7 – Handling Merchandise Claims

**1 – Claims Procedures for Merchandise Losses**

**Objective**: Describe the procedures and practices a claim rep should follow when handling merchandise claims.

When handling large merchandise losses, claim reps must know how to work closely with the insured to determine the payable loss amount. The claim rep’s first visit with the insured is vital for establishing rapport with the insured and gathering the information and documentation needed to conclude the claim accurately and efficiently. The claim rep also needs to understand the insured’s business and operations and be familiar with resources that can help establish the fair value of merchandise.

Claim reps should use a checklist that outlines standard investigation procedures for all large merchandise losses. **While conducting the initial site survey, the rep may find lightly damaged merchandise that can be sold. The insured and claim rep can agree to a percentage damage settlement that allows the insured to sell the merchandise at a reduced price. For small merchandise losses, the claim rep can streamline procedures for a more efficient settlement**.

**Checklist for Claims Adjusting**

To build an acceptable and reliable claim file when handling a merchandise loss, the claim rep must follow investigation procedures in an orderly manner. Using a **written checklist** on the first visit to the insured’s premises may help the claim rep.

* Establish a relationship and rapport with the insured. Gain an understanding of how the insured business operates
* Inspect the entire premises, including merchandise that is not involved in the claim
* Decide whether to use a salvor. If using a salvor, tell the insured because the salvor will probably visit the insured premise when you are not present
* Take photographs or videos of the premises, damaged merchandise and undamaged merchandise
* Ask the insured whether books and records of the inventory are available and whether he or she has other insurance. Explain to the insured how they will have to document the loos. Identify the insured’s accounting firm or bookkeeping firm. Obtain authorization for the accounting firm to release financial information
* Discuss with the insured immediate steps to minimize damage, including boarding gup the property and general security. Provide authorization for the insured to secure a restoration company if needed
* If fire was the cause of loss, obtain the insured’s explanation of the origin and cause of the fire. Ask the insured whether a fire department investigator has been to the scene. If possible, inspect that area and take photos or videos of it.
* Explore subrogation options. In many claims, the claims rep discovers that the damage resulted from equipment malfunction or from a third party’s negligence. Timely documentation can preserve valuable evidence. Questioning the insured and other investigative authorities can help the claim rep determine whether subrogation is possible
* Provide the insured with a general description of what will happen during the claims adjusting process. Inform the insured or tis representative about the insured’s duties after loss, including the requirement to cooperate with the investigation
* Provide the forms the insured will need to present the claim to the insurer
* Anticipate questions the insured may have, and answer them in a professional but cautions manner

**Procedure for Large Losses**

When damage to merchandise is severe and widespread but doesn’t result in a total loss, the claim rep must visit the premises to both inspect and take photos or videos of the premises, the damaged merchandise, and the undamaged merchandise. During this first visit, the claim rep must also establish a rapport with the insured and develop mutual trust and confidence. **The claim rep must guide the insured, who may have just suffered his or her first major loss, through the claim process.**

**Preliminary Survey**

The claim reps initial inspection of the premises and the damaged merchandise should reveal whether a complete physical inventory should be conducted or is even possible. Even when a lot of merchandise has been damaged beyond identification, **a physical inventory of the remaining merchandise can help provide an estimate of the out-of-sight loss and information on pre-loss obsolescence or other loss of value**.

During the first visit, the claim rep should also gain a preliminary idea of the scope of damage and of the total value involved (a statement from the insured may suffice), and assure the insured that he or she will be treated fairly and reasonably throughout the claims handling process.

**Discussion With the Insured**

During the first visit with the insured, the claim rep must outline the procedures that will be followed during the claim handling process. The claim rep must also notify the insured of his or her duties following the loss, which are outlined in the policy. The claim rep should not, on the visit, try to describe to the insured every aspect of claims adjusting. The claim rep should also refrain from discussing complex policy provisions, such as a coinsurance clause, with the insured, who is likely already upset and may become confused.

**The claim rep should have a thorough, and courteous discussion with the insured about how the business was conducted before the loss occurred. By questioning the insured about marketing and merchandising methods, the claim rep can gain insight into how the business operates and can develop ideas about how to prepare the claim file**.

If a lot of lightly damaged merchandise remains on the premises, the claim rep should determine how the insured feels about selling it at a reduced price after the adjustment is complete. The insured’s answers to questions about selling damaged merchandise at a reduced price will help the claim rep decide whether to use a salvor.

The claim rep should be prepared to answer questions that the insured will likely ask about boarding up and protecting the premises, the expense to minimize the damage, and use of a public adjuster. In larger cities, public adjusters often contact insureds after a serious fire, before the insurer’s claim rep visits the premises. The insurer’s claim rep should be prepared to answer question about public adjusters’ activities and reassure the insured that the claim will be properly adjusted, regardless of whether a public adjuster is involved.

**Exercise and Nonwaiver Rights**

During the first visit, the claim rep should exercise the insurer’s right to access all books and records of the insured’s business. If an outside accountant possesses the records, the claim rep should get the insured’s permission to contact the accountant directly to obtain the necessary information.

The claim rep should be aware of the policy terms and conditions an avoid making commitments, such as these, that may waive policy conditions:

* **Giving permission to move merchandise before it has been inventoried**
* **Approving expenses**. These may not be covered under the policy, or if they are covered, approval may not be justified by the circumstances
* **Making a premature claim adjusting decision**. This may end up being detrimental to the adjustment of a subsequent business income claim or may inadvertently increase a business income claim

**Percentage Damage Settlement**

Percentage damage settlements are often advisable in loss situations where merchandise is only lightly damaged. During these settlements a properly prepared claim rep negotiates a settlement based on the value of the damaged merchandise to the insured. The insured then retains the damaged merchandise and sells it at a reduced price. The insurer benefits from not having to conduct a salvage sale.

