Business Insurance Fundamentals

3rd Edition

Steven M. Bragg

CPE Edition
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Printed in the United States of America

Course Information

Course Title: Business Insurance Fundamentals

Learning Objectives:

- Recognize what the combined ratio is designed to measure
- Determine the intent of using a deductible in an insurance contract
- Pinpoint what coinsurance is intended to do
- Identify a unique benefit associated with boiler and machinery insurance
- Spot a key advantage of using credit insurance
- Ascertain the difference between whole life and term life
- Recognize a concern with insurance riders
- Determine why an insured entity would avoid filing claims for smaller amounts
- Spot an example of a situation in which self-funded insurance works well

Subject Area: Finance

Prerequisites: None

Program Level: Overview

Program Content: Every business needs insurance to mitigate its exposure to risk. This course is designed to enhance one's knowledge of business insurance by providing an overview of the insurance industry, including the operations and distribution systems of insurers. It also notes the more common insurance policy terms and conditions, the types of insurance most applicable to businesses, and how to manage and account for insurance. There is a particular emphasis on managing the cost of insurance. In short, this course shows how to determine which risks require insurance and which types of insurance to buy.

Advance Preparation: None

Recommended CPE Credit: 3 hours

Course Expiration: Based on standards set by NASBA and the AICPA, this course will expire one year from the date of purchase.

About the Author

Steven Bragg, CPA, has been the chief financial officer or controller of four companies, as well as a consulting manager at Ernst & Young. He received a master's degree in finance from Bentley College, an MBA from Babson College, and a Bachelor's degree in Economics from the University of Maine. He has been a two-time president of the Colorado Mountain Club, and is an avid alpine skier, mountain biker, and certified master diver. Mr. Bragg resides in Centennial, Colorado.

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Overview of Business Insurance

Learning Objectives

- Recognize what the combined ratio is designed to measure
- Determine the intent of using a deductible in an insurance contract
- Pinpoint what coinsurance is intended to do

Introduction

Insurance is a contractual arrangement in which an organization pays an insurance carrier in exchange for the assumption of risk by the carrier. The arrangement is used by a business when it wishes to offload risk that it does not want to or cannot retain internally. An insurance company takes on the risk of many entities, because a large pool of risk exposures results in a highly predictable total payout. In essence, the insurer needs a large pool of insured entities in order to pay claims to a small number of the total group.

Insurance is designed for events that are infrequent and high-loss. If events are too frequent, the cost of insurance coverage will be too expensive. If an event has small losses, there is no point in obtaining insurance coverage, since self-insurance is less expensive. Thus, insurance is intended for a very specific set of situations. All other types of risks must be dealt with in other ways, as noted in the author's *Enterprise Risk Management* course.

In this chapter, we provide an overview of the insurance industry, including the operations and distribution systems of insurers, how they make money, and how they are evaluated. We also review the more common insurance policy terms and conditions.

Types of Insurers

There are many types of insurers, which operate within the following general classifications:

- **Mutual insurance company.** This type of entity is owned by its policyholders, so no ownership shares are outstanding. If dividends are distributed, the payouts are in the form of policy dividends to the policyholders. Dividends are paid when the financial results of the entity have been good, or if the number of claims received has been lower than expected. These entities have a more

difficult time raising money in the capital markets, since they do not sell shares; this means that they can only grow at a relatively slow rate. Because of the funding restriction, a number of mutual companies have altered their structures to be stock insurance companies (see next).

- **Stock insurance company.** This type of entity sells shares to investors, which are used to pay initial operating costs and provide an equity reserve against policy payouts. Dividends may be paid to investors from time to time.
- **Public insurance company.** The federal and state governments operate a number of insuring entities that target specific types of risk. For example, there are programs for crop insurance, mortgage insurance, and workers compensation insurance. Some of these insurance programs are compulsory, such as the Social Security program.
- **Risk retention group.** This is a liability insurance company that is owned by its policyholders. This structure is designed to spread liability exposure among the policyholders. Members must be in the same business, so that they are exposed to similar liability risks.

The preceding classifications have described the operating structures of insurers, but not the areas that they insure. The typical insurer operates in one of two areas, which are life/health and property/casualty. Insurers targeting the life/health area offer protection against premature death, unexpected medical costs, and outliving one's finances. Those insurers in the property/casualty sector offer protection against risks to tangible property, and against negligent acts or omissions.

In the life/health part of the market, the "life" part of the name essentially covers the risk of dying too early (with life insurance products) or of living too long (with annuity products). The "health" part of the name refers to the payment of benefits to those who become ill or are injured. This involves managed care, where insurers establish fee agreements with doctors and hospitals, and services are reimbursed at specific prices. When a health plan originates with an employer, the employer pays the insurer a fixed amount per covered employee, while employees make copay payments directly to health care providers.

In the "life" part of the market, insurers must deal with extremely long coverage horizons, since the events triggering their policies may be decades away. Because of the long-term nature of their products, insurers have quite lengthy investment horizons, resulting in massive investments in

bonds and real estate. Because of competitive pricing pressures, insurers offering life insurance are commonly dependent on investment performance in order to earn a profit.

In the "health" part of the market, insurers may experience claims at any time, and so must tailor their investments to be short-term and highly liquid.

In the property/casualty part of the market, the "property" part of the name refers to losses related to physical objects, such as buildings, vehicles, and ships. The "casualty" part of the name represents a focus on the liabilities incurred by insured parties, particularly in regard to negligent acts or omissions. Insurance products related to the casualty area include auto liability, workers' compensation, general liability, and professional liability. Catastrophes, such as hurricanes and tornadoes, can have an overwhelmingly negative impact on the property/casualty market, especially if there are excessive concentrations of policyholders in the affected areas. To mitigate the risk of a catastrophe, insurers try to spread out the locations of their policyholders over broad geographic regions.

Insurance Distribution

There are several methods by which insurance is sold. *Direct writers* are insurance companies that sell insurance through their own distribution networks. Salespeople are only allowed to sell the insurance offerings of their employer. There is no option for a client to review quotes from other insurers, unless the clients also work with a broker. A variation on the direct writer concept is the *exclusive representative*, where the representative is required to first approach its designated insurer about a prospective insurance policy, which has the right of first refusal. If the request is denied, the representative can then offer the policy to other insurers. Direct writers also contact prospects through a variety of solicitations, such as the Internet, phone calls, and the mail. These latter approaches can be cost-effective for an insurer, because no commissions are paid.

Other insurance providers sell through a network of independent agents or brokers, who typically represent the insurance products of several insurance companies.

An *agent* is a legal representative of an insurance company, and may represent several insurers. An agent receives the rights to policy renewals for the agent's clients, along with the associated commissions. This renewal right allows an agent to build up a larger revenue stream over time. A variation on the agent concept is the *captive agent*, which only represents a single insurer. A captive agent may receive certain benefits, training, and even business leads in exchange for agreeing to this arrangement.

The business leads appear when a policyholder moves into a captive agent's territory.

A *broker* represents the client, and assists the client in shopping for the best combination of coverage and price. Once a client accepts the recommendations of the broker, the broker must place the insurance contracts with the agents of the selected insurers.

If an organization decides to work with an agent or broker, it should make a selection based on multiple possible criteria, such as:

- **Areas of expertise.** An agent or broker may have particular experience in certain industries, and provide advice in these areas. Evidence of expertise includes the resumes of its technical support staff and the types of clients represented.
- **Carriers represented.** The company may have good experience with certain insurance carriers, and so will only work with an agent that represents those same carriers.
- **Services provided.** An agency or broker may offer an array of services, such as claims management, on-site inspections, policy analysis, and loss modeling.

An entirely different approach to insurance distribution is price comparison websites, which receive commissions when policies are sold through their sites. Alternatively, they may be paid a fee for each click-through from their sites.

Insurance Company Analysis

When purchasing insurance, be sure to review the credit rating of the insurer, to see if it has adequate reserves to pay claims if the company experiences a loss. The easiest way to do so is to look up the *financial strength rating* (FSR) of the insurer, which is formulated and published by A.M. Best. The FSR rating represents an assessment of an insurer's ability to meet its payment obligations to policy holders. The rating is based on numerous factors, including an insurer's balance sheet and financial performance and an assessment of its operating plans and management. The A.M. Best ratings are noted in the following table.

A.M. Best Ratings

Secure Insurer Ratings		Vulnerable Insurer Ratings	
Rating	Description	Rating	Description
A++, A+	Superior	B, B–	Fair
A, A–	Excellent	C++, C+	Marginal

Secure Insurer Ratings		Vulnerable Insurer Ratings	
Rating	Description	Rating	Description
B++, B+	Good	C, C–	Weak
		D	Under
		E	Under regulatory supervision
		F	In liquidation
		S	Rating suspended

It is imperative to only do business with insurers that have secure ratings. In particular, the umbrella policy should be with an insurer that has been awarded an A+ or A++ rating, since this policy provides coverage for extremely large losses. If a business finds that the insurer backing its umbrella policy is bankrupt, a massive claim could then bankrupt the business, as well.

