Module 7

Handling Merchandise Claims

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Chapter 7

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Learning Objectives

- Obj I – Claims Procedures for Merchandise Losses
- Obj II – Valuation of Merchandise
- Obj III – Determining the Value of Out-of-Sight Merchandise
- Obj IV – Handling Salvage in Merchandise Losses
- Obj V – Peak Season Endorsement and Value Reporting Form

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Claims Procedures for Merchandise Losses

Objective I

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Loss Adjustment

- Adjusters should handle every merchandise loss with at least one visit to the insured's premises.
  - Should not leave loss determination to insured.
- To build an acceptable and reliable file, the adjuster must prepare to do everything in an orderly and complete manner.
  - Adjuster should use a checklist beginning with the first visit to the insured's premises.

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Large Losses

- When damage to merchandise is severe and widespread but not total, the first visit by the adjuster involves:
  - Inspecting the premises.
  - Taking photos.
  - Guiding the insured.
- The adjuster's inspection of the premises should reveal whether a complete physical inventory is practical or even possible.

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Large Losses

- During the first visit with the insured, the adjuster should:
  - Establish procedures that will be followed.
  - Notify the insured of the insured's duties.
  - Determine the insured's attitude about a fire sale after the adjustment is complete.
  - Exercise the insurer's right of access to all books and records of the insured's business.

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Large Losses

- The adjuster should be cautious not to make any commitments that waive policy conditions:
  - Giving permission to move merchandise before it has been inventoried.
  - Approving expenses that later prove not to be covered under the policy.
  - Approving expenses that might not be justified by the circumstances.
  - Making a decision on the property adjustment that might be prejudicial to adjusting the business income claim.

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Large Losses

- Merchandise damaged but still salable is almost certainly worth more to the insured than to anyone else.
  - Salvor can assign a possible damage allowance percentage.
- A brands and labels clause requires the manufacturer's label to be removed from all merchandise taken in salvage by the insurer.

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Large Losses

- The adjuster's negotiating ability determines whether a satisfactory adjustment is possible.
  - Adjuster should maintain a confident but flexible attitude, depending on the insured's attitude.
- In negotiating a settlement for partial damage to merchandise, the adjuster is dealing in an area in which the insured is much more knowledgeable.

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Small Losses

- Most merchandise claims are relatively small and uncomplicated.
  - Following all of the preceding procedures can be contrary to the insured's and the insurer's interests.
- The adjuster should establish to the best of his or her ability the accurate measure of the insured's actual loss.
  - Without bringing in outside salvors or accountants.

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Practice

- All of the following represent commitments that could waive policy conditions, EXCEPT:
  - A. Making a decision on the property adjustment that might be prejudicial to adjusting the business income claim.
  - B. Giving permission to inventory merchandise before it has been moved.
  - C. Approving expenses that, although possibly covered, might not be justified by the circumstances.
  - D. Approving expenses that later prove not to be covered under the policy.

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Valuation of Merchandise

Objective II

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Replacement Cost

- Policies normally insure merchandise for either replacement cost or actual cash value.
  - Could also base value on sales price.
- Replacement cost is:
  - Insured's cost to buy stock from suppliers.
  - Less any trade discounts or allowances.
  - Plus incoming freight.
  - Plus cost of receiving, tagging, marking, and arranging goods in the insured's premises.

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Freight

- Elements of replacement cost:
  - Incoming freight charges – amounts insureds pay to have goods shipped to their premises.
  - Trade discounts and allowances – stated purchase price reductions suppliers grant the insured for purchasing in volume.
  - Internal handling costs – costs of insured's own employees handling the items.
  - External handling costs – costs of a third party handling the item for the insured.

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Actual Cash Value

- Calculating ACV is more difficult than calculating replacement cost.
  - No policy defines ACV.
- ACV can be calculated as replacement cost less depreciation.
  - Principal causes of depreciation are physical damage and obsolescence.

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Actual Cash Value

- In some jurisdictions, ACV equals market value.
  - The market is where the insured merchant obtains its stocks of merchandise.
  - Insured's costs reflect the value of goods in the wholesale market.
- Adjusters should use the accounting method for determining value that mirrors the insured's accounting system of valuation.
  - Retail method of accounting assumes a consistent profit percentage.

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Selling Price

- Adjusters sometimes encounter policies that give merchants selling price coverage.
  - Selling price is the tagged price on the merchandise at the time of the loss.
- A layaway should be valued at the selling price, whether it has been completely paid for or not.
  - Assumption that once the item has been put aside for a customer, the sale has been made.
- The universal pricing code (UPC) is the small box of bars of various widths appearing on an item of merchandise.