**Merchandise that is damaged but still able to be sold at the retail level is almost certainly worth more to the insured than to anyone else. If the insured retains the merchandise to sell it at a reduced price, the merchandise would only have to be moved within the store and repriced. That would cost much less than paying an outside purchaser to pack the merchandise and move it to another location, unpack it, classify it, and reprice it.**

Also in general, if a salvor estimates the net salvage return on merchandise that’s taken over by the insurer to be 40% of the cost, then the merchandise is likely to be worth more, perhaps between 50 – 60% of the cost, to the insured (a merchant) who retains it.

**Mutual Advantage of Percentage Damage Settlement**

If, in the insured’s opinion, the merchandise has lost at least 40% of its value, the insured could sell it for no more than 60% of its value. Still, to the insurer, that merchandise has lost no more than 60% of its value.

Settlement in this case should be made at a loss figure between 40% (the least that the insured would accept) and 60% (the most that the insurer would pay). This damage allowance percentage is fair because the insurer could reimburse the insured 100% and take the merchandise for salvage. That salvage would then be expected to yield 40% of value, so it has suffered no more than a 60% loss. If both parties have accurately assessed the situation, any amount between 40 and 50% would be fair and advantageous to both parties.

**A salvor’s advice can and should guide, but not control, the claim rep throughout this process. For example, after inspecting the damaged merchandise, the salvor can advise the claim rep on the extent of the damage, the process of preparing the merchandise for salvage sale, and the anticipated net proceeds from the sale. With this information, the claim reps can determine what the break point, or maximum the insurer should pay, will likely be. Seldom is an entire stock subject to the same degree or percentage of damage**.

**Brands and Labels Clause**

If an insurance policy contains a brands ad labels clause, which is usually included by endorsement, it can make the ultimate salvage value much less than the value that would normally be expected. A brands and labels clause allows the insured to remove labels from merchandise taken in salvage by the insurer or mark the merchandise as “salvage”. When a label from a popular or prestigious brand is removed from merchandise taken by the insurer as salvage, the value of that salvage to the insurer is reduced.

**Negotiation**

The claim rep’s negotiation skills are especially important when adjusting serious merchandise damage claims. The claim reps negotiating ability can determine whether an adjustment will be satisfactory to both parties.

When the decision turns to damage allowance, the claim rep should inform the insured that a negotiated settlement of the damage allowance will be considered. During the process of negotiating an adjustment, the claim rep should maintain a confident and flexible attitude.

If the insured is inflexible about a damage allowance percentage, the claim rep has the right to take over the damaged merchandise for salvage disposal. Prior to negotiation, **the claim rep should have a break point in mind at which he or she can decide that paying the insured for the full insured value and taking the salvage for the insurer’s account is less expensive than paying the percentage that the insured demands**.

Insureds are likely more knowledgeable than claim reps regarding appropriate settlement amounts for partial damage to merchandise because insureds are more familiar with the merchandise. The claim rep, in consultation with a salvor, should become familiar with the merchandise’s income potential, even if it will be sold at a reduced price, and should use that information to conclude the claim in a way that’s fair to both the insurer and the insured.

**Small Losses**

Most merchandise claims are relatively small and uncomplicated. For these routine losses, following all the preceding procedures may not be in the best interest of the insurer and insured. Instead, the claim rep should streamline the process by determining, without consulting outside salvors or forensic accountants, an estimate of the insured’s actual loss, and the applying policy conditions to conclude the claim fairly and efficiently.

**2 – Valuation of Merchandise**

**Objective**: Explain how to determine the replacement cost, actual cash value and selling price of merchandise

When retail businesses make claims under their commercial property or businessowners polices, their merchandise, or inventory, may be valued are replacement cost (RC), actual cash value (ACV), or selling price. To determine the replacement cost, ACV or selling price of merchandise, claim reps apply concepts and considerations in addition to those that apply to valuation of other types of business personal property.

A retailer’s claim for merchandise losses is typically made under a commercial property policy or a businessowners policy that includes coverage for the insured’s business personal property, including a category of property referred to as stock. **A common policy definition of stock in this context is “merchandise held in storage or for sale, raw materials, and in-process or finished goods, including supplies used in their packaging or shipping”.**

**Which Valuation Basis Applies?**

A claim rep handling a merchandise claim must review the insured’s policy to determine whether it covers merchandise on a replacement cost basis or an ACV basis. The selling price basis has limited application, so it is not usually a factor in this determination.

The building and Personal Property Coverage Form, also referred to as the BPP, covers stock on an ACV basis unless both of these statements are true:

* The insured has obtained the Replacement Cost optional coverage, which is ordinarily indicated in the policy declarations
* The including “Stock” option is shown in the declarations

**The BPP’s Valuation condition states that the insurer will determine the value of stock the insured has sold but not delivered at is selling price**.

**The Businessowners Coverage Form (BCF) covers all business personal property, including merchandise, at replacement cost unless the merchandise is one of the types of property listed in the BCF Loss Payment Condition as being covered at ACV.** “Used or secondhand merchandise” is one of those types because such merchandise is usually subject to significant depreciation.

Both the BPP’s Replacement Cost optional coverage and the BCF’s Loss Payment condition lists “works of art, antiques or rare articles” as being limited to ACV coverage even though replacement cost valuation otherwise applies to business personal property.

As you can see, more than one valuation basis could apply to items of the insured’s merchandise. Even if replacement cost valuation applies to business personal property, some items of merchandise may be covered for ACV, and under the BPP, stock that has been sold but not delivered is covered for its selling price.