Insurer Operations

Most insurers have a consistent organizational structure, which works well within the unique requirements of the insurance industry. The following operating divisions can usually be found within an insurer:

- **Underwriting.** This group examines all proposed insurance contracts and selects those that meet its underwriting guidelines. There may be specialists who only deal with the more arcane types of insurance, as well as specialists who are qualified to examine most types of insurance proposals. There may also be several support specialists, such as actuaries and loss control experts.
- **Marketing.** This group brings the insurer's various policies to the attention of the public. There may be several support specialists who deal with public relations, advertising, sales training, and publications. Their activities may be regulated by the insurance commission of the applicable state government.
- **Claims.** This group is responsible for reviewing incoming claims and issuing payments as expeditiously as possible. There may be claims adjusters who settle claims outside of the office, as well as in-house analysts who handle the same functions from a central office. Claims adjusters are responsible for visiting locations where losses have occurred, interviewing witnesses, evaluating the amount of each loss, and settling with claimants. There may be a legal team that assists the claims group with litigation activities, as well as appraisers and claims auditors.

- **Administration.** The administrative function of an insurer contains the usual management, accounting, human resources, and information technology functions. Of particular interest is its investment group, which is responsible for investing insurance premiums in order to generate an adequate return, which is needed to pay for claims and generate a profit.

Insurer Financial Performance

How does an insurer make money? There are two ways to do so. First, an insurer receives insurance payments from its (presumably) many policyholders, from which it can then earn income by investing the funds. Second, it can generate a profit by charging premiums that will exceed all related administrative expenses and claims payments. Both tasks can be difficult, as noted next:

- **Profit from investments.** The insurer has a time period known as the float, during which it can invest premiums paid by policyholders. The float is the time period from the receipt of a premium to the date of a claim payment. The insurer matches the duration of its investments to the dates when its claims payments are expected. Thus, an insurer with predominantly short-term obligations would invest in highly liquid investments, such as commercial paper, while an insurer with longer-term obligations could afford to invest in real estate (or real estate investment trusts), bonds, and commercial mortgages. In general, investments must be made cautiously, in order to avoid a loss of invested funds. Also, state regulators prohibit risky investments.
- **Profit from underwriting.** Employees of an insurer must properly assess the risk associated with a potential policyholder, as well as the likelihood of any valid claims being received, and the amount of those claims. A bad decision in this area could lead to massive losses.

The amount of claims made against a policy may not be known for quite a long time, so insurers recognize an estimated reserve against future losses. These reserves can be impacted by a catastrophe, and so are not always good indicators of the financial performance of an insurer.

One method for determining the financial performance of an insurer is to calculate its combined ratio, which compares the total amount of incurred losses and expenses to insurance premiums earned. When this ratio is less than 1, an insurer is generating a profit from its underwriting activities. However, a key failing of the ratio is that it does not include any

investment income that an insurer may generate, which could be a substantial amount. The combined ratio formula appears next.

$$\frac{\text{Claims incurred + Expenses}}{\text{Earned premiums}} = \text{Combined ratio}$$

EXAMPLE

In the past year, Gulf Coast Insurance has incurred claims of $15 million and other expenses of $3 million. During that time, its earned premiums totaled $16 million. The resulting combined ratio is:

$$\frac{\$15{,}000{,}000 \text{ Claims incurred} + \$3{,}000{,}000 \text{ Other expenses}}{\$16{,}000{,}000 \text{ Earned premiums}} = 1.125 \text{ Combined ratio}$$

The combined ratio for Gulf Coast is 1.125, which indicates a solid underwriting loss. However, the company has also generated $1.5 million of investment income. If investment income were to be added to the denominator of this calculation, the revised combined ratio would be 1.03. This more comprehensive calculation still indicates a loss, but a much smaller one.

Insurer Failures

What happens to an insurer that is financially unable to continue in operation? Insurers are regulated by state insurance commissions whose job is to protect policyholders from the financial shortfalls of their insurers. When there is a problem with an insurer, the applicable state insurance commissioner begins a process called rehabilitation, which is intended to restore the finances of the insurer. The insurance department gains control of the insurer, and appoints either an in-house or third party receiver to examine the books of the insurer. If the receiver determines that the insurer cannot be rehabilitated, the insurance commissioner will order its liquidation.

When there is a liquidation, some portion of outstanding policyholder claims will be covered by a state guarantee fund. The funding for a guarantee fund comes from periodic fees charged to the insurers licensed by the state. However, a maximum payout is typically imposed on these funds, so policyholders may still not be able to obtain complete settlement of their claims.

Insurance Pricing

The insurance industry in unique in that it first sets the price of a product and then spends the next few years discovering the associated cost, in the

form of policyholder claims. This means there can be a lengthy period after new insurance products are introduced, before insurers can reasonably match their prices to actual claims experience. The result can be wildly fluctuating insurance prices.

A number of other factors impact the price of insurance. It is useful to understand the vagaries of these pricing drivers, since excessively high prices can mean that insurance is not a viable risk mitigation tactic. Insurance pricing factors include the following:

- **Recent loss experience.** Pricing can be based in part on the loss experience of an insurance carrier. This means that a prior history of significant payouts will likely lead a carrier to continually raise its rates until its cash inflows from policy premiums are sufficient to offset its continuing payouts. For example, rates tend to rise following a catastrophe that caused massive numbers of claims on insurers. Conversely, if a carrier has a declining loss experience, it will be more likely to reduce its prices. These factors have nothing to do with an organization's specific circumstances, but can still impact the prices it pays.
- **New entrants.** A new entrant into an insurance market may set aggressively low market prices in order to rapidly gain market share. A business can take advantage of this pricing by switching carriers, but be aware that the new entrant's prices will probably increase in the near future, once it develops a loss experience.
- **Pricing base.** The calculation of certain types of insurance is based on the volume level of the insured entity. For example, the cost of workers' compensation insurance is based on payroll costs, while liability insurance is based in part on the sales of the insured entity.

An Insurable Risk

A risk arises when there is uncertainty regarding whether a loss will occur, and the amount of that loss. Some risks can be mitigated internally, but some cannot, in which case an organization must either accept the risk or offload the risk to an insurer. In the case of the last option, what types of risks are insurable? The following conditions should be met:

- **There should be a large homogeneous group seeking insurance.** A large cluster is needed, so that a probability of loss can be established across the group, thereby allowing insurers to set prices. Thus, if an entity is one of only a few firms seeking insurance for a specific risk, it may not be possible to obtain any insurance at all, or else the quoted price may be very high, which reflects the uncertainty of the insurer in setting a price.

- **The amount of a loss should be measurable in monetary terms.** If a loss cannot be quantified, then the organization and its insurer will bicker over the amount of any losses. For example, the loss of reputation is very difficult to quantify.
- **Losses should only be caused by accidents.** When a loss is caused by an intentional act, this interferes with the probability calculations conducted by insurers to set prices. This is why a common exclusion from insurance policies is actions instigated by terrorists and by wars in general—these actions are deliberately taken, and so are not insurable.

The Insurable Interest Concept

Before buying an insurance policy, one should establish whether an insurable interest exists. Such an interest is present when the party buying a policy would experience an economic loss if the insured person or property were to die or be damaged or destroyed. For example:

- There must be an insurable interest when a life insurance policy is written. As examples, a wife buys an insurance policy on her husband, or a company buys an insurance policy on a key employee. For this type of insurance, the insurable interest must exist when the policy is written, but does not need to be present upon the death of the insured party.
- There must be an insurable interest when a property insurance policy is written, as well as at the time of loss. As an example, the corporation that owns a warehouse can buy property insurance on the warehouse; an individual unrelated to the corporation cannot buy a similar policy on the same warehouse.

Insurance Policy Terms and Conditions

When buying insurance, an organization must be cognizant of the related contract terms and conditions, since they can greatly restrict the amount of coverage that a carrier is actually agreeing to. The net result of the following terms and conditions is that a carrier is limiting the extent of its maximum payout, avoiding certain high-loss events, and forcing buyers to participate to varying degrees in any losses incurred.

Indemnity

The terms of an insurance contract may state that the insurer will indemnify the insured party if there is a loss. An indemnity refers to a payment by the insurer for the monetary value of a loss, as defined by the related

insurance contract. The amount of an indemnity does not exceed the monetary loss experienced by the insured party, since an excessive payment would be akin to a gambling win by the insured.

