Property Insurance Values ... *It's That Time Again*

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Every year companies go through the annual tradition of renewing their property insurance. Larger corporations have dedicated risk managers who are responsible for this transfer of risk, along with many other insurance related tasks.

For companies that do not have a dedicated risk manager or risk management team, insurance responsibilities typically fall to other executives who may have other unrelated responsibilities. Unfortunately, for many of these executives, insurance is a secondary function and not a primary focus. In this case, the property values used during the renewal may not get the attention they require, which could equate to a direct financial impact to a company.

Overstated values consequently cause a company to carry more insurance than necessary and pay excessive premiums. On the other hand, an even worse scenario is a company with understated values. Even though a company would likely be paying less for premiums, the financial impact could be devastating if that company suffers a loss. Unfortunately, we work with policyholders in claim scenarios on a daily basis who are not adequately insured. As may be expected, underinsured losses create serious financial and operational issues. I have seen extreme examples where companies were put out of business after suffering a loss because they were underinsured.

Below I explore some of the valuation issues surrounding each of the three major property insurance claim categories.

Real Property

Generally, the definition of "Insurable Value" for real property is its replacement cost. Because of a lack of understanding of what constitutes Insurable Value, many people rely on Market Value or Book Value to determine the amount of property insurance coverage they should carry. It is important to understand that the Insurable Value of real property can vary significantly from its Market Value or Book Value, and more than likely this method is not an accurate basis for Insurable Values.

Insurable Value is the cost to replace an insured asset with property of like kind and quality without consideration for any depreciation that may exist. It also includes construction, installation and demolition costs, but does not include the value of the site itself, any below-ground improvements (such as utility lines) and concrete foundations. These are items that would not typically be destroyed in a covered peril.

The reason that Market Value is not an accurate basis for insurance valuation is because it represents what a buyer would be willing to pay for a piece of property. This has nothing to do with the cost to replace that asset. The Market Value of a property is instead driven by such things as the location and condition of the property. For example, a warehouse located in a rural setting would have a significantly higher market value if it was moved to a metropolitan area. However, the insurable replacement cost may be similar regardless of this geographic change. In regard to the condition of a property, a new facility will have a higher Market Value than a facility of the same size, use and location that is 40 years old and not well maintained. In spite of the age difference, however, the actual cost to replace each facility could be identical.

It is also not uncommon for Book Value to be used to determine the insurance valuation, even though it 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 mainly for income tax purposes. It is calculated by taking the historic cost of assets less accumulated depreciation, which is an accounting formula rather than consideration of market forces. Since assets can be fully depreciated, and therefore have a Book Value of $0 (common with older assets), its' replacement cost may be similar to a facility many decades younger. This point illustrates why Book Value may not be an accurate measure for the insurable replacement cost.

Business Personal Property

Similar to Real Property, the Insurable Value of the Business Personal Property is the cost to replace the damaged asset. When estimating the replacement costs of Business Personal Property you also must consider related costs, such as installation and shipping. These ancillary costs can equate to a material portion of the replacement and frequently exceed the equipment cost for large complex large pieces of machinery and equipment.

Whether you are estimating the insurable values internally or utilizing an expert independent appraiser, there are standard methods that will likely be considered. You may create a detailed inventory and value items individually; utilize existing fixed asset records; or use some type of "ballpark" estimate based on various factors, such as square footage or production volume.

The advantage of creating a detailed inventory is that it provides the most accurate and reliable estimate of value. However, creating a detailed 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 best performed by professional appraisers who have the training, experience and access to information that allow them to be highly efficient. In addition to generating the most accurate value, a professionally prepared and valued inventory can be quickly updated and can be useful in the event of a loss.

While the use of fixed asset records is typically less expensive and time consuming than performing a detailed 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) 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 also 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 part of an acquisition where the purchase price is commonly allocated to the assets. Quantity discounts, pricing incentives or trade-in allowances can also distort the purchase price set forth in the records, causing inaccurate cost estimates.

The quickest method to quantify Insurable Value is to simply estimate the amount. These methods rely on unit costs developed from similar properties, such as replacement cost per square foot or cost per unit of production,. Even when used by an experienced estimator with a clear understanding of the facts and circumstances employed 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 underinsured 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 when a claim occurs 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 an analysis 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 reporting values for business interruption coverage.

An almost unlimited number of variables can impact a business interruption calculation, such as the time of year, market prices and condition, competition, etc. One important factor that affects a company's business interruption exposure is the ability to mitigate a loss when a claim occurs. These mitigation costs are referred to Extra Expenses. The likelihood of loss mitigation is very realistic for many companies. From my claims experience, we have found that the majority of policyholders can mitigate their loss to some degree, though mitigation opportunities can differ greatly between businesses and can significantly impact the business interruption and extra expense exposure. Obviously, the more product lines, facilities and locations that are added to the equation the more complex the analysis becomes.

Many insured's confuse their business interruption exposure with the business interruption value as calculated on a business interruption worksheet. A company's business interruption exposure is the amount of loss a company would incur in a "real world" claim scenario, taking into consideration loss mitigation and other realistic variables. The business interruption value calculated by most business interruption worksheets measures the 12 month business interruption amount assuming a company would be completely shutdown without making any attempt to minimize the loss. The perspectives may be drastically different and likely equates to two completely different values and often equates to higher premiums.

Some business interruption worksheets attempt to bridge the gap between the two values. These more complex worksheets ask the insured to list their expected Extra Expenses and ask them to estimate how long it would take to repair damaged property. While accounting for this information helps quantify the exposure, it still falls short of accurately measuring the business interruption exposure. Unfortunately, there are too many variables specific to a company and industry that simply cannot be built into a standardized worksheet.

In most cases, because of the mitigation opportunities discussed above, the business interruption value calculated on the business interruption worksheet is far greater than a realistic business interruption exposure. This excessive valuation can create a scenario of being overinsured, which leads to excessive premiums. However, it is just as easy to end up under insured if the right information and variables are not considered. An under insured situation can be even worse and the policyholders exposure can be far greater because the potential for losses to exceed policy limits.

Conclusion

A close look at the information used to calculate and establish premiums, as well as limits and insurable values, is very important. The values placed on real property, business personal property and business interruption should be reviewed in greater detail in order to minimize the financial exposure to a company. Because the individuals involved in the insurance placement process may lack the resources or expertise to determine accurate insurable values, utilizing experts may be the most cost effective method to arrive at accurate values.

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