**Replacement Cost**

**Replacement cost for merchandise is the insured’s cost to replace stock from its suppliers at current price levels:**

* **Plus, incoming freight (if freight charges are paid by the merchant, they are included otherwise, they are not).**
* **Less, any trade discount and allowances that the merchant enjoys effectively reduce the cost of the goods to the merchant and therefore also reduce the replacement cost**
* **It may also include handling costs for opening, tagging, marking, and arranging merchandise in the insured’s premise. Those services represent a real cost and real value. They reflect the difference in value to the insured between goods on a receiving dock and those ready for sale to the public, and they may be included in the replacement cost**.

Determining replacement cost is not difficult if the claim rep has current price information and access to the insured’s books and business records.

Trade discounts and allowances are reductions of the stated purchase price that suppliers grant to the insured for purchasing in volume or paying in a timely manner. Discounts and allowances reduce the effective price paid by the insured for its merchandise, and they reduce the replacement cost of the insured’s inventory.

When a supplier provides handling services for opening, tagging, marking, and displaying goods it has sold to the insured, those services represent a real cost and a real value. They reflect the difference in value to the insured between goods on a receiving dock and those ready for sale to the public, and they may be included in the replacement cost.

**Insureds, however, do not always want handling costs to be included. These cost increase the insured’s merchandise value for settlement purposes but also for coinsurance purposes. Higher value does not necessarily translate into a higher settlement if a coinsurance penalty is incurred**. Handling costs should be treated the same for both loss settlement and coinsurance purposes.

**When the insured’s own employees perform handling services, the costs cannot be included in the good’s replacement cost**. These expenses represent part of the insured’s markup on inventory and **are covered under the BPP only if the damaged items are stock that has been sold but not delivered, which is covered for its selling price**. However, if the insured has business income and extra expense insurance, **the handling costs for replacement inventory can be covered as extra expense under the Business Income**.

Incoming freight charges are the amount that the insureds pay – to either carriers or suppliers – to have goods shipped to their premises from suppliers.

**Actual Cash Value**

The ACV of merchandise is commonly considered to be tis replacement cost minus any depreciation that may have occurred. **Determining the ACV of merchandise requires examining the insured’s purchase records item by item in the same way that replacement cost is determined except that depreciation, markdown, or other loss of value must then be taken into account.**

**Causes of Depreciation**

Any retail stock of merchandise can suffer a reduction in value and selling cost because of depreciation, event if it never leaves the retailer’s premises. **Possible cause of depreciation are innumerable, but physical damage and obsolescence are the primary ones**.

**Careless handling, dust, moisture or humidity, missing parts, infestation, excessive heat, freezing, and thawing can cause physical damage**. The claim rep must inspect the goods to determine whether any physical damage to merchandise existed before the loss.

Obsolescence means that an item has lost value because it is out of fashion, past it marked shelf life, or a seasonal item; because it show evidence of slow turnover; or because it was offered in an incomplete size, color, or pattern range.

**Market Value**

**In any store where courts have ruled that ACV equals market value**, the relevant market is where the insured retailer obtains its merchandise. For retail, the insured is a buyer in the wholesale market. The insured’s costs reflect the value of goods in this market, including incoming freight and handling costs, less trade discounts. **Unless unusual circumstances exist, the insured’s costs can be interpreted as an accurate reflection of market value in a given wholesale market**.

Any loss of value to the merchandise once it is on the insured’s premises is not easy to detect. Goods are seldom resold on the wholesale market. The claim rep must judge whether goods on the insured’s premises would sell as prime merchandise on the wholesale market. If not, some reduction in ACV is appropriate. Markdowns at retail strongly suggest that goods have lost value to the retailer and would likewise have less value at the wholesale level.

**Markdowns**

**Most retail accounting systems operate on the premise that when the retailer reduces (marks down) the selling price of a piece of merchandise because the item is not moving, is approaching the end of its season, or has become shop-worn, the item’s original cost value automatically drops by the same percentage by which the retailer has reduced the selling price**. For example, if an item’s selling price is reduced 40%, form $100 to $60, then its cost value must likewise be reduced by 40%. If the original cost value was $50 , it would drop (for ACV purposes) to $30 ($50.00 x 40% = $20) $50 - $20 = $30.00

Examples of merchandise affected by this phenomenon are calendars and datebooks. These items rapidly lose value after January of every year. A retailer who suffers a loss in March would certainly have marked down its remaining calendars and datebooks by then. In determining the ACV of that loss, the claim rep would value any damaged datebooks on the basis of marked-down prices. Because these items are nearly worthless to the retailer in March, their ACV would be extremely low, regardless of what the retailer paid for them.

**A claim rep cannot automatically assume that all marked-down items have been reduced in price because of depreciation or obsolescence. Grocery stores commonly have weekly promotions during which certain popular items are marked down as loss leaders. At the end of the promotion, the unsold items are marked back up to their normal prices**. This practice is also common in other retail establishments such as shoe stores, clothing stores, and drugstores. If a loss occurs during the promotion, the claim rep cannot realistically argue that an item only temporarily marked down for a sales promotion has actually been reduced in value and that its ACV should be reduced accordingly.

**Selling Price Valuation**

**The BPP calls for valuation at selling price for stock that the insured retailer has sold but not delivered to the buyer**. In such cases, the sold property is usually on the insured’s premises when it is damaged or destroyed, and the insured will be obligated to either replace the damaged property or refund the full purchase price to the buyer, and without insurance, the insured will lose the property’s cost and its markup. **Valuation at selling price indemnifies the insured**.

To be more precise, the amount recoverable by the insured is “the selling price less discounts and expenses you [the named insured] otherwise would have had”. The selling price is the amount the buyer paid for the merchandise. From that amount, the claim rep subtracts any discounts or expense the insured would have realized had the loss not occurred.

