Underinsurance:

Don't underestimate the impact it can have on you and your business

Make sure you value your business

Australia is a land of uncertainties which can have a major impact on your business. The recent floods, bushfires and cyclones are proof that no one is immune to the forces of nature, not to mention the many internal incidents that force businesses to stop working at full capacity each year.

All businesses should have property insurance that covers their buildings, plant, equipment and contents, and provides adequate business interruption cover under an Industrial Special Risks policy. Most businesses assume they are fully covered for both. Perhaps they've spoken to a competent broker, or perhaps a trusted employee is looking after the insured values and has been for years.

But that's only half the story. Unless your assets have been valued correctly, this kind of approach usually results in chronic underinsurance. This can have dire consequences for your business and its ability to operate as a going concern in the event of a major loss.

Self-assessment leads to underinsurance

Insurance is designed to restore your business to the position it was in before an insured loss and to reinstate your business on a like-for-like basis without financial penalty. Without a formal valuation the likelihood is that the business will be underinsured.

Unfortunately, businesses often base their insured values on incorrect advice and false assumptions leading to two major problems.

Firstly, the methods they use will usually lead to errors in the initial assessment of the value of a property (see examples).

Secondly, these values are generally revised annually by internal staff who fail to account for the rise in associated costs impacting the true cost of reinstatement. These costs include professional fees, changes to building codes, debris removal, site improvements, and currency fluctuations, as well as lead times for DA approval, planning, rebuild period and policy life.

The risks of getting it wrong

Typically businesses only have 50-75% of the correct value insured. Unfortunately, the risks in getting it wrong can be substantial and not just for the business. Ultimately, it is the directors of the business who bear the responsibility for declaring insured values and they can be penalised for misrepresentation in the event of a claim.

Most businesses need to get up-and-running again quickly after a loss. But if there is no solid basis for the declared values, ensuing investigations may lead to protracted claims processes and delayed settlements lasting months or even years.

If it is then discovered that the property has been underinsured and the insurance company does decide to pay, the amount paid out won't cover the full loss. The business is then responsible for finding the shortfall and making good the repair themselves (see example).

There is also the risk that the insurer may decide that the business deliberately understated the declared values and refuse to acknowledge the claim at all. This is the worst case scenario, but it happens.

The Top Reasons Businesses Underinsure

1. Adding 5 or 10% to last year's figures
2. Basing the increase on real estate market conditions
3. Asking the bank, builder, architect, or real estate agent
4. Relying on advice from an in-house accountant or engineer
5. Referring to building guides
6. Adopting book value
7. Using financial valuation reports and deducting land value
8. Adopting the second-hand purchase price of an assert.

The benefits of getting it right

Ensuring that you and your business are fully covered is much simpler than you think. The most important aspect is to make sure you have your business properly assessed by a qualified insurance valuer. A proper valuation process removes the potential risk to directors, and ensures that there will be no gap to cover in the event of a claim.

It's also important to have an up-to-date asset register which will allow you to respond to a loss with the minimum impact to your business. In fact, one of the advantages of the valuation process is that it forces many businesses to implement internal processes, such as asset registers, that have long been on the to-do list.

The benefits of having a valuation carried out are significant, both to you and your business, and include:

> Not paying the consequences of underinsurance in the event of a claim;

> Not paying excessive premiums due to overinsurance;

> More negotiating power when it comes to renewals;

> Fast-tracked claims process without disputes around the insured values;

> Minimised interruption to business operations;

> Established lead times for business interruption calculations;

> Implementation of internal processes, such as asset registers;

> Compliance for risk mitigation.

What should you do next?

At Aon, the Insurance Valuation Program is undertaken by qualified professional valuers who are trained in the process of insurance valuations, something most valuers aren't qualified to do. They provide a three-year service which includes an on-site valuation in year one, followed by an on-desk review in each of the following two years.

And for those who elect to fund their insurance premium, the cost of an Insurance Valuation Program can be added to premium funding facilities.

The impact of underinsurance

Did you know underinsurance won't just impact your business in the event of a total loss? You may also be penalised if you suffer a partial loss.

Let's say your building is insured for $4 million. During the course of the year you have a fire and suffer a $2 million loss. 'That's fine', you think. 'I'm covered for $4 million so this shouldn't be a problem'.

Not so fast. The loss adjuster appointed by the insurer asks you how you arrived at the insured values and to validate what was in the area of loss. Without a proper valuation, you're unable to answer these questions to his satisfaction.

His assessment shows that you were underinsured by 50 percent which means that you may only receive 50 percent of the loss. $1 million to replace a $2 million loss! You're then left to fund the rest.

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