Deductibles

The typical insurance policy contains a deductible, which is an initial loss amount that must be absorbed by the insured party. There are several reasons why insurance companies impose a deductible, which are:

- **Frivolous claims avoidance.** The bulk of all losses incurred by an organization are quite small, and they would inundate insurers with these claims if the insurers were solely responsible for losses. The cost to investigate and pay these claims would be excessive. The deductible keeps these smaller claims from ever being filed.
- **Ownership of losses.** If insured entities can pass the full amount of losses on to their insurers, they have no reason to take action to avoid losses. By making the insured parties responsible for smaller losses, there is a stronger incentive to avoid all types of losses.

Limit of Insurance

All insurance policies contain a limit of insurance, which is the maximum amount that the insurer will pay. This is needed by the insurer in order to avoid massive payouts due to catastrophic loss situations. Some of these limits of insurance are set quite low, so that the amounts paid out are inconsequential. If so, there may be little point in obtaining the insurance, since the amount of risk being passed off to the insurer is immaterial.

Coinsurance

There may be a coinsurance provision in an insurance policy. This provision is designed to penalize the insured party if it under-insures the value of property. Coinsurance is stated as a percentage. The following example illustrates the concept.

EXAMPLE

Hodgson Industrial Design owns its headquarters building, which has a replacement cost of $3,000,000. The company's property insurance contains an 80% coinsurance clause, which means that the insured amount must be at least 80% of the replacement cost of the building, or $2,400,000. The actual amount insured is for $2,000,000. Since the insured value is less than 80% of its replacement value, a loss payout under the policy will be subjected to an under-reporting penalty.

The building subsequently suffers $500,000 of property damage. The amount paid to Hodgson by the insurer is calculated as follows:

$2,000,000 insured amount ÷ (80% coinsurance percentage × $3,000,000 replacement cost) × $500,000 loss

= $416,667

In essence, Hodgson pays an $83,333 penalty because it did not insure the full value of the property.

The most commonly-used coinsurance percentage is 80%. If the percentage is higher, the insurer is imposing a stricter standard on the insured entity to insure the full value of property.

Given the negative impact of the coinsurance provision, a business must routinely examine the values of its insured property to verify that adequate amounts of insurance are being carried. Otherwise, a loss could result in a significantly reduced payout by the insurer.

Exclusions

Insurance policies typically contain a lengthy list of exclusions. If losses are caused by one of these events, they are not covered by the insurance. The exact exclusions will vary by insurance policy, but may include the exclusions noted in the following table.

Sample Policy Exclusions

Earthquakes	Government seizure	War or sabotage
Flooding	Mold damage	Windstorm or hail
	Nuclear explosions or radiation	

Insurance Riders

An insurance rider is an adjustment to a basic insurance policy. A rider usually provides an additional benefit over what is described in the basic policy, in exchange for a fee payable to the insurer. A rider is not a standalone insurance product; it must be attached to a standard insurance policy. A rider is useful for tailoring an insurance policy to the precise needs of the insured entity. Examples of insurance riders are:

- **Life insurance.** An accelerated death benefit is added to the policy, so that a payout occurs when the policy holder is diagnosed with a terminal illness.

- **Directors and officers insurance.** A "tail" is added to the policy, so that the directors and officers receive coverage for several years following the normal termination of the policy.
- **Property insurance.** Additional coverage is provided for flooding, earthquakes, and fire damage, which may not be addressed by the basic policy.

Perils

Insurers may attempt to underwrite only a specific set of risks that they identify in the coverage; this is called *named perils* coverage. Since this type of coverage can exclude many types of risks, one should instead strive for *all-perils* coverage. Realistically, the cost of all-perils coverage may be so high that it is not attainable; if so, obtaining insurance devolves into an analysis of how to obtain the largest amount of named perils coverage for the lowest price.

Endorsements

Endorsements are attachments to a contract that either add to or restrict coverage. In essence, each endorsement is designed to adapt a boilerplate policy to the specific needs of the insured party.

Losses and Claims

Once an insurance policy is in place, the insured entity will not receive a payment from the insurer unless it experiences a loss and then files a claim. A *loss* is characterized as an unexpected and unintentional drop in the value received by an entity that is caused by an occurrence that causes damage or injury. For example, the occurrence of a 500-year flood that destroys a warehouse is certainly unexpected, and would be considered a loss. However, a fire set by the owner of the warehouse is quite intentional, and so is not considered a loss.

Once a loss has been experienced, a claim must be filed. A *claim* is a demand made by the insured entity on the insurer, asking for the payment defined in the related policy that relates to a loss. It is possible that a claim may not be filed, for several reasons. First, the insured party may not realize that it has insurance coverage for a specific loss. Second, a claim may not be filed if the insured party believes that doing so will trigger an investigation by the insurer into the insurability of the insured party. And finally, the insured party may not file a claim when the amount it expects to be paid by the insurer is quite small—in effect, the cost to file a claim is less than the amount to be received.

A loss will only trigger a claim when the cause of loss has already been identified in the related insurance contract. For example, if a windstorm is defined in a contract as a cause of loss and a windstorm then blows down a building owned by the insured, then the windstorm would be considered a cause of loss.

Who is the Payee?

It is useful to understand which party is being paid by an insurer in the event of a claim. When the insurer is taking on a liability on behalf of an insured party, the insurer is paying the injured party, which is not the insured. For example, a company's customer sues in regard to an alleged product flaw that injured the customer. The insurer pays the customer the amount required to settle the claim, doing so on behalf of the insured party. Commercial general liability insurance and directors and officers insurance both feature this type of payment. Most other types of insurance provide for payments being made to the insured party.

Summary

In this chapter, we noted that there are several types of insurance entities, which service different parts of the market. This means that a business may find itself having to obtain insurance from a number of insurers in order to obtain full insurance coverage. To keep from being confused by a plethora of policies from different insurers, it is useful to work with an agent or broker, who can keep track of all coverages and identify where there may be a "hole" in the coverage. This individual is especially useful in explaining the meanings of the many policy terms and conditions, highlighting those that are of particular concern to an organization.

Review Questions

1. Which entity issues dividends in the form of stock dividends?
    A. Risk retention group
    B. Public insurance company
    C. Stock insurance company
    D. Mutual insurance company

2. What term is used for a payment by the insurer for the monetary value of a loss called?
    A. Exclusion
    B. Coinsurance
    C. Limit of insurance
    D. Indemnity

Review Answers

1. A. Incorrect. A risk retention group is owned by its policyholders. The concept is to spread liability exposure among the policyholders, so the emphasis is not on paying dividends.
   B. Incorrect. A public insurance company is operated by a government, so there are no shareholders to whom dividends could be paid.
   C. **Correct.** A stock insurance company is owned by investors, so they are paid with normal dividends.
   D. Incorrect. A mutual insurance company is owned by its policyholders, so dividends are paid back to them in the form of policy dividends.

2. A. Incorrect. An exclusion is a subtraction from the coverage provided by an insurance policy.
   B. Incorrect. Coinsurance is a percentage threshold of insurance that a policyholder is required to purchase in order to avoid under-insuring a property.
   C. Incorrect. A limit of insurance is the maximum amount that an insurer will pay for a claim.
   D. **Correct.** An indemnity is a payment by an insurer for the monetary value of a loss, as defined by the related insurance contract.

Chapter 2
Types of Business Insurance

Learning Objectives

- Identify a unique benefit associated with boiler and machinery insurance
- Spot a key advantage of using credit insurance
- Ascertain the difference between whole life and term life

Introduction

In this chapter, we describe the many types of insurance that can be used to mitigate the risks of a business, presented in alphabetical order. We also note the uses of reinsurance, though it is not directly applicable to a business, and finish with a discussion of the types of insurance to consider for a home business.

Boiler and Machinery Insurance

Boiler and machinery insurance (also known as equipment breakdown insurance) was initially designed to provide coverage for boiler explosions, but has since expanded to include coverage against equipment breakdowns (depending on the exact coverage purchased). A key benefit of this type of insurance is that the insurer provides safety inspections and loss prevention advice as part of its coverage. Because of these inspections, an insurance company can also suspend its coverage if a reviewer determines that covered equipment is in a dangerous condition.

There is an insurance loss under this policy when there is an equipment breakdown. The definition of a breakdown will depend on the specific policy, but typically encompasses a mechanical or electrical failure, or the failure of pressure equipment. A covered event should be one in which there is a sudden and accidental breakdown that causes damage to the equipment. Certain issues are excluded from coverage. These exclusions include breakdowns caused by computer viruses, damage to support structures, defects, and leakages.

Payments made under this coverage include not just the damage to equipment, but also any damage to other property that is caused by the damage to the covered equipment. The cost of debris removal caused by the damage is also covered. Further, coverage is provided for those costs needed to make temporary repairs to equipment.

Quite a broad range of equipment may be covered by this policy, include heating and air conditioning systems, motors, telephone systems, office and computer equipment, compressors, and production machinery. Be sure to review the document carefully to determine which types of equipment are *not* covered, such as excavation equipment and equipment being manufactured for sale.

This type of insurance is most commonly purchased by manufacturers, since they own a large amount of the targeted equipment.