For example, the selling price of property that the insured had sold but not yet delivered included a delivery charge. If the buyer demands a full refund of the selling price because the insured cannot obtain new merchandise in time to meet the buyer’s needs, the insured will not incur the expense of delivering the merchandise, and therefore that expense is deducted from the selling price in calculating the amount payable to the insured.

**3 – Determining the Value of Out-OF-Sight Merchandise**

**Objective**: Given a retail store’s financial records, establish the book value of out-of sight merchandise

To adjust a loss in which the merchandise has been so badly damaged that it is not recognizable, the claim rep uses the insured’s records to establish its value.

**Merchandise damaged beyond recognition, called out-of-sight merchandise**, poses a problem for claim reps because it cannot be inventoried or identified. **If a physical count, or inventory, is impractical because the merchandise has been destroyed or damaged beyond recognition, the claim rep can use the insured’s records to establish the property’s book value. (historical cost less accumulated depreciation).**

**Income Statement and Balance Sheet**

The fundamental financial records of any business are its **income statement** (reports an organization’s profits or loss for a specific period by comparing the revenues generated with the expenses incurred to produce those revenues) and **balance sheet** (reports the assets, liabilities, and owner’s equity of an organization as of a specific date**). Also called the profit and loss, or earnings, statement, the income statement is an account of the business’s operations, from gross revenue to net profit before taxes, over a defined period**.

**At a minimum, insureds prepare income statements at the end of each fiscal year. However, they commonly prepare them monthly so that merchants can follow trends in business.**

Year end statements furnish claim reps with valuable reference material for handling property claims. They disclose the cost of goods sold and other merchandise related costs that claim reps can use to value stock.

**A balance sheet provides values on a stated date of all assets, liabilities, and paid in capital (also known as owner’s equity). It is especially important for the claim rep because it also includes a physical inventory figure**.

Insureds usually prepare balance sheets at the end of a fiscal year. The corresponding inventory figure represents an actual physical inventory at value determined by the insured and the insured’s accountant. To correlate that inventory figure with the date of loss, the claim rep must examine purchase and sales records since that physical inventory.

**Determining book Value**

The method used to determine the value of out-of-sight merchandise if straightforward: The merchandise’s value was accurately known the last time a physical inventory was conducted, usually at the end of the year or at the end of the business’s fiscal year. Since then, the business has added to its inventory by making purchases from its suppliers.

Suppose for example, that a retailer selling men’s suits had 500 suits in inventory on Dec 31st and purchased 900 suits between Dec 31st and the date of loss. The retailer had a total of 1,400 (5oo that was in inventory + 900 purchased) suits that it could have sold between Dec 31 and the date of loss.

The number of suits sold between Dec and the Date of loss is subtracted from this total. If 950 suits were sold between Dec 31 and the date of loss, the number of suits remaining in inventory would be:

1,400 (500 + 900) – 950 (amount of suits sold) = 450 (remaining inventory)

**The method for determining book value of out-of-sight merchandise can be summarized**:

X Amount in last physical inventory

+ Amount added to inventory (from last physical inventory and date of loss)

= Amount that could have been sold

* Amount that was sold (from last physical inventory and date of loss)

= Amount remaining in inventory on date of loss

**To determine merchandise’s true book value, dollar amounts must also be used in the formula. The claim rep must use the value of the merchandise. The method for determining book value of out-of-sight merchandise can be summarized:**

**X Value of beginning inventory**

**+ Value of additions to inventory**

**= Value of amount that could have been sold**

* **Value of amount that was sold**

**= Value of amount remaining in inventory on date of loss**

The dollar value of damaged or lost merchandise must be used because an insurer isn’t obligated to replace 450 suits, **but to pay the insured’s claim based on the insured value of those suits**. If the insured value of the suite is $100 per suit, the book value of merchandise would be calculated like this:

|  |  |  |
| --- | --- | --- |
| $50,000 inventory value | 500 Suits x $100 Each | Value at beginning inventory |
| $90,000 added inventory | 900 suits x $100 Each | Value of additions to inventory |
| $140,000 total inventory | 1,400 suits x $100 Each | Value of amount that could sold |
| $95,000 Less records of sales | 950 Suits x $100 Each | Value of amount sold |
| $45,000 remaining inventory | 450 Suits x $100 Each | Value of remaining inventory |

In this analysis, the dollar figure for the amount of suits sold cannot be directly obtained from most business’s records. **Although all businesses can provide a dollar figure for the number of items sold, these figures are recorded in terms of retail prices or values.**

To determine the merchandise’s book value accurately, this amount must be reduced from the retail value to the business’s cost of obtaining the suits on the wholesale market. In this analysis, $100 is what the retailer pays to obtain suits from its suppliers. This cost must be used for two reasons:

* Sales figures and purchase figures are otherwise not comparable. Purchases to inventory worth $1,000 are not the same as retail sales of $1,000. Assume for example, that the retail store actually sells the suits for $200. The store’s wholesale purchases of $1,000 represent 10 suits, but the store’s sales of $1,000 represents only 5 suits.
* Generally, the insured value of merchandise is the cost to the business of replacing the damaged stock, not its selling price.

**Determining Cost of Goods Sold**

**To assess merchandise’s book value accurately, the cost of goods sold since the last physical inventory must be known. The historical relationship between the cost and selling price of goods determines the cost of goods sold. Insight into this relationship can be gleaned from a business’s complete records for a year, or several years, in which no loss occurred**.