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Practice

- All of the following statements are correct regarding the determination of replacement cost of merchandise, EXCEPT:
  - A. Replacement cost would be reduced for the cost of insurance on the merchandise.
  - B. Replacement cost would be increased by any incoming freight costs associated with the merchandise.
  - C. Replacement cost would be reduced by any trade discounts on the merchandise.
  - D. Replacement cost would be increased by the cost of arranging the merchandise in the insured's premises.

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Determining the Value of Out-of-Sight Merchandise

Objective III

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Book Value

- Merchandise losses require the adjuster to use the insured's books to determine value.
  - Merchandise should be inventoried after loss.
  - Out-of-sight merch. cannot be inventoried because it is damaged beyond recognition.
- Fundamental financial records of any business are the income statement and balance sheet.

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Book Value

- Method for determining book value:
  - Amount in last physical inventory
  - + Amount added to inventory
  - = Amount that could have been sold
  - – Amount that was sold
  - = Amount in inventory on date of loss
- To determine inventory's true book value, dollar amounts must be used in the formula.

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Cost of Goods Sold

- To determine inventory's book value accurately, the cost of goods sold must be used.
  - Appears on income statement to determine gross profit.
- Method for determining cost of goods sold:

Beginning inventory	$5,000
+ Additions to inventory	14,000
= Amount that could have been sold	19,000
– Ending inventory	9,000
= Cost of goods sold	10,000

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Cost-to-Sales Ratio

- The cost-to-sales ratio is the ratio of cost of goods sold to sales.
  - Historical cost-to-sales ratio can be used to determine approximate inventory value with out-of-sight merchandise.
  - Company should know its sales for the year, and this can be used to project cost of goods sold using cost-to-sales ratio.

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Practice

- ABC Suit Company had the following transactions with respect to their suit inventory:
  - Beginning inventory – 200 suits purchased for $200 each
  - Purchases of suits in February – 100 suits purchased for $300 each
  - Purchases of suits in March – 200 suits purchased for $250 each
  - Sales of suits in April – 250 suits
- Assuming they sold the oldest suits first, what is the current value of their inventory?
  - A. $40,000.
  - B. $55,000.
  - C. $65,000.
  - D. $80,000.

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Practice

- Flores Floral Boutique had an inventory of $50,000 at the beginning of the year. Throughout the year, $25,000 worth of floral arrangement materials were added. The inventory at the end of the year was $28,000. Flores Floral Boutique's cost of goods sold was:
  - A. $22,000.
  - B. $47,000.
  - C. $48,000.
  - D. $53,000.

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Handling Salvage in Merchandise Losses

Objective IV

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Role of Salvor

- A salvor is an expert in preserving and realizing the value remaining in damaged merchandise.
  - Role is to protect inventory and also to sell damaged merchandise if necessary.
  - Salvor does not determine coverage.
- If one is needed, the salvor should be contacted at the beginning of the adjustment process.
  - Salvor can offer adjuster professional advice on merchandise's degree of damage.

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Sale of Salvage

- If the decision is made that the merchandise is salable, salvor arranges a sale.
  - Salvor does not take ownership of property.
  - When necessary, salvor must communicate with a health and food inspector.
- Salvor knows the best people to contact if a sale is held.
  - Salvor can ensure best possible price is obtained for the merchandise taken over by the insured.

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Salvage Contracts

- Salvor's fees and commissions come out of the sale proceeds.
  - Become part of the loss indemnified by the insurer.
  - Settlement with insured is based on net proceeds.
- Insured is not directly liable for salvor's fees.
  - Unless insured hires salvor to separate, inventory, and protect the merchandise.

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Salvage Contracts

- Insured retains ownership of property.
  - Can contract directly with salvor.
- Salvor's advice should be sought to resolve adjuster-insured disputes over whether property should be removed.
  - If salvor believes property is safe on insured's premises, insurer bears the risk of the salvor's being wrong.

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Accounting for Salvage Proceeds

- Several methods are available in accounting for salvage proceeds:
  - Sale on account of insurer – insurer receives salvage proceeds.
  - Sale on account of insured – insured receives salvage proceeds.
  - Sale on account of whom it may concern – salvage sale is completed before value of stock is determined.
  - Sale in which insured coinsures – insured shares in loss with insurer.