Business Interruption Insurance

Business interruption insurance is designed to provide compensation to an organization if a designated disaster shuts down its operations for a period of time. This policy covers lost profits from business interruption, as well as the reimbursement of actual expenses incurred during the period when a business cannot conduct its normal operations. Though the probability of a major business interruption is usually low, this coverage may be critical when a claim does occur, and may keep a business from being forced into bankruptcy. It can be expensive insurance for manufacturers, which have a larger base of fixed costs to cover during periods when they are inoperable.

Policy Inclusions

The amount of profit to be reimbursed by the insurer is based on the amount of lost sales or customer orders, which are estimated based on historical sales information. The calculation of compensation can be quite subjective, involving the roll-forward of historical performance into the period of loss. The company's lost profits are then estimated based on the amount of lost sales and its historical profit percentage.

The amount of reimbursement under this policy is based on its profit history. If an organization has a continuing history of sustaining losses, the insurer will not reimburse it for lost profits, since there were no profits to lose. However, the insurer may still issue payments to reimburse the entity for certain fixed costs.

The policy will also reimburse the insured party for normal operating costs incurred during the shutdown period, including payroll. Depending on the policy, this can include extra expenses incurred that would not have been incurred if there had been no property damage or suspension of operations. Examples of these extra expenses are relocation costs and the incremental increase in costs required to subcontract work to third parties.

The reimbursement of certain costs incurred by the insured party may be subject to debate, depending on the circumstances. Examples are:

- **Advertising.** When the operations of a business have been completely halted, a case can be made that there should be no ongoing advertising expenditures until operations have been restarted. However, if the insured party uses advertising to sell off goods damaged during the event, this can be considered a loss mitigation cost, and so should be reimbursed by the insurer.
- **Depreciation.** This expense will not be covered to the extent that it relates to destroyed property, but should be covered for any assets that continue in operation.
- **Insurance premiums.** Most types of insurance that benefit the business are considered a fixed cost of operating a business. As such, they should be covered by the insurer. Conversely, any insurance intended to benefit a third party would not be covered.
- **Interest expense.** If a business is obligated to pay interest on outstanding debt, this is considered a fixed cost of doing business, and so will be covered.
- **Rent.** If a business rents a facility, and the rental agreement contains a clause not requiring rent payments when the facility is unusable, then this is an avoidable cost, and is not covered by the insurance. If such an abatement clause is not present, then rent is considered a fixed cost through the business interruption period, and so is a covered expense.
- **Utilities.** Charges for electricity, phones, sewage, and Internet access will be covered when there is a contract that involves ongoing fixed charges.
- **Variable operating costs.** If certain activities of the insured party have been stopped, then so too should the expenses associated with those activities. For example, the use of warehouse vehicles and delivery trucks may cease, in which case there should be a substantially reduced amount of expenditure for fuel. Similarly, if there are no sales during a stoppage period, there should be no commission expense.

Additional Coverages

Several coverages can be added to the basic business interruption insurance, which may be attractive options under certain circumstances. These coverages include:

- **Civil authority.** This coverage pays for business interruption losses caused by order of the local government. This usually occurs when damage to a facility forces the government to prohibit access to it for a period of time, typically for safety reasons.

- **Extended business income.** As the name implies, this coverage extends the period during which business interruption coverage applies, up until operations return to normal. This coverage can be useful when there is a large fixed asset base that cannot easily be returned to its normal operating condition (such as an oil refinery).

Management Actions

An organization can take several steps to improve its interactions with the insurer following the filing of a claim, including the following:

- **Mitigate insurance cost.** There are several actions that management can take to reduce the cost of business interruption insurance. For example, it can install sprinkler systems to suppress fires, adopt fire-resistant construction materials, and use safety procedures such as 24×7 patrols of the facility to detect in-process fires or flooding. Another option is to have multiple facilities among which capacity usage can be shifted, so that the shutdown of one facility will not have an undue impact on the entity as a whole. The same concept can be applied to the dispersed storage of inventory, so that the destruction of one warehouse will not completely eliminate all available stocks. All of these issues should be pointed out to the insurer when it formulates the insurance quote.
- **Maintain off-site records.** The impact of a disaster implies that an organization's records might be destroyed, which makes it quite difficult to calculate lost profits. To improve the situation, store financial records in the cloud or in a secure off-site location.
- **Return to full performance.** A requirement of this policy is that the insured entity must make its best efforts to reduce the amount of its losses from a disaster. This calls for active management of the situation to promptly protect damaged property from the elements, and to return to normal productive operations within a reasonable period of time. This may call for a detailed contingency plan to subcontract work elsewhere, sublease alternate working space, and so forth, run by a properly organized loss recovery team with members from all key areas of the business.
- **Documentation of mitigation costs.** When a business is actively engaged in mitigating its losses from a business interruption, the accounting staff must collect and organize all related billings. If internal company labor is used, the staff should keep track of the hours worked and the cost of this labor. The information is then forwarded to the insurer for reimbursement. If the documentation

process is disorganized, it is quite likely that some expenditures will never be reimbursed, or that the insurer will question certain submitted items for which the associated documentation is poor or nonexistent.

Tip: Review the larger remediation expenses with the insurance adjuster before accepting supplier quotes, since the adjuster may disagree with the assertion that these expenses will be reimbursed. Doing so will prevent a company from incurring obligations and later finding that it does not have the cash to pay for them.

The best efforts clause just described also means that the insured party cannot simply abandon a property and effectively turn it over to the insurer.

Commercial Automobile Insurance

This policy covers damage to the vehicles used in a business, as well as injuries to third parties caused by those vehicles. This coverage may not be necessary if a company does not own vehicles or has employees use their own vehicles on company business.

The core coverage is comprehensive coverage, which (despite the name) does not provide protection from the collision of an auto with another object; that requires the additional purchase of collision coverage. It is also possible to acquire special perils coverage for such events as fire, explosion, theft, hail, flooding, and vandalism.

A truckers policy is available that is designed for long-haul truckers. It provides liability, physical damage, and medical payments coverage. Pricing is based on vehicle size, the intensity of usage, and the radius of operation.

Commercial Crime Insurance

This policy covers a business against losses arising from a number of criminal activities. The insured party can select from several possible coverages, each of which provides a specific type of loss protection. These coverages are:

- **Employee theft.** The theft of property by employees.
- **Forgery or alteration.** Losses due to the forgery or alteration of checks or similar documents.
- **Inside the premises.** The theft of money and securities held on the premises of the insured party. Also, the taking of money or other valuables on the premises by force; includes shoplifting and safe burglary.

- **Outside the premises.** The taking of money or other valuables outside the premises, such as from an armored car.
- **Computer fraud.** The fraudulent transfer of property by use of a computer.
- **Funds transfer fraud.** The loss of funds and securities from the account of the insured party at a bank, due to fraudulent transfer instructions.
- **Money orders and counterfeit money.** The loss of funds from money orders that are not paid, and from counterfeit money that was accepted in a commercial transaction.

In determining the amount of a loss, securities are valued at their market value on the date of loss discovery, while property is valued at the cost to replace it.

Commercial General Liability Insurance

The purpose of liability insurance is to protect the insured entity from losses if the entity is held liable for causing injuries to others or damage to property owned by a third party. Commercial general liability insurance provides coverage for a number of possible events, such as claims arising from bodily injury, personal injury, and damage to property that is caused by the operations or products of a business. When a claim is made, the insurer defends the insured. The main types of coverage that can be purchased are:

- **Bodily injury and property damage.** Pays for losses arising from bodily injury or property damage to a third party when the insured entity is legally liable.
- **Personal and advertising injury.** Pays for losses arising from the loss of reputation, humiliation, economic loss, and bodily injury that is caused by several actions by the insured party, including copyright infringement, libel, slander, and wrongful eviction.
- **Medical payments.** Pays for the medical expenses of third parties when an injury was caused by an accident on the premises of the insured party or as a result of the operations of the insured party.

General liability insurance may contain coverage exclusions, so be sure to review the proposed policy with care. A selection of these exclusions follows:

- Criminal acts
- Distribution of materials in violation of statutes

- Intended injuries
- Material published prior to policy period
- Use of electronic chatrooms or bulletin boards

Another consideration when buying this type of insurance is to determine whether it is a claims-made or occurrence policy. A *claims-made* policy only provides coverage for claims made during a specific date range. An *occurrence* policy provides coverage for events occurring within a specific date range. Thus, a claims-made policy focuses on the date of the claim, while an occurrence policy focuses on the date of the triggering event.

Some customers may require that their suppliers have commercial general liability insurance, especially when large contracts are involved, so this is usually considered a mandatory type of insurance.