The cost of goods sold during an accounting period (such as a year) is determined using this formula:

X Beginning inventory

+ Additions to inventory

= Amount that could have been sold

* End inventory (amount not sold during the year)

= Cost of goods sold

Steve’s stationary had a single store that was destroyed by fire on Oct 15 2x3. The loss was total and the merchandise was not recognizable. Steve last conducted a physical inventory on 12/31/2x2. BBI’s financial records show these figures:

$40,000 Beginning inventory

+ 100,000 Additions to inventory

= 140,000 Amount that could have been sold

* 30,000 End inventory (amount not sold during the year)

= 110,000 Cost of goods sold

$150,000 Net Sales

**The $110,000 cost of goods sold is then compared with the retail sales figure for 20X2 to determine the cost-to-sales ratio (cost of goods sold divided by retail sales).**

In this example, **the cost-to-sales ratio is $110,000 / $150,000 = 73%**

If the retailers suffers an out-of-sight merchandise loss in the following year, the cost of goods sold up to the date of loss cannot be determined without an accurate ending inventory figure as of the date of loss. Obtaining an accurate ending inventory figure requires a physical inventory, which is not possible for out-of-sight merchandise.

**However, the cost of goods sold since the last physical inventory can be determined using the retailer’s cost-to-sales ratio and the dollar amount of its retail sales from the date of the last physical inventory to the date of the loss**. If the

* retail sales since the last physical inventory were $84,000 and
* the cost-to-sales ratio is 56%,

**the cost of goods sold for this period is $84,000 x .56 = $47,040**

**Illustration of Book Value Method**

After calculating the cos o goods sold since the last physical inventory the claim rep can begin the last phase of determining the book value of out-of-sight merchandise immediately before the loss occurred. The claim rep must ascertain two additional numbers – the beginning inventory and the additions to inventory for the accounting period in which the loss occurred – an insert those numbers and the cost of goods sold into this formula.

A simplified case will illustrate how to use this method from start to finish. Good Times Merchandise, Inc (GTM) suffered a total out-of-sight merchandise loss because of a fire that occurred on 12/20/2012. The last physical count of inventory occurred nearly a year ago, on 12/30/2011 and is recorded on GTM’s Income statement for the period of January 1, 2011 through 12,31 2011.

|  |  |  |
| --- | --- | --- |
| Gross Sales |  | $240,000 |
| Less   * Returns and allowances * Discounts * Bad debts * **Net sales** | $2,500  $2,800  $700 | * 6,000   **$234,000** |
| Determination of Cost of Goods   * Inventory * Purchases * Incoming freight * Less discounts/returns * Merchandise available * ***Less ending inventory*** | $50,000  $144,000  $3,000  $197,000   * $3,000   -----------------  $194,000  -----------------   * ***$46,000*** |  |
| **Cost of Goods Sold** | **$148,000** | **$148,000** |
| Gross Profit on Sales   * (36.75% of net sales $234,000) | $86,000 |  |
| Expenses |  | $77,000 |
| Net Income |  | $9,000 |

To determine the cost value of GTM’s merchandise immediately before it was destroyed, the claim rep first **calculates the cost-to-sales ratio using the net sales and cost of goods sold**

**Cost of goods sold $148,000 / $234,000 Net Sales = 0.6325**

The cost of goods sold after the last physical count of inventory on 12/31/2011, can be calculated by **multiplying the cost-to-sales ratio by GTMs net sales of $215,000** (substantiated by GTM’s business records)occurring between 1/1/2012 and the date of loss:

**0.6325 X $215,000 cost-to-sales for 2012 = $135,988**

This number will be inserted into the formula for calculating the book value of out-of-sight inventory.

The other numbers needed to calculate the book value of out-of-sight inventory when the loss occurred are derived from GTM’s books and records as noted:

* GMT’s beginning inventory in 2012 and ending inventory of $46,000 shown in GTM’s 2011 income statement
* The additions to GTM’s inventory in 2012 total $140,000 according to GTM’s records of inventory purchases in 2012

The numbers for beginning inventory, additions to inventory, and cost of goods sold can now be inserted into the formula for calculating the book value of out-of-sight inventory:

$46,000 Beginning inventory

$140,000 + Additions to inventory

$186,000 = Amount that could have been sold

$135,988 - Cost of Goods Sold

$50,012 = Value of Inventory remaining on date of loss

BBI’s financial records show that the beginning inventory on 1/1/2012 was $20,000, additions to inventory in 2012 were $150,000; and **net sales from 1/1/201 – 11/12/2012 were $245,000**. The book value of the inventory remaining on the date of loss would be which:

$20.000 Beginning inventory

$150,000 + Additions to inventory

$170,000 = Amount that could have been sold

**$137,200 - Cost of Goods Sold (Cost to sales ratio 56% $137,200 / $245,000) not asked for**

$32,800 = Value of Inventory remaining on date of loss – Book Value

Ben's gross sale of canoes on December 31 was $240,000. His **net sales were $234,000**. Ben's **cost of canoes sold is $148,000**. What is the gross profit on Ben's canoe sales?

Select one:

A. $ 6,000

B. $35,100 **$234,000 - $148,000 = $86,000 Gross profit**

C. $77,000 To determine **Cost to sales ratio** – Gross profit $86,000 / Net Sales $234,000 = **36.75**

**D. $86,000**

***Correct***

***Correct. $234,000 (gross sales) − $148,000 (cost of goods sold) / $234,000 (gross sales) = $86,000 / $234,000 (gross sales = 36.75 percent. $86,000 is the gross profit.***

Robert Smith, the owner of Robert's Ties, reported a fire and smoke loss to the ties in his clothing store. At the beginning of the year, the store had an inventory of 1,400 ties. Between then and the time of the loss, he purchased an additional 700 ties. Between the beginning of the year and the time of the loss, Robert **reports sales of $45,000**. The ties cost $10 each when Robert purchases them. **The ties sell for** **$45.** The cost-to-sales ratio is 50%.

