculation of Gross Profit, when depreciation is not listed in the Specified Working Expenses (SWE) listing, it would automatically become inclusive in the Gross Profit by definition.

Conversely, when depreciation is listed in the SWE, it is automatically excluded in the Gross Profit by definition.

A comparative study of the Gross Profit with (Column I) and without depreciation (Column II) is set out in the box marked Illustration 8 hereunder.

For the sake of simplicity, the following illustration, using modulated figures, would illuminate the complexity of the process of Gross Profit as defined.

Illustration 8

		Column i SWE including Depreciation	**Column II SWE excluding Depreciation**
		$	$
Turnover		28,000,000	28,000,000
Closing Stock		1,200,000	1,200,000
		29,200,000	29,200,000
Less			
Opening Stock	2,600,000		
Purchases	14,500,000		

Specified Working Expenses			
O & G expenses	410,000		
Lab. expenses	272,000		
Wages	1,650,000		
Transportation	362,000		
Waste expenses	185,000		
Cess	124,000		
QC charges	284,000		
Factory charges	1,780,000		
Depreciation	4,126,000	26,293,000	22,167,000
GROSS PROFIT AS DEFINED		2,907,000	7,033,000
Column I			
Rate of GP			
2,907,000 x	100 = 10.38 %		
28,000,000			
Column II			
Rate of GP			
7,033,000 x	100 = 25.11 %		
28,000,000			

Modulated figures are used for illustration purposes only. Any similarities or resemblance with past, present and future cases are purely coincidental, unintentional and unrelated.

Those who advocate that depreciation is not a standing charge (Column I), then the rate of gross profit is 10.38%.

Many who believe depreciation is a standing charge (Column II), the rate of gross profit is 25.11%.

The rate of 25.11% is incongruous and unrealistic when compared with the manufacturing industry's benchmark of gross profit margin of between 9.00 % to possibly 15.00 % as a primary producer or source of the bulk mass product.

It is remarkable that the rate of depreciation at 14.74 % to the turnover disproportionately exceeded the rate of gross profit excluding depreciation (10.38 %) as seen below:

$$\frac{4{,}126{,}000}{28{,}000{,}000} \times 100 = 14.74\,\%$$

In all circumstances, it would be highly improbable that the depreciation of $4 million will be completely lost or indemnified, in the event of a Business interruption loss, bearing in mind, the plant and machinery are mandatorily well designated and spaced apart in compliance with the Factories & Machinery Act 1967 (Act 139).

The depreciation in Column ii above may well be subject to proportionate reduction (average).

For the purpose of insuring depreciation as an Optional charge, Column 1 is applicable, following that, depreciation can be insured as an Optional charge[53] in full or a discretionary portion thereof or not insured at all, on a standalone basis, as an item of the policy schedule, with a limit of liability. (see Illustration 5).

In a peculiar situation where the SWE has no listing of the specified expenses (completely blank) then, the option would rest with the Insured in accordance with their books and accounts, pursuant to N.B. 2 above[54] On this note, the Insured is at liberty to include or exclude Depreciation with a view to reflect the Business insured as a whole.

Furthermore, in the Difference Basis, depreciation, (as a Capital Allowance) is actually deducted from the Net Profit at source in consonant with the ITA 1967.

It can be seen that learned authorities, such as Riley[55] and Hickmott,[56] had bravely delved into the application of Depreciation as an optional charge. Unfortunately, since then, no other authorities have broached on Depreciation as an optional charge.

Variable costs which are not listed in the SWE do not automatically become standing charges in the Gross Profit by way of definition as shown in Illustration 6.

A variable cost could not become a standing charge, not even by definition of the gross profit. Unfortunately, some die-hard professionals would 'stick to their guns' that a variable cost is a standing charge simply because it is not listed in the SWE.

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[53] Ibid 7
[54] Ibid 11
[55] Ibid 8
[56] Ibid 9

Depreciation in Gross Revenue[57]

Gross Revenue is the basis of BI cover for the service industry.