Coverage Limitations

Liability limits will be set for each individual policy. For example, a policy may state that there is a $100,000 limit per personal injury occurrence and $250,000 per property damage occurrence. The insured party would be liable for any losses above these limits. When there is a per occurrence limit, this means that the amount paid by the insurer is limited to the designated amount for an occurrence, irrespective of the number of claims received from all affected parties that arose from that occurrence.

An alternative form of coverage limitation is for the insurer to set a single aggregate liability limit, irrespective of the number of occurrences. Once claims are paid up to this limit, the insurer will not pay out any additional amounts during the policy year.

Umbrella Coverage

Umbrella coverage is a separate policy that provides an extra tranche of coverage for a general liability policy. It is not activated unless a loss exceeds the per occurrence or aggregate limits on the underlying liability policy. The underlying coverage must be maintained for the umbrella coverage to take effect.

Credit Insurance

A business may find that it can shift some of the risk associated with its accounts receivable to a firm that provides credit insurance. Under a credit insurance policy, the insurer protects the seller against customer nonpayment. The insurer should be willing to provide coverage against customer

nonpayment if a proposed customer clears its internal review process. Credit insurance offers the following benefits:

- **Increased credit.** A company may be able to increase the credit levels offered to its customers, thereby potentially increasing revenue.
- **Faster international deals.** An international sale might normally be delayed while the parties arrange a letter of credit, but can be completed faster with credit insurance.
- **Custom product coverage.** The insurance can cover the shipment of custom-made products, in case customers cancel their orders prior to delivery.
- **Reduced credit staff.** Credit insurance essentially shifts risk away from a business, so it is especially beneficial in companies that have an understaffed credit department that cannot adequately keep track of customer credit levels.
- **Knowledge.** A credit insurance firm specializes in the risk characteristics of various industries, and so may have deep knowledge about the risk profiles of individual customers, as well as aggregations of customers by region. This information is a useful supplement to other sources of information about customers.
- **Tax deductibility.** Credit insurance premiums are immediately deductible for tax purposes, whereas the allowance for doubtful accounts is only deductible when specific bad debts are recognized.

Be sure to examine the terms of a credit insurance agreement for exclusions, to see what the insurer will not cover. In particular, coverage should include the receivables of customers that file for bankruptcy protection or simply go out of business.

Insurers will only provide coverage for legally sustainable debts, which are those receivables that are not disputed by the customer. If there is a dispute, the insurer will only provide coverage after the company has won a court judgment against the customer. The issue of a legally sustainable debt can be a serious one if a company has a track record of disputes with its customers over product quality, damaged goods, returns, and so forth.

Tip: It may be possible to offload the cost of credit insurance to customers by adding it to customer invoices. This is most likely to be acceptable for international deals, where a customer would otherwise be forced to obtain a letter of credit to pay for a transaction.

Insurers are more willing to provide coverage of accounts receivable if the seller is willing to take on a small part of the bad debt risk itself. This typically means that a customer default will result in the insurer reimbursing the seller, minus the amount of a 5% to 20% deductible. There may also be an annual aggregate deductible that requires the company to absorb a certain fixed amount of losses in a year before the insurer begins to pay reimbursements. Requiring a deductible means that the company continues to have an interest in only selling to credit-worthy customers.

EXAMPLE

Micron Metallic sells stamping machines to a variety of industrial customers. The company's credit insurance policy states that Micron will absorb the first $200,000 of bad debt losses in each calendar year, after which the insurer will pay 85% of all bad debts incurred, other than for invoices related to international sales, which are not covered by the policy. The policy also specifically excludes receivables related to ABC Company, which the insurer considers to be at an excessively high risk of default.

For some customers, or geographic regions subject to considerable political risk, a credit insurer may consider the risk to be so great that it will not provide coverage, or only at a high premium. If so, the credit manager must decide whether it is better for the company to assume the risk of these sales, or to pay the cost of the insurance to obtain coverage. Also, if the insurer discovers that the company's historical loss experience with its customers has been excessively high, it may require such a large premium that the company may conclude that insurance coverage is not a cost-effective form of risk reduction.

Insurers may only be willing to insure a certain amount of receivables per year with some customers. If the company chooses to sell additional amounts on credit to these designated customers, the company will sustain the entire incremental amount of credit risk. To avoid the additional risk, it is necessary to track the cumulative amount of credit sales to these customers on an ongoing basis.

Cyber Risk Insurance

This insurance covers damage to or theft of electronic information, which is arguably the most critical asset in a business. Consider the damage to a business if its customer database is stolen, client medical records are destroyed, or product design specifications are damaged. Besides recovery costs, a business may also have to deal with privacy-related class action lawsuits and the loss of customers. Further, many governments require

companies to notify every person whose personal identity information was compromised.

Depending on the policy, coverage may include the following:

- Loss of business income
- Data restoration expenses
- Cyber extortion expenses
- Litigation and regulatory defense expenses
- Public relations and consumer notification expenses

Management Actions

To obtain coverage, insurance companies will want to review the network security standards and related security procedures of a business. It may be necessary to upgrade the level of security in order to obtain insurance coverage.

Directors and Officers Liability Insurance

Directors and officers (D&O) liability insurance covers claims made by third parties against directors and officers, alleging that the directors and officers have caused damages by violating their duty. Examples of such claims are as follows:

- A competitor claims that the company has improperly hired away several key employees
- A shareholder claims that the company has failed to properly disclose financial information related to irregular accounting practices
- A limited partner claims that the company has diverted assets to several related parties
- Company officials are held liable in a trademark infringement case
- The owner of a nearby business claims that the demolition of a structure on company property damaged his own property
- The government claims that a company is liable for the illegal dumping of hazardous materials

D&O coverage is essential, since the personal assets of directors and officers can be pursued by aggrieved shareholders, vendors, customers, employees, government agencies, and other parties. With this insurance, directors and officers are covered for acting within the scope and capacity of their positions. Coverage includes defense costs, as well as settlements and judgments. Typical exclusions from this policy include fraud, criminal acts, known liabilities, and punitive damages.

D&O insurance is underwritten on a *claims-made* basis. This means that the policy currently in effect absorbs the liability for claims made, rather than the year in which the alleged wrongdoing took place. This aspect of D&O coverage can be a major problem for directors and officers, who have a five-year statute of limitations on alleged wrongdoing, and yet may no longer be with the company during the latter part of that period, and so have no control over the quality of the D&O coverage in subsequent years. It is possible to purchase insurance for retired directors and officers that addresses this problem. Realistically, most claims are filed against directors and officers immediately after the triggering event, so this risk may not be considered an especially large one.

Management Actions

An excellent supplement to D&O insurance is for a company to indemnify directors and officers in its charter or bylaws, thereby limiting their personal liability from the assertion that they acted negligently. This approach helps to retain directors and officers when a business is in difficult financial circumstances for various reasons, and is therefore more likely to be sued.

Additional Coverages

Coverage against the employment practices liability (EPL) can be added to D&O insurance. EPL coverage protects against damages related to wrongful termination, sexual harassment, emotional distress, and similar issues. If EPL is added to D&O coverage, the aggregate limit of the D&O coverage will be shared with the EPL coverage, which effectively weakens the total amount of D&O coverage. A reasonable solution is to pay for an increase in the aggregate D&O coverage limit.

Fidelity Bonds

A fidelity bond protects an employer from losses caused by the theft of money, securities, or property by an employee. Despite the name, a fidelity bond is actually an insurance policy. This type of insurance is most commonly purchased by organizations that own or handle large amounts of liquid assets, such as brokerages and securities firms.

A fidelity bond may provide blanket coverage for all employees, or it may provide coverage only for specific employees. The insurer may require that certain hiring practices be used by an entity in order to qualify for a fidelity bond, with the intent of screening out undesirable job candidates.

Inland Marine Insurance

This policy covers damage to commercial goods while in transit on dry land, as well as when the goods are in storage. This coverage may not be necessary if a company uses third-party carriers that also have the insurance.

The policy coverage has gradually expanded from goods being transported on ships to a large number of coverages that may not appear to have any connection to the concept of "marine." The following table contains examples of what may be covered by an inland marine policy:

Sample Inland Marine Policy Coverage

Accounts receivable	Fine arts	Mobile medical equipment
Camera equipment	Furriers	Motor truck cargo
Communications towers	Guns	Museums
Contractor's equipment	Jewelry	Musical instruments
Exhibitions	Leased property	Valuable papers

Coverage under this type of policy is generally worldwide.

There may be several exclusions from an inland marine policy, such as pilferage from a shipment, securities, and currency. There may also be exclusions for goods transported by air, or outside of a specific geographic region.

It is possible to buy additional coverage for the loss of samples carried by salespersons, equipment used by contractors, livestock, and goods sold on an installment plan or rented.