The insurer pays Robert for the value of the smoke-damaged ties and takes the salvage. A salvor sells the ties for $6,000 and pays the insurer this amount. What is the insurer's net loss?

Select one:

A. $0

B. $2,500

***Incorrect***

***Incorrect. 1,400 (beginning inventory) + 700 (additions to inventory) = 2,100 (what could be sold) − ($45,000 / $45) 1,000 (amount sold at time of loss) = 1,100 (inventory at time of loss) x $10 (cost of ties) = $11,000 (amount due insured)− $6,000 (salvage) = $5,000 (insurer's net loss).***

**C. $5,000**

D. $43,500

**4 – Handling Salvage in Merchandise Losses**

**Objective**: Describe the services performed by a salvor in merchandise losses; the interaction among the insurer, the insured, and the salvor; and the method of accounting for salvage.

Even if merchandise is damaged, it may not be a total loss. It may retain some value, even if it requires repackaging, repair, or cleaning.

Damaged merchandise can be sold as salvage to help reduce the insurer’s loss payable amount. So a claim rep needs to know how to manage salvaged goods and account for their sale.

Claim reps often use the services of a salvor on merchandise claims. As outside experts in preserving and realizing the value remaining in partially damaged merchandise, salvors prepare inventories, verify values, preserve damaged items, locate the best possible market for salvaged goods, and oversee sales. But **because, in each instance, the insured owns the items, a claim rep must obtain a contract signed by the insured, insurer, and salvor before the salvage can be sold**. After the salvage is sold the claim rep must account for the net sales proceeds.

**Salvor’s Services**

If a claim rep thinks salvage services will be needed, he or she should retain a salvor at the beginning of the adjustment process who has experience with the type of merchandise damaged.

A salvor can provide various kinds of assistance:

* Help the claim rep survey the loss
* Offer advice on protecting remaining merchandise and determining the feasibility of a physical inventory
* Talk professionally with the insured about the insured’s line of business
* Work with the insured’s employees to separate damaged and undamaged goods, conduct a physical inventory, and check invoices
* Provide advice to the claim rep on the degree of damage to merchandise.

**Salvor’s Role in Settlement**

One of the most important decisions a claim rep must make on a merchandise loss is how to settle the claim. **The rep can choose to settle in any of these ways:**

* **Pay the insured the full value of the merchandise and take the salvage for the account of the insurer**
* **Sell the salvage on the account of the insured and pay the insured the difference between the salvage proceeds and the merchandise’s value**
* **Agree with the insured on the merchandise’s percentage of damage, paying the insured for that percentage of value and leaving the merchandise with the insured for disposal.**

The salvor can provide advice on the likely outcome of each choice. Even with the third option, in which the salvor doesn’t sell the merchandise, the salvor’s advice can be valuable.

**Sale of Salvage**

If it’s decided that the merchandise can be sold, the salvor arranges a sale. This sale can occur at either the insured’s premises or the salvor’s own facility.

The salvor can arrange for packing and shipping the merchandise or for selling the merchandise on-site in an “as-is, where-is” condition. A salvor knows the best people to contact if a sale is held and can help ensure that the best possible price is obtained for the merchandise taken over by the insurer.

With merchandise claims, certain types of damaged stock must be treated differently from ordinary stock. Examples are prescription drugs, which there is practically no market, no matter how minimal the damage is; alcoholic beverages, which can only be sold through licensed dealers; and **highly perishable edibles, which should be cleared by local health authorities and food inspectors before sold**.

Salvors are equipped to determine whether to sell damaged edibles – and to whom. For example, almost all granulated sugar can be re-refined at a reasonable cost, regardless of how it has been damaged. Contaminated salt and items not fit for human consumption but acceptable as animal feed also have markets. **When regulations require that damage stock be destroyed, a salvor ensures it’s destroyed properly**.

**Claim Reps Role**

The claim rep will want to engage a salvor whose expertise matches the type of stock that’s damaged. Insurer often have lists of approved salvors for claim reps and independent adjusters.

**Although claim reps depend on salvors to reduce losses by selling or otherwise disposing of damaged merchandise in the best possible way, claim reps maintain control of the claims handling process**.

Claim reps must be able to make on-the-spot field decisions during the adjustment of a merchandise loss. For example, if certain types of merchandise become wet, the claim rep must work with the insured to dry out the merchandise, prevent mildew or staining, and ensure that the damaged stock retains some value.

**Transactions Among the Parties**

**Because damaged merchandise is owned by the insured, it cannot be taken without permission. Salvors should not move merchandise from an insured’s premises until the insurer, the insured, and the salvor have signed the proper contract**.

The Salvor’s fees and commissions come out of the sale proceeds the insurer; settlement with the insured is based on net proceeds. The insured is not directly liable for the salvor’s fees.

If goods must be sold quickly, as in the case of perishables, the claim rep and the insured don’t have to settle the claim before the salvor takes control of the goods. As long as the claim rep and insured agree that the goods must be sold, they can execute a contract with the salvor.

