

## THE RISK OF LOSS OF PROPERTY

### SUMMARY

**This BMA covers the classification and itemization of property to be insured. Also described are the various methods for determining the proper valuation of this property.**

The acquisition and use of property occupies more time and effort than, perhaps does any other pursuit. We should, therefore, be equally concerned with its preservation.

A first step in examining those risks which threaten property is to think of the general term "property" in its component parts. This is something more than a simple distinction such as real vs. personal property. The risk cannot be measured until each element of that risk is dealt within specifics. A simple and inclusive list of those specific items of property is essential. When this is drawn up, then a meaningful study of those risks to which your property is exposed can be made. The property list will also provide a means of establishing proof if a loss is sustained. Standard insurance policies state that the insured will, at the time of a loss, provide a list of the damaged and **UNDAMAGED** property.

There are various approaches to this step in risk analysis. Some authorities conclude that the valuation of property should be performed in conjunction with this itemization. You will find, however, that particularly when property is numerous and various, putting the valuation off until a complete list is drawn results in much clearer analysis.

Visual inspection of property is the most important single step when compiling an accurate list. Insurance company files are replete with claims denied because an insured relied too heavily on memory or on outdated documents. Your property list can be outlined in the following manner:

### REAL PROPERTY

- Unimproved land.
- Buildings owned and occupied by yourself.
- Buildings owned and leased to others.
- Buildings not owned but leased from others.
- Improvements and betterments in leased buildings.
- All other premises.

### PERSONAL PROPERTY

Personal Property is always more difficult to itemize in an organized way. This is even more true when you consider that personal property is both tangible and intangible. In some instances it consists of nothing more than a property right. So long as it has value, however, it must appear as an item for consideration.

Ordinarily, the contract shop will have at least these six distinct classes of tangible personal property:

1. Raw stock.
2. Stock in process of manufacture.
3. Finished stock. Sold but not delivered.
4. Machinery, tools, and equipment for manufacturing.
5. Furniture and fixtures.
6. Vehicles: Cars, trucks, aircraft, boats, etc.

There are classes of personal property which are often overlooked. In many instances these represent such high values that they must be considered:

- Cash and checks.
- Securities.
- Valuable records and drawings.
- Copyrights, patents, and other property rights.
- Accounts receivable.

The foregoing method may appear to be rather detailed for the purposes of some who involve themselves with risk analysis. Experience shows, however, that unless this is done, a really clear picture of actual property at risk cannot be obtained.

### PROPERTY VALUATION

How do we ascertain our values? A quick review of the items listed will show the magnitude of this problem. Value

has many connotations and prudence dictates that your idea of value should accord with that of the person who will pay the loss in event of damage or destruction. These values are Usually considered by applying at least one of the following four guides:

1. Replacement Value: The cost of replacement without consideration of depreciation.
2. Actual Cash Value: The cost of replacement less an allowance for depreciation.
3. Market Value: The amount in dollars a willing buyer will pay a willing seller.
4. Book Value: An arbitrary value assigned for purposes of recording a predetermined amount of depreciation on financial statements.

These four measures of value should be studied in all cases where attempt is made to value real property. The important point here is to know exactly which of the four measures will be used.

### **REPLACEMENT VALUE**

When considering replacement cost of real property the object is to replace the existing structure with a new one of like kind and quality. If the building is well suited to the needs of its owner and is almost one hundred percent functional, the replacement cost approach will usually be the most practical and economical. It should be noted that the definition of replacement value cited here is that used in the typical insurance policy. Appraisers may use the term "cost of reproduction new" to describe the cost of replacing the existing asset with a new one of like kind, quality and material. This is to distinguish from the appraiser's definition of replacement cost which implies replacement of the asset with one providing the same utility but not necessarily of like kind, quality and material.

### **ACTUAL CASH VALUE**

Actual Cash Value expresses the idea of value new, less a percentage factor for depreciation. Depreciation in this sense does not refer to that used in various accounting methods. The best way to think of depreciation for insurance purposes is probably as a decrease in utility. If a property of this construction has lost some of its value because of changes in production techniques, products, etc., then, perhaps, the use of replacement cost may not be the best guide. Both historically and in general use today, actual cash value is typically expressed as replacement cost less depreciation or cost of reproduction new less depreciation. There have been some instances where the courts have considered functional and economic obsolescence *and* market value when arriving at actual cash value. While this is the exception, some consideration as to the policy of the insurer and the applicability to the assets to be insured should be made prior to placing insurance.

