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What's The Value?

It is the owner's responsibility to determine the "value" of their real property. It is the insurance advisor's job to help the owner insure buildings at their proper "value." But, what is the proper "value," and how is it determined?

Determining the "value" of new buildings is simply a matter of the cost of the building. Or is it? Determining the "value" of older buildings at camp is an even more involved process.

Variable factors also influence the "value" of buildings, and as you will soon realize, you must be quite specific about what you mean when you use the term "value." Let's explore what "value" means to the insurance industry, identify some issues to be aware of, and consider how the different insurance "values" may be used in your insurance program.

Understanding "Cost New"

This is simple, right? Well, there are a few issues to consider. First, many camps have wonderful resources, such as volunteer workers, talented maintenance staff, and generous donors. In situations where these resources are used to construct a new building, the cost can be considerably less than if a general contractor built the building. This is certainly a good thing, especially when budgets are tight and resources are limited. However, these circumstances, while a benefit on one hand, could result in an underinsurance problem if the cost of the new building is used as its insurance replacement cost "value."

The insurance industry estimates replacement cost "value" under the assumption a general contractor will be doing the work. To avoid being underinsured and possibly underpaid for a loss, it is important to recognize the difference between "cost new" and insurance replacement cost in this situation. Let's explore what the insurance industry means by replacement cost "value" a little further.

Replacement Cost

Property replacement cost insurance promises to replace old with new. Generally, replacement of a building must be done on the same premises and used for the same purpose, using materials comparable to the quality of the materials in the damaged or destroyed property. There are some other limitations to this promise.

For example, the cost of repairs or replacement for buildings doesn't include the increased cost associated with building codes or other laws controlling how buildings must be built today. An endorsement adding coverage for the operation of Building Codes and

the increased costs associated with complying with them is available separately — usually for additional premium.

In addition, some camp insurance underwriters will only cover certain property on a *depreciated value* (actual cash value — ACV) basis even when attached to the building. This includes awnings and floor coverings, appliances for refrigerating, ventilating, cooking, dishwashing, and laundering. *Depreciated value* also applies to outdoor equipment or furniture.

Actual cash value (we will explore its meaning below) applies to these items, because underwriters see them as subject to rapid depreciation. These limitations (especially on appliances, etc.) have been a surprise for more than one camp director following a loss to the camp's dining hall.

Generally, the insurance company will not pay a *replacement cost* settlement until the property that was damaged or destroyed is actually repaired or replaced as soon as reasonably possible after the loss. Under no circumstances will the insurance company pay more than your limit of insurance or more than the actual amount you spend to repair or replace the damaged property if this amount is less than the limit of insurance.

Replacement cost insurance terms give the insured the option of settling the loss on an ACV basis. This option may be exercised if you don't plan to replace the building or if you are faced with a significant coinsurance penalty on a *replacement cost* settlement.

Actual Cash Value

ACV is the default valuation clause for *commercial property* insurance. It is also known as depreciated value, but this is not the same as *accounting depreciated value*. *Actual cash value* is determined by first calculating the *replacement value* of the property. The next step involves estimating the amount to be subtracted, which reflects the building's age, wear, and tear.

This amount deducted from the *replacement value* is known as depreciation. The amount of depreciation is reduced by inflation (increased cost of replacing the property); regular maintenance; and repair (new roofs, new electrical systems, etc.) because these factors reduce the effective age of the buildings.

The amount of depreciation applicable is somewhat subjective and certainly subject to negotiation. In fact, there is often disagreement and a degree of uncertainty over the amount of depreciation applicable to a particular building. Given this reality, property owners should not leave the determination of depreciation to chance or wait until suffering a property loss to be concerned about it. Every three to five years, camp property owners should obtain a professional appraisal of the *replacement value* and depreciated value of the buildings at camp.

The ACV valuation is an option for directors to consider when certain buildings are in need of repair, or budget constraints prevent

insuring all of your facilities on a *replacement cost* basis. There are other valuation options for camp property owners to consider as well.

Functional Replacement Cost

This valuation method has been available for some time but has not been widely used. It is beginning to show up on camp property insurance policies imposed by underwriters with concerns about older, buildings. It can also be used for buildings, which are functionally obsolete. This method provides for the replacement of a building with similar property that performs the same function, using less costly material. The endorsement includes coverage for building codes automatically.

In the event of a loss, the insurance company pays the smallest of four payment options.

1. In the event of a total loss, the insurer could pay the limit of insurance on the building or the cost to replace the building on the same (or different) site with a payment that is “functionally equivalent.”
2. In the event of a partial loss, the insurance company could pay the cost to repair or replace the damaged portion in the same architectural style with less costly material (if available).
3. The insurance company could also pay the amount actually spent to demolish the undamaged portion of the building and clear the site if necessary.
4. The fourth payment option is to pay the amount actually spent to repair, or replace the building using less costly materials, if available (Hillman and McCracken 1997).

Unlike the *replacement cost* valuation method, which excluded certain fixtures and personal property used to service the premises, this endorsement provides functional replacement cost coverage for these items (awnings, floor coverings, appliances, etc.) (Hillman and McCracken 1997).

As in the standard *replacement cost* value option, the insured can elect not to repair or replace the property. Under these circumstances the company pays the smallest of the following:

1. The Limit of Liability
2. The “market value” (not including the value of the land) at the time of the loss. The endorsement defines “market value” as “the price which the property might be expected to realize if offered for sale in fair market.”
3. A modified form of ACV (the amount to repair or replace on the same site with less costly material and in the same architectural style, less depreciation) (Hillman and McCracken 1997).

Agreed Value or Agreed Amount

Agreed value or *agreed amount* is not a valuation method. Instead, this term refers to a waiver of the coinsurance clause in the property insurance policy. Availability of this coverage feature varies among insurers but, it is usually available only when the underwriter has proof (an independent appraisal, or compliance with an insurance company valuation model) of the value of your property.

Which Valuation Method Is Best?

This depends upon your situation. Clearly, *replacement cost value* is a preferred method. But, if your budget won't allow for this, buyers can insure some buildings at ACV and others at *replacement cost*

value. This approach will save money, but involves assuming the risk for the difference between the ACV and the *replacement cost value*. If some buildings are functionally obsolete and the goal is to replace the square footage, consider insuring them using the *functional replacement cost* value option.

Protect Your Buildings

Take some time to consider the different valuation options available to you. Know which “value” your insurance advisors are referring to in their discussions and correspondence. Choose the valuation clause that is most cost effective for you. Get a professional appraisal of your building's replacement value and ACV every three to five years. Select an insurance advisor, who can help you think through the various options. Take the necessary action to protect your buildings by purchasing a proper amount of insurance that reflects their “value.” ■

Reference

Hillman, B., J.D., and McCracken M.K., C.P.C.U. (1997). *Commercial Property Coverage Guide*, National Underwriter Company, p. 151.

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