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Sale on Account of Insurer

- Insurer pays the insured full amount.
  - Insurer takes salvage for its own account.
- Example:

Agreed full value of stock	$200,000
Insurer pays insured	$200,000
Net proceeds from salvage sale paid to insurer	$70,000
Insurer's net payment	$130,000

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Sale on Account of Insured

- Insured receives salvage proceeds.
- Example:

Agreed full value of stock	$200,000
Net proceeds from salvage sale paid to insured	$70,000
Therefore, insurer pays insured	$130,000
Total payments to insured from salvage and insurance	$200,000

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Sale on Account of Whom It May Concern

- Salvage sale is made before agreement on the value of stock.
- Example:
  - Net proceeds from salvage sale held by salvor pending agreement $70,000
  - Agreed full value of stock $200,000
  - Net proceeds paid to insured $70,000
  - Insurer pays insured $130,000

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Sale in Which Insured Coinsures

- Insurer and insured share in the loss.
- Example:
  - Coinsurance penalty 25%
  - Agreed full value of stock $200,000
  - Insurer will pay no more than $150,000
  - Net proceeds of salvage sale $70,000
  - Shared 75% with insurer $52,500
  - Shared 25% with insured $17,500
  - Insurer's net payment $97,500
  - Insured's net loss $32,500

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Practice

- After a fire loss, an adjuster and insured agreed the damaged merchandise's full value is $500,000. Under the "sale on the account of the insurer" method of handling salvage proceeds, if the salvage proceeds to the insurer are $220,000, the insurer's net payment is:
  - A. $0.
  - B. $220,000.
  - C. $280,000.
  - D. $500,000.

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Practice

- Which one of the following statements is correct regarding the salvor's role in the merchandise loss settlement process?
  - A. The salvor takes title to the merchandise prior to the sale.
  - B. The salvor knows the best people to contact if a sale is held and can ensure that the best possible price is obtained.
  - C. The insured is directly liable for the salvor's fees.
  - D. If the salvor thinks the merchandise is safe on the insured's premises, the insured bears the risk if the salvor is incorrect.

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Peak Season Endorsement and Value Reporting Form

Objective V

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Fluctuating Values

- Certain property values may fluctuate over time.
  - Poses an insurance problem.
  - A single, fixed amount of insurance is not appropriate for inventory that fluctuates in value.
- Approaches to deal with fluctuating values:
  - Peak Season Limit of Insurance Endorsement.
  - Value Reporting Form.

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Peak Season Endorsement

- Peak Season Limit of Insurance endorsement provides differing amounts of insurance for selected time periods.
  - Eliminates the need for extra transactions to change value based on fluctuating inventory.
  - Avoids risk the insured may overlook the need to increase its insurance.
- Endorsement may be added mid-term.
  - Pro-rata increased premium is charged.

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Value Reporting Form

- Value Reporting Form avoids costs of over or under insuring business personal property.
  - Limit of insurance is set high enough to cover the insured's maximum expected values.
- Insured reports values to the insurer at periodic intervals specified in the form.
  - As long as insured reports values accurately, insurer will pay the full amount of any loss.
  - Final premium is based on the values reported by the insured as exposed to loss.

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Value Reporting Form

- Usually, a specific limit of insurance applies to property at each location.
  - If coverage is written on a blanket basis, the blanket limit can apply at any one location.
- Insured is required to report the value of all property on hand as of each report date.
  - Insured must pay a premium based on the full value even if it exceeds the limit of insurance.

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Value Reporting Form

- Insured must file required report within 30 days after the end of each reporting period (60 days for initial report).
  - Initial report not filed – insurer pays no more than 75% of amount due.
  - Subsequent reports not filed – insurer will pay no more than last report values.
  - Inaccurate report – insurer uses formula:
    - [(Reported/Actual) x Loss] - Deductible

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Value Reporting Form

- Value Reporting Form carries a limit of insurance that is the most insurer will pay.
  - Limit of insurance is usually set higher than the maximum value expected.
- Initial provisional premium is typically 75% of annual premium required to purchase nonreporting coverage with the same limit.
  - Typically paid at beginning of policy period.
  - Premium adjusted at end of policy period.

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Practice

- Power's Flowers, a small chain of stores selling floral arrangements, has an extremely busy period during the two weeks before Valentine's Day, requiring it to significantly increase its inventory during this period. To adequately cover its fluctuating inventory values and keep premiums to a minimum, Power's Flowers should purchase a Building and Personal Property Coverage Form (BPP) with a(n):
  - A. Spoilage Coverage endorsement.
  - B. Value Reporting Form.
  - C. Agreed Value coverage extension.
  - D. Peak Season Limit of Insurance endorsement.

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