### **MARKET VALUE**

Market Value is usually not a reliable guide for determining insurable values. The land upon which the building sits is almost always crucial to the market value of a property. Unless circumstances are very unusual, land values (although necessary when itemizing property) have little to do with ultimate insurable value.

### **BOOK VALUE**

Book Value which presupposes a fixed rate of depreciation (e.g., straight line depreciation) is the least satisfactory guide. It is fair to say that insofar as Real Property valuation is concerned, this approach should be avoided. Insurance buyers who insist on this method of valuing property for insurance purposes are generally deluding themselves in an effort to save premium dollars. On the other hand, the insurance agent who accepts figures arrived at in this manner without making an honest effort to ascertain the source of these values does a disservice to all parties concerned. The decision as to which of the four methods to use can often be made before an actual dollar value is placed on property at risk. In many cases, however it is best to place all four kinds of value on real property before insuring. This point will be clarified in future issues which consider insurance Rates and Premium Costs.

### **GUESSWORK CAN BE COSTLY**

Tooling and machining executives should find it easy to accept the idea that just as their field must reject the amateur, so must the profession of property appraisers. There is no substitute for a professional appraiser, and this is particularly true in the industrial field. Should a professional appraiser be used, this individual will stipulate in his or her report the dollar value of the property on a Cost of Reproduction New Basis, and Depreciated Cost of Reproduction Basis. The insurance report will also include the cost of executable items, such as piping below grade, and will subtract this cost in arriving at insurable value. The buyer who is reluctant to pay for assistance by a professional appraiser will, of course, use sources such as his own records, local building contractors, and real estate people. The key point here is that whatever the source used, the final values must be such that agreement with company adjusters in the event of loss is easily reached.

### **PERSONAL PROPERTY VALUATION**

Personal Property Valuation is more difficult. Maintaining correct values on this kind of property is almost impossible because of the dramatic fluctuation which can occur. Basically, the four methods used in connection with Real Property still apply. The question of placing proper values without using a professional appraiser is one for which there is no concrete answer. The alternative is generally a subjective decision made by the insurance buyer. Of course, where the personal property consists of office furnishings such as desks and chairs, proper valuation is no problem for the contract

shop because usually these items are of minor value as compared to the other equipment. What about specialized, highly valued tools, machines, and dies, however? Market Value? The nature of the animal is such that obsolescence can occur overnight. Because of this the shop owner must consider *TECHNOLOGICAL CHANGE* as a factor in valuation of these items. All of this type property should probably be pulled out of the over-all personal property inventory and accorded special valuation treatment.

The Actual Value approach is almost universally applied to personal property. As is apparent from the foregoing, however, these are risk situations where this is a mistake and the Replacement Cost is the only adequate value for needed protection.

Probably another reason for the relatively limited use of Replacement Cost on personal property was the lack of an insurance market for it. This is changing, however, and it is possible to secure such coverage from several substantial and sound companies.

Market Value was discussed briefly above. Since for our purposes it has little relevance to the problems of personal property insurable value we can forego any additional comment.

#### **OTHER PERSONAL PROPERTY**

Most buyers, when analyzing personal property, do not think of items of value, (for example, accounts receivable, valuable papers, records, drawings, patents, copyrights, monies and securities) in this context. As a result, these values, if they do exist, are often overlooked. Of course, no one shop will ordinarily have all of these risk exposures but it is fairly certain that one or more of these situations exist in every shop. The critical difference in valuation of these items is that the four methods here discussed in connection with other

kinds of property, have only limited application. Money value is fixed by law, valuable drawings, etc., will obtain much of their value by man-hour cost of creating them. Receivables reflect the value of services rendered and not paid for. The risk study must simply answer, "Do there exist values of this kind, and, if so, are they of sufficient size to threaten the business in event of disaster?"

A last item of personal property which deserves mention is that pertaining to instruments of transportation. To most buyers this means the automobile and the truck. Probably nothing in the process of insuring more clearly illustrates the "cart before the horse" approach used by so many insurance buyers and sellers alike. The idea that when it is two or three years old it should not be insured is absurd. Whether to insure or not should be put to the same value test as all other property. How much value does that vehicle represent? Could its loss or damage impair the business? If not, what degree of hardship would it impose? When these questions are answered, the intelligent buyer makes a decision.

#### **CONCLUSION**

This BMA may have accentuated the obvious to many readers. Nothing written here is really new and each of us has probably utilized some or all of these ideas. The purpose of this BMA, however, has been to crystallize and organize all of the elements required in the processes of itemization and valuation.

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