The service industry comprises businesses of accountants, architects, lawyers, engineers, doctors, hotels and other professional service undertakers.

Save for boutique and high-tech professional service firms having substantial investments in fixed assets, for those income solely from services, variable charges are negligible or are excluded in the definition of income.[58]

In the same manner, depreciation, among others, can be written as a SWE, with an option to either insure it, as a separate item with a selected limit of liability, or not insured at all.

The policy schedule can be written along the following Illustration 9.

Illustration 9

Item	Interest insured	Sum Insured
1	On Gross Revenue	$10,000,000
2	On Additional Increase IN Cost of Working	1,000,000
3	On Accountants' Fees/Charges	100,000
4	On Depreciation	200,000
	Total Sum Insured	$11,300,000

Irreconcilability between the Principle of Depreciation ("PD") and the Principle of Indemnity ("PI")

PD is related to a "past event" in which the diminishing value of the asset had been accounted for in the financial statement.

PI is concerned with the "future event" called interruption (indemnity) period in which the BI loss is assessed appropriately termed "what would have been but for the loss".

Following a BI loss, the indemnity period commences from the date of loss (DOL) until the date the turnover has returned to normal, within the maximum period of indemnity insured or otherwise.

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[57] Gross Revenue, Fees, Income, Commission and Receipts are synonymous.
[58] At para 308, page 256 of Riley.

It follows that the Gross Profit (GP) is derived from the last financial statement, anterior to the said loss, using the Difference Basis of calculation.

Typically, the gross profit as defined, inclusive of depreciation, is factored to arrive at the Rate of Gross Profit (RGP).

In a nutshell, the "past event" as per financial statement is based on facts whereas the "future event", that is, what would have been but for the loss, is based on a calculated speculation, not facts. would be subject to an audit exercise and the Inland Revenue Board's final valuation. As such, the calculated speculation on depreciation is merely a provision.

Conclusion

In the final analysis, it is noteworthy that despite the fact that the MASB, IASB, Inland Revenue Board, and other authorities and professional bodies do not regard Depreciation as a fixed cost, it defies logic as to why those in the insurance sector continue to pontificate depreciation as a fixed cost?

It is axiomatic that Depreciation is an allocation simpliciter designed for specific purpose of its facsimile Capital Allowance to be deducted from the Net Profit of the business as at the financial year-end.

Just picture this, what one's business put in as a capital to purchase an asset, later, one recovers one's same capital (in the guise of depreciation), as allowed by law, in the form of Capital Allowance from one's own Net Profit of the business at the close of the financial year. Hence, the Capital Allowance is regarded as a redeemable credit against the Net Profit, sanctioned by law, in reduction of tax liability during that year of assessment. There is no movement of cash flow.

Another aspect, it would seem incredulous to the Business insured that, in a short-term interruption period, attributed to an insured peril, indemnity for admissible depreciation, as a standing charge, will be pro-rated to that period, the remainder period provision, or allocation, is regarded as savings[59]. Since depreciation is deducted from net profit, whatever savings ought to revert to the net profit, thus, increasing it as part of the policy indemnity for loss of Net Profit.

In closing, in good conscience, it would only be reasonable and equitable for the insured to have a freedom of choice, whether or not, to insure Depreciation or a part of it or not insured at all, as an optional item.

[59] Ibid 10

Lastly, let's give credit to the Finance Director, Finance Manager, Accountants and internal auditors for their insider's knowledge of the depreciation structure of the company assets.

Without a shadow of doubt, they are the most reliable and trustworthy frontline sources of priceless information on the depreciation aspect of the assets of the Business insured.

The bottom line is that these frontline sources would be able to save millions in premiums by selective Sum Insured on Depreciation as an Optional Charge. Excessive premiums incurred for Depreciation cover as a standing charge are simply an economic waste and a delusion.

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