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THE PROPERTY INSURANCE SEESAW – THE IMPORTANCE OF ACCURATE VALUES

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Inaccurate values in the commercial property insurance placement process can have significant financial implications on a company. Over reported values can cause a company to carry more insurance than necessary. Being over insured means a company is likely paying unnecessary premiums. On the other hand, and an even worse scenario, is a company with under reported values. In this case the opposite is true. Even though a company would likely be paying less for premiums, if that company suffers from a loss, the financial impact could be devastating. The destruction caused by Hurricane Katrina in 2005 has forced this issue into the spotlight. It is very easy for decision makers to be driven by premium costs, but having accurate values is the key to balancing a company's insurance need.

Depending on the company seeking insurance and the specific type of coverage, the level of involvement by the individuals associated with the placement process can vary greatly. Most would consider each of the individuals involved in the placement process as insurance experts. While each of these individuals is very knowledgeable about the many different aspects of insurance, there is an inherent lack of expertise when you get into the specific coverage areas. This lack of specific expertise is what creates an environment for potential inaccurate values.

The typical property insurance policy provides many different areas of coverage for businesses. It is important to note that most insurance policies specifically state that the insurance company is not responsible for determining the amount of coverage required. Each of the major property coverage areas faces its own particular challenges when determining the values. While the consequences of inaccurate values apply to each area of commercial property coverage, only some of the major coverage areas are discussed below.

Real Property

Generally, the definition of “Insurable Value” for real property is its replacement cost in the event of the physical loss of an asset or assets. Because of a lack of understanding of what constitutes

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Insurable Value, many risk managers rely on Market Value or Book Value to determine the amount of property insurance coverage they should carry. It is important for risk managers, be they corporate staff or individual property owners, to understand that the Insurable Value of a property can vary significantly from its Market Value or Book Value and actually lead to increased risk scenarios.

Market Value for real estate appraisals is often determined by the cost approach, one of three approaches to value traditionally used in the appraisal profession. In the cost approach, the depreciated replacement cost of a property is an indication of a property's Market Value. It is determined by estimating the replacement cost of all building and site improvements, less all forms of depreciation, plus the value of the underlying site. By contrast, Insurable Value is the cost to replace an insured asset with a like-kind replacement without consideration for any depreciation that may exist. Insurable Value includes construction, installation and sometimes demolition costs, but does not include the value of the site, below-ground improvements such as utility lines and concrete foundations – i.e., items that would not typically be destroyed in the event of a natural disaster.

It is also not uncommon for Book Value to be used to determine insurance requirements even though Book Value has little to do with the replacement cost of an asset. Book Value is an accounting term generally defined as the value of an asset as it appears on a company's balance sheet. It is determined by the historic cost of assets less accumulated depreciation, the latter often being an accounting formula rather than market forces. And as with Market Value, the components included in Book Value are typically not the same as those considered in an Insurable Value estimate.

Business Personal Property

A typical insurance policy will define value as the replacement cost of the property. In practice, the value that is commonly used for insurance is the current cost to purchase a new, identical or similar asset plus installation costs. When faced with the task of providing an estimate of the insurable value of business personal property, a risk manager may choose to use internal resources or hire an independent appraiser. In either scenario, one of the following three methods will likely be used:

1. Prepare a complete inventory of the contents and then value each item.
2. Utilize the company's fixed asset records and make adjustments to arrive at replacement cost.
3. Apply a "rule-of-thumb" or calculator method in which cost is estimated based on certain factors such as production volume or building square footage.

The primary advantage of creating a complete inventory of the contents is that it provides the most accurate and therefore most reliable estimate of value. Creating an inventory of a company's personal property and assigning the appropriate value to each item can be time consuming. When this method is used, it is almost always performed by professional appraisers who have the training, experience and access to information resources that allow them to be highly efficient. In the event of a loss, a professionally prepared and valued inventory, held safely off-site by the appraiser, can be quickly updated and used to expedite the claim process.

While the use of fixed asset records is typically less expensive than performing an inventory, this method has certain inherent pitfalls. When fixed asset records are used to estimate replacement cost, adjustments are commonly made to account for the increase in costs over time. A simple approach is to adjust the cost of the assets to account for inflation as measured by the Consumer Price Index (“CPI”). However, the cost of certain raw materials (such as steel and copper) used in many capital assets can increase much faster than the CPI, resulting in a replacement cost that exceeds the CPI adjusted replacement cost.

In addition, fixed asset records also include costs that should not be included in the insurable value. Besides excluded property that is insured separately (e.g., licensed vehicles and industrial boilers), the records may include intangible property or costs of repairs, modification or relocation the asset. Fixed asset records may also be unreliable if assets have been purchased used or if the company has been acquired. In the acquisition scenario, the purchase price is commonly allocated to the assets. Quantity discounts, pricing incentives or trade-in allowances can also distort the purchase price displayed in the records, causing inaccurate cost estimates.

The quickest method to estimate Insurable Value is to use a “rule-of-thumb” or calculator method. These methods rely on unit costs, such as replacement cost per square foot or cost per unit of production, developed from similar properties. Even when used by an experienced estimator with a clear understanding of the facts and circumstances used to develop the unit cost, it is likely that the value will be somewhat inaccurate. An inexperienced estimator may come to conclusions that can leave the insured dangerously under insured or paying excessive premiums.