Life Insurance

Life insurance pays the beneficiary if the insured person dies. This can be useful in a business under two circumstances. The first is when there will be a serious financial impact if an employee dies. For example, if a highly-experienced salesperson dies, the organization could see a major drop in its order volume. Life insurance can be used to keep a business afloat while it searches for a replacement hire. The second situation is to protect against the death of a sole proprietor. In this case, the heirs may need to pay estate taxes or the liabilities of the business, or both, and need cash from a life insurance policy to do so. A partnership might consider having life insurance on a partner, so that the proceeds from the policy can be used to buy out this person's heirs. For example, there could be a cross-purchase plan under which each partner buys insurance on the other partners, so that each partner can pay for his or her share of the buyout of the interest of a deceased partner.

Key man (or key person) life insurance is designed for use by businesses, where the insured person is an employee of a business and the beneficiary is the business. The term of the policy does not extend past the key person's employment period with the business.

The two main types of life insurance are term life and whole life. The characteristics of each one are as follows:

- **Whole life insurance.** This policy pays a death benefit and accumulated a cash value. Coverage extends over the life of the insured party, and premium payments remain level over time. Some variations on the concept require periodic payments only over a specific period of time, after which coverage continues.
- **Term life insurance.** This policy pays a death benefit. The coverage terminates at the end of the policy term, and there is no savings element to the insurance. The amount of premium paid increases as the insured individual ages, thereby reflecting the increased risk of death. It is intended to provide financial protection to the beneficiary for a set period of time.

Group Term Life Insurance

A business may purchase term life insurance as part of a basic benefits package for its employees, which is called group-term life insurance. A problem with this insurance when it is paid for by the company is that the IRS requires the entity to report as taxable income to the employee the amount of the benefit that exceeds $50,000 of life insurance. The company should not report such excess insurance coverage as income to the employees if the company is the beneficiary of the policy. The calculation of this benefit for employee tax reporting purposes is:

1. Round the amount of insurance coverage granted to the nearest $100.
2. Subtract $50,000 from the total amount of insurance coverage.
3. Multiply the number of thousands of dollars of insurance coverage remaining by the cost shown in the following table. To determine the correct employee age, use the employee's age on the last day of the employee's tax year. The result is the cost of the insurance on a monthly basis.
4. Calculate the insurance cost for every month of coverage in the tax year.
5. Include the total of these amounts in the employee's W-2 form.

Monthly Life Insurance Cost, per IRS[1]

Employee Age	Insurance Cost
Under 25	$0.05
25 through 29	0.06
30 through 34	0.08
35 through 39	0.09
40 through 44	0.10
45 through 49	0.15
50 through 54	0.23
55 through 59	0.43
60 through 64	0.66
65 through 69	1.27
70 and older	2.06

EXAMPLE

The life insurance benefit provided by the Red Herring Fish Company to its employees is to provide them with one times their annualized pay as life insurance. Mr. Vernon Harness is 52 years old and is paid $150,000 per year, and so has life insurance coverage in the same amount. On July 1, Red Herring increases his annualized pay to $180,000, and alters his life insurance accordingly. The calculation of his taxable life insurance benefit is:

Time Period	Calculation	Total Benefit
Jan. to June	($150,000 – $50,000) ÷ 1,000) × 0.23 multiplier × 6 months	= $138.00
July to Dec.	($180,000 – $50,000) ÷ 1,000) × 0.23 multiplier × 6 months	= $179.40
	Total	= $317.40

In order for the amount of group-term life insurance under $50,000 to be exempt from reporting as taxable income for employees, the insurance coverage must meet all of the following requirements:

- It provides a general death benefit.
- It is provided to at least ten full-time employees at some point during the year. There are limited exceptions to this rule.
- The amount of insurance provided to each employee is based on such factors as age, years of service, pay, or position. These factors cannot be used to exclude an employee from coverage.

[1] Accurate as of 2021

- The company directly or indirectly carries the insurance policy.

Tip: The calculation and reporting of the life insurance benefit exceeding $50,000 is moderately time consuming, so consider eliminating the work load by capping all company-paid life insurance at $50,000, and making supplemental life insurance available to employees.

If the company is only providing life insurance to a few key employees, rather than to all employees, the company must report the entire insurance benefit as taxable income to employees. For this purpose, the reportable cost of the insurance is the greater of the actual premiums paid or the cost derived using the preceding IRS insurance cost table.

Medical Insurance

Medical insurance provides protection to individuals for losses caused by injuries or illnesses. Group health insurance is offered to employees by employers. The employer typically arranges for a single health insurance plan with one provider, and then offers it to employees, with the provision that they accept a deduction from their pay to defray the total cost of the insurance. The amount of the deduction is entirely up to the employer. Typical deduction amounts are:

- Pay 80 percent of the employee's medical insurance
- Pay 80 percent of the employee's medical insurance and 50 percent of any incremental cost attributable to family members
- Pay for a minimum medical plan and allow employees to cover the entire incremental cost of a more comprehensive plan

There are a variety of health insurance providers available. The major types of providers are:

- **Health maintenance organization (HMO).** An HMO plan requires employees to only use doctors who have signed up to work with that specific plan. Services received from doctors outside of the plan are not covered.
- **Point of service plan (POS).** A POS plan requires employees to select a primary care physician who is the primary point of contact, but also allows consultations outside the plan's designated network of doctors.
- **Preferred provider organization (PPO).** A PPO plan allows employees to consult with doctors who fall outside of a core group of designated doctors, but at a higher copay and deductible cost.

Given the very high cost of medical insurance, some larger companies use *self-insurance*, rather than using an outside health care provider. Under this approach, employees submit their medical claims either to the company or a designated plan administrator, and are reimbursed by the company. Above a predetermined expenditure level for the entire plan, a *stop loss* insurance policy pays for all remaining claims for the year. The stop loss policy keeps a company from incurring catastrophic losses from major medical claims, while eliminating the profit that would otherwise have been paid to an outside health care provider.

The trouble with a self-insurance arrangement is that it can be considered discriminatory in favor of highly compensated employees, in which case all excess medical reimbursements made to this group are considered taxable income to those employees. The portion of medical reimbursements considered taxable is those payments made that exceed the average reimbursements paid to the other employees in the plan. Under these circumstances, a highly compensated employee is defined as:

- One of the five highest-paid officers; or
- An employee who owns more than 10% in value of the employer's stock; or
- An employee who is one of the highest-paid 25% of all employees.

EXAMPLE

Luminescence Corporation pays for a $2,000 cat scan and detailed doctor evaluation for the entire management team. This benefit is not provided to any other employees. Luminescence should include the entire cost of this procedure in the reportable income of each member of the management team, since it was not offered to the other employees.

Tip: When employees leave employment with a company part-way through a month, always charge them the full-month deduction for the medical insurance for the final month. The reason is that the insurance provider always charges for a full month of coverage for a departing employee, even if the employee is leaving just a day or two into the month, and the employee will benefit from that coverage through the end of the month. It is common to not charge this extra deduction, since deductions are usually automated in the payroll system, and a lesser amount is usually charged (since the deduction is spread over multiple payrolls in a month). Thus, include a medical insurance deduction in the checklist used to calculate a person's final pay check.

When a company pays for a portion (or all) of the medical insurance for an employee, this payment is not considered income to the employee

(other than the exception just noted), so the employer should not report such payments as income in the year-end Form W-2 that it sends to the IRS. Further, if a company chooses to reimburse its employees for any deductibles or copayments that they incur as part of their medical insurance, this is also not reportable income for the employees.

Political Risk Insurance

This policy reimburses a company for the loss of fixed assets, net investment values (investment plus retained earnings) and sales and supply contracts that are destroyed by civil wars, taken through expropriation, or damaged by contract repudiation or regulatory changes. Even if company management does not believe this coverage is necessary, investors or lenders may force the issue in order to protect their investments in the company, though only if it is doing business where there appears to be a reasonable degree of political risk. The policy is particularly useful for businesses contemplating overseas expansion, or which have production facilities in low-wage areas.

Professional Liability Insurance

This insurance provides coverage for specific types of liabilities that are not available under a commercial general liability policy. There are two main types of professional liability insurance, which are as follows:

- **Errors and omissions insurance.** Provides coverage for those working with clients, where errors can be detrimental to the interests of a client, such as accountants, architects, attorneys, and consultants. These policies can be structured so that all members of a practice are covered by the same policy.
- **Malpractice insurance.** Provides coverage for those working in the healthcare industry, such as doctors and dentists. Coverage is intended for liabilities to third parties arising from losses caused by the professional services of the insured party.

Property Insurance

This policy protects against the loss of physical assets. The cost ranges from minimal for a services business with few assets to a substantial sum for an asset-intensive manufacturing facility. If a business has used mortgages to acquire assets, the lienholders will require that property insurance be purchased in order to protect their interests in the assets. This is usually considered essential insurance, since it provides coverage of what may be the largest assets of a business.