**Method of Accounting for Salvage Proceeds**

Various methods of accounting for proceeds from a salvage sale may be used for a claim, depending on whether the insured or insurer receives the sale payment, timing of the sale and applicability of a coinsurance penalty. There are 4 primary methods:

* **Sale on account of insurer – (Fastest Resolution**) if **the claim rep and insured agree on the merchandise’s full insured value** and the insurer pays the insured the agreed amount before the salvage occurs, the salvage is sold on account of the insurer. This means that the insurer receives the net sale proceeds for its own account.
  + Agreed full value of Stock $100,000
  + Insurer pays insured $100,000
  + Net Proceeds from salvage sale paid to insurer $35,000
  + Insurer’s net payment $65,000
* Sale on account of insured – If the claim rep and the insured agree on the merchandise’s full insured value and the salvage sale occurs before the claim is settled, the salvage is sol on account of the insured. This means that the net sales proceeds are paid directly to the insured. To settle the claim, the insurer then pays the insured the agreed upon full value of the merchandise minus the net sales proceeds that were paid directly to the insured:
  + Agreed full value of stock $100,000
  + Net proceeds from salvage paid to insured $35,000
  + Therefore, insurer pays insured $65,000
  + Total payments to Insured from Salvage & Ins $100,000
* **Sale on account of whom it may concern – If the salvage sale occurs before the claim rep and the insured can agree on the value of the lost or damaged property, the salvage is sold on account of whom it may concern. This method is often used when the damaged items are perishable goods. The net proceeds of the salvage sale are held by the salvor until the claim rep and the insured agree on the merchandise’s full insured value; then the insured receives the proceeds. To settle the claim, the insurer then pays the insured the agreed upon full value of the merchandise minus the net sales proceeds that were paid directly to the insured**.
  + **Net proceeds from salvage sale pending agreement $35,000**
  + **Agreed full value of stock $100,000**
  + **Net proceeds paid to insured $35,000**
  + **Insurer pays insured $65.000**
* Sale in which insured coinsurers – Insureds with inadequate limits of coverage and who are required to bear a coinsurance penalty share in net proceeds of salvage sale in the percentage of the loss. This is the calculation, assuming a 25% coinsurance penalty.
  + Agreed full value of stock $100,000
  + In light of Co-Ins, insurer pay no more than $75,000
  + In light of Co-Ins, insured might have to pay up to $25,000
  + Net proceeds of salvage sale $35,000
  + Shared 75% with Insurer $35K x .75) $26,250
  + Shared 25% with insured ($35K x .25) $8,750
  + Insurer’s net payment ($75,000 - $26,250) $48,750
  + Insured’s net loss ($25,000 - $8,750) $16,250

**The claim rep should be familiar with the law in the jurisdiction of the claim because the insured may be entitled to first dollar recovery on salvage, regardless of coinsurance.**

**5 – Peak Season Endorsement and Value Reporting Form**

**Objective:** Explain why the Peak Season Limit of Insurance endorsement and the Value Reporting Form are used, and how the amount of loss payable is determined under each

Fluctuating personal property values pose an insurance problem for many businesses – especially those with widely varying inventory levels. For some businesses, values fluctuate in predictable cycles, but for other businesses, external and other factors may cause inventory fluctuations with no predicable patterns.

The term “fluctuating values” refers to values that rise and fall over time. For some businesses, values fluctuate in predictable cycles. A toy store, for example, may predictably double its inventory during the months preceding Christmas, with inventory values declining rapidly just before Christmas and stabilizing for the next nine months.

Similarly, a seasonal business such as a nursery can be expected to have higher inventory values in spring and summer than in fall and winter. Other businesses may experience inventory fluctuations with no predictable pattern.

Other insurable values may be affected by external factors, such as the number of houses being build in the area or rapid changes in the price of material. Whatever the cause of the fluctuation, an insured usually wants insurance to adjust to the circumstances and provide economical protection year-round, rather than pay excess premiums (for unneeded coverage) or have too little coverage (to avoid paying excess premiums).

The usual approach of a single, fixed amount of insurance, with premiums based on that policy limit is **unsatisfactory** for fluctuating inventories.

**The Peak Season Limit of Insurance endorsement and the Value Reporting Form address the fluctuation in personal property values during the policy period. In different ways, the two options reduce the premium that the insured must pay to cover actual values at risk. The insured does not have to pay for unneeded insurance when property values are reduced**.

**Peak Season**

**The Peak Season Limit of Insurance endorsement (CP 12 30) provides differing amounts of insurance for selected time periods during the policy term, as indicated by specific dates shown in the endorsement**.

For example, a swimsuit manufacturer is covered under a Business and Personal Property Coverage Form (BPP) providing $3M in coverage on business personal property with peak season endorsement increasing coverage to $4M from February 1 to Mary 31, the time when its inventories increase to meet the summertime demand. This would have exactly the same effect as endorsing the February 1 to increase coverage and endorsing it again on May 31 to reduce coverage.

The peak season endorsement eliminates the need for the extra transactions and avoids the risk that the insured may overlook the need to increase its insurance.

Usually the Peak Season Limit of Insurance endorsement is attached when the policy is issued – although it may be added mid-term -and a prorate increased premium is charged for the period during which the limit is increased.

**Value Reporting Form**

**The Value Reporting Form (CP 13 10)** **provides another way to avoid the costs of over insuring or underinsuring business personal property.**

A limit of insurance is set high enough to cover the insured’s maximum expected values at any time during the policy period. The insured reports values to the insurer at periodic intervals specified in the form. **As long as the insured reports property values accurately and on time, the insurer will pay the full amount of any loss that occurs (subject to the policy limit), even if the values on hand at the time of the loss are greater than those last reported to the insurer.**

At the end of the policy period, the insurer computes the average values that were exposed to loss and uses that average to determine the premium. Thus, the final premium is based not on the policy limit but on the values reported by the insured as exposed to loss.

Major features of the Value Reporting Form: Reporting requirement; Limit of Insurance; Penalties; Treatment of specific (nonreporting) insurance

**Reporting Requirement**

The insured must give the insurer periodic reports of dollar values covered by the policy. The time period for which the reports of value are due is referred to as the reporting period. Fire reporting period options are available.