Business Interruption

Business interruption coverage is intended to cover the net profit and expenses that continue when a company suffers from a covered peril. The most important issue to note about the business interruption coverage placement process is the difference between the information analyzed in the claim process compared to the information relied upon in the placement process. A simple business interruption claim analysis will commonly include a review of historical monthly income statements, payroll records and financial budgets or forecasts. The period reviewed typically will include one to two years of historical information. A more complex business interruption claim can include a review of detailed production quantities, shipping records, invoices from outsourcing, and a whole host of other financial information. The historical information reviewed can go back as far as five years. Unfortunately, this level of detail is rarely reviewed when placing business interruption coverage.

An almost unlimited number of variables impact a business interruption claim calculation such as the time of year, market prices and condition, competition, etc. One important factor that impacts a claim is a company’s Business Continuity Plan (BCP). A BCP is an entity’s plan to continue operations in a business disruption scenario. Some businesses have formal plans in place; while others have very informal plans. A company’s BCP could be the most important factor to consider when placing coverage. This is because many businesses will be able to mitigate a loss, to some degree, subsequent to an interruption of business. Mitigation can come in many forms, such as operating from a temporary facility. Mitigation opportunities can differ greatly between businesses and can significantly impact the business interruption exposure.

In most cases, because of mitigation opportunities, the maximum potential business interruption loss exposure is far greater than the realistic exposure in a total loss scenario. Maximum loss exposure is equal to sales minus all expenses that would discontinue in a total loss scenario, such as cost of goods sold.

XYZ Widget Manufacturing Co.		Figure 1	
Income Statement			
Fiscal Year Ending 2006			
	Total 2006	Total 2006 – Loss Scenario	[Difference] Business Interruption Exposure
Sales	\$ 1,662,452	\$ 0	\$ 1,662,452
Cost of Goods Sold	498,735	0	498,735
Gross Profit	1,163,717	0	1,163,717
Operating Expenses:			
Salaries and Wages	378,230	324,894	53,336
Employee Benefits	113,469	97,468	16,001
Direct Operating Expenses	39,100	0	39,100
Marketing	25,980	25,980	0
Utility Services	78,543	12,024	66,519
General and Administrative	45,082	28,424	16,658
Repairs and Maintenance	89,754	3,510	86,244
Occupancy Costs	45,024	45,024	0
Depreciation	54,239	54,239	0
Total Operating Expenses	869,421	591,563	277,858
Net Income / (Loss)	\$ 294,296	(\$ 591,563)	\$ 885,859

The above illustration shows a manufacturer’s income statement from 2006. The first column labeled “Total 2006” represents the actual results from operations in 2006. The second column represents what this income statement hypothetically would have looked like if they would have suffered from a total loss during 2006. The difference column equates to their maximum business interruption exposure.

In this example you will see that Sales in the loss scenario are \$0. This is true for Cost of Goods Sold as the expense is 100% variable with sales. Looking at the “Operating Expenses” you will notice their behavior in the loss scenario differs greatly between expenses, which is due to the unique nature of each expense.

Note the net Business Interruption Exposure amount totals \$885,859. This amount represents the annual total maximum business interruption exposure for XYZ Manufacturing Company. The problem with this scenario is that it assumes that XYZ would do nothing while they were down. In figure 2 below the amounts have been modified to consider the impact of XYZ’s loss mitigation efforts.

XYZ Widget Manufacturing Co. Income Statement Fiscal Year Ending 2006	Figure 2		
	Total 2006	Total 2006 – Loss Scenario	[Difference] Business Interruption Exposure
Sales	\$ 1,662,452	\$ 1,496,207	\$ 166,245
Cost of Goods Sold	498,735	897,724	(398,989)
Gross Profit	1,163,717	598,483	565,234
Operating Expenses:			
Salaries and Wages	378,230	324,894	53,336
Employee Benefits	113,469	97,468	16,001
Direct Operating Expenses	39,100	0	39,100
Marketing	25,980	25,980	0
Utility Services	78,543	12,024	66,519
General and Administrative	45,082	28,424	16,658
Repairs and Maintenance	89,754	3,510	86,244
Occupancy Costs	45,024	45,024	0
Depreciation	54,239	54,239	0
Total Operating Expenses	869,421	591,563	277,858
Net Income / (Loss)	\$ 294,296	\$ 6,920	\$ 287,376

This example illustrates a common scenario where XYZ was able to outsource production. While the Cost of Goods Sold was twice as much as it would have cost XYZ to manufacture the goods themselves, they were able to sell 90% of the goods that they would have. The behavior of the “Operating Expenses” remains the same in the loss mitigation scenario. Thus, you will notice that, in this more realistic scenario, the business interruption exposure is only \$287,376.

This amount is significantly less than the maximum exposure amount calculated in figure 1. While this is an oversimplified version of a realistic loss scenario, the likelihood of loss mitigation for many companies is very realistic. Obviously, the more product lines, facilities and locations that are added to the equation the more complex the analysis becomes.

The example discussed above focused on being over insured because of loss mitigation opportunities not considered in the placement process. However, it is just as easy to end up under insured if the right information is not considered. An under insured situation can be even worse than being over insured. In an over insured scenario, the greatest financial exposure to the policyholder is the extra premium amount. However, in a under insured scenario the policyholders exposure can be far greater because of the potential for losses that could exceed policy limits.

Conclusion

A closer look at the information used to calculate and establish premiums, as well as limits and insurable values on real property, business personal property and business interruption should be reviewed in greater detail in order to minimize exposure in the event of loss. Because the individuals

involved in the insurance placement process typically lack the resources and expertise to determine accurate insurable values, becoming more informed of the specific coverage areas will allow for better decision making. Individuals should also consider utilizing experts and the analyses they can perform, which can be invaluable tools for risk managers and brokers when placing coverage and taking the risk to market.