Types of Property

The coverage given by property insurance applies to two types of property, which are real property and personal property. *Real property* is defined as any property that is directly attached to the land, plus land itself. Examples are buildings and storage units, as well as improvements to these structures. *Personal property* is defined as being movable, and so may include furniture and fixtures, vehicles, and collectibles. Inventory is considered personal property, and includes raw materials, work-in-process, and finished goods.

Policy Inclusions

There are three different classifications of damage to property that may be covered by property insurance, depending on the type of coverage purchased. The three classifications are as follows:

- **Causes of loss—basic form.** Coverage is provided when the causes of loss include fire, lightning, windstorms, hail, riots, damage by aircraft or vehicles, smoke, explosion, vandalism, volcanism, a sinkhole collapse, or discharge from an automatic sprinkler system.
- **Causes of loss—broad form.** Coverage is provided for all of the perils just noted for the basic form, as well as for falling objects, weight of snow, ice, or sleet, and water damage.
- **Causes of loss—special form.** Coverage is provided for all types of accidental loss, unless there is a specific exclusion.

Damage due to flooding and earthquakes is typically excluded from all property insurance policies, but can be added back as a separate endorsement to a policy.

Property is covered if it is located within 100 feet of the insured premises. Additional coverage can be obtained that provides coverage at other locations, as well as for newly acquired or constructed property that is obtained after the effective date of the policy.

Finished goods can be insured at their cost or their selling price. In the latter case, this means that a profit component is included in the coverage, which is similar to business interruption insurance. If the insured entity also has business interruption insurance, the value of this profit component will be subtracted from any business interruption insurance payments, to avoid double payments.

Personal property owned by third parties is also included in the insurance coverage, if this property is in the custody of the insured party and is located on the premises.

Policy Exclusions

A number of items are specifically excluded from a property insurance policy. Depending on the policy, exclusions may encompass the following:

- **Animals.** This depends on who owns the animals and how they are being stored. For example, horses boarded by the insured entity may be covered if they are kept in a stable.
- **Cash and securities.** This includes bills and coins, bonds, and equity securities.
- **Land and land improvements.** This includes roadways, lawns, bridges, underground pipes, patios, roadways, pilings, and parking lots.
- **Plants and outdoor property.** This includes crops, lawns, shrubs, trees, antennas and signs.
- **Vehicles.** This exclusion applies except when the vehicles are being manufactured, held for sale, or stored.
- **Covered elsewhere.** This includes property that is more specifically addressed under another insurance policy.

Additional Coverages

There are a number of additional coverages that can be added to property insurance. They only apply to specific circumstances, and so may only be needed for shorter periods of time. If so, be sure to remove them during the next coverage period, so that the company is not needlessly paying for inapplicable coverage. Several additional coverages are:

- **Buildings under construction.** A building that is under construction may not be covered by property insurance. This situation can be remedied by adding an endorsement to the standard property insurance policy. The endorsement should cover materials, equipment, and temporary structures adjacent to the work site. For example, a general conflagration could consume nearby building materials and the on-site trailer used by the construction staff.
- **Debris removal.** This coverage pays for the cost of removing debris from a damaged or destroyed facility, up to a maximum cap. This typically does not include the cost to remediate pollution caused by whatever caused the property damage. This can be useful coverage when property is extensive, such as a large warehouse facility.
- **Fire department charges.** This coverage reimburses the insured entity for the amount of any service charges imposed by the local

fire department for sending its equipment to a covered location. This coverage can be useful when local ordinances require such charges to property holders by the fire department.

- **Pollutant clean-up.** This coverage pays for the cost to remove pollutants from the premises if the pollution was caused by the event that damaged the property. This coverage can be useful when a business stores pollutants on its premises. There is a cap on this coverage.
- **Property preservation.** This coverage addresses any damage to property while it is being transported to a safe location or being stored there. This coverage can make sense if high-value items are being insured, such as artwork.

Coverage Limitations

Depending on the policy, the insurance limitation applies to each individual loss occurrence, with no aggregate limit. However, an aggregate limit *does* apply to any pollution cleanup or debris removal losses.

A coinsurance clause will likely be applied to this type of insurance. As described earlier in the Overview of Business Insurance chapter, coinsurance is designed to penalize the insured party if it under-insures the value of property.

Valuation Issues

The insurance pays for the rebuilding of damaged or destroyed real property. Further, it pays for the value or replacement cost of any lost or damaged personal property. If a policy is paying for the value of an asset, this means the replacement cost of the asset, less depreciation. Thus, an older asset will have a significantly lower replacement value than a new asset. The amount paid may be based on the production capacity of equipment. For example, if a fire destroys several identical machines, the insurer might decide to reimburse based on a single machine that has the same production capacity as the group of destroyed machines.

EXAMPLE

Grissom Granaries owns a grain storage facility near the Mississippi River. The facility is pummeled by a hailstorm, and must be replaced. The insurer notes that the facility had a useful life of 30 years, of which 10 years had already passed prior to the loss event. This means the value of the facility is depreciated by one-third when calculating the amount of the claim payout.

The depreciation concept can seriously reduce the amount of a payment related to a loss, since the insurer reduces the value of the damaged asset by an estimate of its prior use. The following example explains the concept.

Management Actions

There can be arguments over the number and types of assets for which reimbursement is claimed. To bolster the organization's case, it is useful to take the following steps:

- **Record contents.** Create a record of the contents of the business' offices, including digital photos, which can be used to substantiate a claim. This record will soon be out of date, so schedule an annual update of the report. A variation on the concept is to take a video of the offices, to which can be appended an audio commentary. A video takes less time to complete than a formal written record.
- **Store records safely.** Maintain all documentation pertaining to the purchase cost of assets in a fire-proof safe, or in a secure off-site location. It may make sense to maintain a duplicate set of records in an alternate location.

Management should be made aware of situations in which insured equipment is old, and needs to be replaced with more modern equipment. In these cases, an insured loss will only result in a payment that covers the old equipment, leaving the business with a potentially large funding shortfall to pay for the latest equipment. It is useful to periodically summarize this potential shortfall and recommend that a cash reserve or line of credit be maintained that can be used to cover the difference.

In addition, one should take action to prevent further damage to property, once a loss event has occurred. For example, if a building's roof is destroyed, the insured should take prompt action to protect the contents of the building from further weather-related damage. If not, the insurer may deny claims related to subsequent damage to the building contents.

Surety Bonds

A surety bond is a contract that involves a guarantee that a legal agreement will be completed. It is commonly used to ensure that performance is completed under the terms of a contract. A bond agreement involves the participation of the following three entities:

- **The principal.** This is the party that is supposed to perform in accordance with the requirements of a contract.
- **The obligee.** This is the party receiving the obligation; typically the counterparty to the contract with the principal.

- **The surety.** This is a third party that does not directly perform the requirements of the contract, but rather who guarantees the performance of the principal under the contract.

Thus, a surety bond is a promise to pay the obligee if the principal does not perform under the contract. The surety makes the payment to the obligee. In exchange for this service, the principal pays a fee to the surety for as long as the surety bond is outstanding. In cases where the financial resources of the principal are in doubt, the fee will be quite high, or the surety will insist that all or most of the bond be kept in escrow during the term of the bond.

If there is a claim by the obligee for reimbursement under the surety bond, the surety will investigate the claim, pay it if the claim is valid, and then turn to the principal for reimbursement.

There are a number of types of surety bonds, including the following:

- **Bail bond.** The bail bondsman guarantees that an individual will appear in court.
- **Bid bond.** The principal guarantees that it will enter into an agreement with the obligee if awarded the contract.
- **Performance bond.** The principal guarantees that it will perform the services specified in the contract.

The principal agrees to enter into a surety bond arrangement in order to mitigate the risk to the obligee that the contract between the two parties will not be fulfilled. Also, it is common practice in some industries (particularly the government and construction sectors) to always require a surety bond of any party that does a certain minimum amount of contractual business with an entity.

While a surety bond does show that a business has a certain amount of capital, it also acts to block smaller competitors unable to obtain a surety bond from bidding against them. Thus, a surety bond tends to reduce competition.

Surplus Lines Insurance

A surplus lines policy is one that protects against a financial risk that a normal insurer is incapable of accepting, for any of the following reasons:

- A very high insurance limit is needed
- The risk is extremely specialized
- The risk has such unfavorable attributes that normal insurers will not accept it

Given the one-off nature of these risks, a surplus lines policy is more likely to be a unique one that is constructed for a specific policyholder. Since there is more administrative overhead associated with this type of coverage and there is little competition, insurance premiums are usually higher.

An insurer that takes on this type of risk is usually one that has not been licensed by the state in which the insured entity is located; as non-admitted carriers, these insurers have fewer restrictions on certain types of coverage and pricing requirements. Also, the insurance agent handling the transaction must have a surplus lines license in order to offer this type of insurance.

A concern when making use of surplus lines insurance is that there is no state guaranty fund from which a claim payment can be obtained if the surplus lines insurer is unable to make a payment. This is because the insurer has not been licensed by the state, so the state's guaranty fund does not apply to it.