* DR – Daily values reported monthly
* WR – values as of the last day of the week reported monthly
* MR – values as of the last day of the month reported monthly
* QR – values as of the last day of the month reported quarterly
* PR – values as of the last day of the month reported at the end of the policy year

**MR, monthly reporting of monthly values on the last day of the month, is the most commonly used alternative**.

The applicable code letters (DR, WR, and so forth) appear in the commercial property declarations in place of a coinsurance percentage. The insured must file the required report within 30 days of the end of each reporting period. The 30-day requirement applies to the renewal, by the same insurer, of a policy previously written with a reporting form. For coverage that was not previously written with a reporting form by the insurer, the insured has 60 days from the end of the reporting period to file the first report on all except the quarterly report basis. Different rules apply to quarterly reports, as described in the form.

**Limit of Insurance**

Usually, a specific limit of insurance applies to property at each location. The insurer’s obligation is limited by this maximum amount per location unless coverage is written on a blanket basis, in which event the blanket limit can apply at any one location.

The insured is required to report the value (using the valuation basis specified in the policy) of all covered property on hand of each report date. If $250,000 worth of property is on hand and the limit of insurance is $150,000, then the insured must still report $250,000. Because the premium is based on the reported values, the insured must also pay a premium based on $250,000. **However, coverage is still capped by the $150,000 limit of insurance**. If such a situation occurs, the insured should increase the policy limit or purchase specific insurance to cover the additional $100,000 of value.

**The Report Values (CP 13 60) that is used to report property values** to the insurer prominently **displays this notice of this potential problem: “The values you report do not change your limits of insurance. If values exceed or come close to your limits of insurance, contact your agent or broker. You may need additional insurance**.

For the Value Reporting Form to work properly – and for the insurer to collect adequate premiums – the insurer must have information that accurately reflects the values exposed to loss. Accordingly, the form imposes penalties for failure to submit reports on time and for inaccurate reports.

**Penalty for Failure to Submit Required Reports on Time**

**If at the time of loss the first required report of values is due, but has not been received, the insurer will pay no more than 75% of the amount that would otherwise have been paid.** For example, assume that the insured had made no reports of value at the time that a loss occurred under these circumstances:

* Limit of insurance $100K
* **Reporting Period – MR**
* **Policy Inception – 1/1**
* **DOL – 4/12**
* Loss $40,000 X .75 = $30K (failure to submit required report on time)

Because the fire report was due but had not been received at the time of the loss, the insured would collect only 75% of the amount that the insurer would have otherwise paid. Thus, ignoring any deductible, the insurer would pay $30,000 instead of the full $40,000

**If at the time a loss occurs the insured has failed to submit any required report after the first required report has been made, the insurer will pay no more than the values last reported for the location at which the loss occurred.** This provision can result in a serious penalty for an organization whose values at the loss location are higher than they were at the time of the last report. **However,** it has not effect on an organizations whose values at the loss location are the same or lower than they were at the last report date.

* Limit of ins - $100K
* Report Period – MR
* **Value last report $60K**
* Policy Inception – 1/1
* DOL – 6/20
* **Loss $70K**

Because the 2nd report was overdue at the time of the loss, the insurer would pay no more than value last reported for that location; Thus disregarding any deductible, the insurer would pay only $60K leaving the insured with a $10K uninsured loss. Had the loss been $60K or less, no penalty would have applied.

**Penalty for Inaccurate Reports**

**The Value Reporting form replaces the Coinsurance Condition of the BPP with a Full Reporting provision, which stipulates that if the last report showed less than the full value of covered property at the affected location on the report date, then the insurer would pay claims according to this formula:**

**Insurer payment (not to exceed limit) = Value reported/Actual Value x Loss – Deductible**

To understand the consequences of underreporting values. Assume that a loss occurs under these circumstances, and the insurer’s claim representative investigating the loss has discovered that the actual value at the time of the last report was greater than the value reported:

* Limit of Insurance: $2M
* **Value reported: $1M**
* **Actual value: $1.5M**
* **Loss: $600K**
* Deductible: $1K

Payment would be calculated:

$1M Value reported/ 1.5M Actual value X 600K amount of loss = $400,000

$400,000 - $1K Deductible **The carrier will pay only $399,000**

In this case, the insured’s inaccurate reporting resulted in an uninsured loss that was $200,000 greater than it would have been if the insured had made an accurate report. The potential severity of the penalty for inaccurate reports should deter anyone who is aware of it from trying to same on premiums by intentionally underreporting values.

Unfortunately, many insured do not understand the consequences of inaccurate (or late) reports until after they have suffered a loss.

**As long as reports are accurate and made on time, the penalties described do not apply; the insurer will pay the full amount of any loss (up to the limit of insurance), even if it exceeds the amount last reported**.

**Specific Insurance**

Reporting form insurance may be combined with other, nonreporting insurance covering the same property. **This other insurance is then referred to as specific insurance**. The terminology is confusing because “specific” is also used as the opposite of “blanket”.

The Value Reporting Form defines specific insurance as;

*… other insurance that:*

1. *Covers the same Covered Property to which this endorsement applies; and*
2. *Is not subject to the same plans, term, conditions and provisions as this insurance, including this endorsement.*

**Coverage on property subject to the Value Reporting Form is excess over the total of (1) the amount due from specific insurance plus (2) the amount of any deductible applying to the specific insurance.**

If the specific insurance is written with no coinsurance, the specific coverage pays the loss up to its policy limit, and the reporting insurance pays the balance, less any applicable deductible.

If the specific insurance has a coinsurance requirement, the reporting form coverage is not counted when determining whether the coinsurance requirement has been met.

* Amount of Insurance $5M
* **$1,000 Deductible**
* Reports due MR
* Policy Incept 1/1
* Date of Loss 11/10
* **Loss amount $240,000**
* **Value reported $4M on time**
* **Actual value stated on report was 3.2M**

**3.2M** actual reported/ **4M** last reported x $**240** loss - $**1,000** deductible = **$191,000**