State Unemployment Insurance

Each state has its own unemployment insurance program, which evaluates unemployment claims and administers the payment of benefits to individuals. Each of the states has its own rules regarding who is eligible for unemployment benefits, the amounts to be paid, and the duration of those payments, within guidelines set by the federal government.

State governments impose a state-level unemployment insurance tax on employers that can be quite high. A state typically assigns a relatively high default rate to a new business, and then subsequently adjusts that rate based on the history of unemployment claims made by employees of the business (known as the *experience rating*). If a business rarely lays off its staff, it will eventually be assigned a lower rate, with the reverse being true for a business with an uneven employment record.

States mail unemployment rate notices for the upcoming year to businesses near the end of the current calendar year. Include the rate noted on the form in the organization's payroll calculations for all of the following year.

Tip: If the business is outsourcing payroll to a third party, forward the rate notice to that supplier. If you forget to do so, the supplier will likely contact you to request this information.

The wage base for state-level unemployment taxes can vary dramatically by state. The following table shows the amount of wages subject to

state unemployment tax, as well as the range of the tax and the amount charged to a new employer, as of December 2021.

Summary of State Unemployment Taxes as of December 2021[2]

State	Wages Subject to Tax	Minimum Tax Rate	Maximum Tax Rate	New Employer Rate
Alabama	$8,000	0.65%	6.80%	2.70%
Alaska	43,600	1.00%	5.40%	2.07%
Arizona	7,000	0.08%	20.60%	2.00%
Arkansas	10,000	0.30%	14.20%	3.10%
California	7,000	1.50%	6.20%	3.40%
Colorado	13,600	0.71%	9.64%	1.70%
Connecticut	15,000	1.90%	6.80%	3.00%
Delaware	16,500	0.30%	8.20%	1.50%
District of Columbia	9,000	1.60%	7.00%	2.70%
Florida	7,000	0.10%	5.40%	2.70%
Georgia	9,500	0.04%	8.10%	2.70%
Hawaii	47,400	0.00%	5.60%	2.40%
Idaho	43,000	0.20%	5.40%	1.00%
Illinois	12,960	0.68%	6.88%	3.65%
Indiana	9,500	0.50%	7.40%	*
Iowa	32,400	0.00%	7.50%	1.00%
Kansas	14,000	0.20%	7.60%	2.70%
Kentucky	10,800	0.30%	9.00%	2.70%
Louisiana	7,700	0.09%	6.20%	*
Maine	12,000	0.49%	5.81%	2.31%
Maryland	8,500	2.20%	13.50%	2.30%
Massachusetts	15,000	1.04%	15.88%	*
Michigan	9,500	0.06%	10.30%	2.70%
Minnesota	35,000	0.20%	9.10%	*
Mississippi	14,000	0.20%	5.60%	1.20%
Missouri	11,000	0.00%	9.45%	2.38%
Montana	35,300	0.13%	6.25%	*
Nebraska	9,000	0.00%	5.40%	1.25%
Nevada	33,400	0.30%	5.40%	3.00%
New Hampshire	14,000	0.05%	8.50%	2.70%
New Jersey	36,200	0.40%	5.40%	2.80%
New Mexico	27,000	0.33%	5.40%	1.00%
New York	11,800	2.10%	9.90%	4.10%
North Carolina	26,000	0.06%	5.76%	1.00%
North Dakota	38,500	0.08%	9.69%	1.02%
Ohio	9,000	0.30%	9.30%	2.70%

[2] Source: ADP Fast Wage and Tax Facts

State	Wages Subject to Tax	Minimum Tax Rate	Maximum Tax Rate	New Employer Rate
Oklahoma	24,000	0.30%	7.50%	1.50%
Oregon	43,800	1.20%	5.40%	2.60%
Pennsylvania	10,000	1.29%	9.93%	3.69%
Puerto Rico	7,000	1.00%	5.40%	2.70%
Rhode Island	24,600	1.20%	9.80%	1.16%
South Carolina	14,000	0.06%	5.46%	0.55%
South Dakota	15,000	0.00%	9.35%	1.20%
Tennessee	7,000	0.01%	10.00%	2.70%
Texas	9,000	0.31%	6.31%	2.70%
Utah	38,900	0.20%	7.20%	*
Vermont	14,100	0.80%	6.50%	1.00%
Virginia	8,000	0.33%	6.43%	2.73%
Virgin Islands	32,500	3.50%	6.00%	2.00%
Washington	56,500	0.23%	6.02%	*
West Virginia	12,000	1.50%	8.50%	2.70%
Wisconsin	14,000	0.00%	12.00%	*
Wyoming	27,300	0.18%	8.72%	*

* Industry average or a variable rate
** Greater of: 1% or industry average

The difference in wage base can have a dramatic effect on the amount of state unemployment insurance that a business pays, as noted in the following example.

EXAMPLE

Albatross Flight Systems is considering moving its 100 employees to a facility in another state. The average annual pay of its employees is $55,000, and no one earns less than $30,000. The best sites selected by the CEO of Albatross are Nevada and Colorado. Assuming that Albatross is assigned a new employer rate when it moves, the calculation of the annual amount of state unemployment taxes that it would pay is:

State	Expense Calculation		Total Expense
Colorado	100 staff × $13,600 wage base × 1.70% rate	=	$23,120
Nevada	100 staff × $32,500 wage base × 3.00% rate	=	$97,500

Thus, the lower state unemployment tax for Colorado could pay for an additional staff person, when compared to the rate for Nevada.

Tip: If you are contemplating the expansion of a business into a new state, and the cost of state unemployment insurance is a significant factor in the decision, peruse the preceding summary table of state unemployment insurance to see which ones have a combination of the lowest amount of wages subject to tax and the lowest new employer rate.

Unemployment Benefit Claims

Employees who have left a business are responsible for filing unemployment claims with the state government. Once an individual files such a claim, the state unemployment agency forwards a summary of the claim to the person's former employer. The claim summary includes a request to review and correct any information on the claim, as well as to provide additional information about dates worked and wages paid.

An individual who has lost his job through no fault of his own (such as a lay off) will generally be granted unemployment benefits by the state government. Most states use the ABC test to determine whether an individual is a contractor (and therefore not able to collect unemployment benefits). The three elements of the ABC test are:

1. There is an **a**bsence of control by the entity; and
2. **B**usiness conducted by the individual is substantially different from that of the entity or is conducted away from entity premises; and
3. The individual **c**ustomarily works independently from the entity as a separate business.

If the employer becomes aware of a claim from a person who was let go for cause or who left voluntarily, it should protest the claim. By protesting unjustified claims, an employer can reduce the amount of unemployment benefits paid, and thereby keep its experience rating as high as possible. The higher experience rating keeps it from paying for an excessive amount of state unemployment insurance in future periods.

Workers' Compensation Insurance

Workers' compensation insurance is required under state law, and compensates employees for injuries suffered in the workplace. The advantage of these mandated programs is that state law does not allow employees to sue their employers for negligence related to workplace injuries, unless there is gross negligence by the employer. Most employees are covered by this insurance, with the exception of casual laborers, domestic workers, and farm workers in certain states. An individual must be classified as an employee in order to receive coverage, which means working under the

direct supervision of an employer. An independent contractor is not classified as an employee.

The basic process flow when an employee is injured is that the employee first notifies the employer, which reports the injury to its insurer. The insurer then notifies the applicable state insurance administration agency. Most claims are settled by common agreement among the parties. If there is a dispute regarding the amount of a settlement, it is usually settled through a state-run review process.

Policy Inclusions

The essential coverage provided by workers' compensation insurance is for all medical expenses, as well as disability income, rehabilitation costs, and death benefits. Disability income is based on an evaluation of an employee as either being totally permanently disabled, totally temporarily disabled, partially permanently disabled, or partially temporarily disabled. The amounts to be paid are mandated by the applicable state governments.

Management Actions

The pricing of workers' compensation insurance is partially based on the claims history of a business, so it makes sense to have an ongoing workplace safety program in place. This program trains employees in workplace safety, identifies potentially risky activities and locations for correction, and investigates accidents to determine underlying causes.

Another issue is the annual categorization of employees into different risk classifications, along with their pay. Each employee is slotted into a different classification, such as sales, clerical, or manufacturing, along with their compensation, after which this information is reported to the insurer. The insurer then calculates the cost of the insurance based on the categories to which employees are assigned, and this becomes the annual insurance premium for the company. The information is usually audited once a year by the insurer.

The insurance cost related to each employee category is based on the probability of employee injury. Thus, assigning an employee to a clerical classification is best, since these employees are rarely injured, while a manufacturing classification implies a much higher injury rate. Due to the cost differential, the payroll staff should be careful to legitimately assign personnel to the lowest-cost classifications.

EXAMPLE

Lowry Locomotion manufactures toy cars and trucks. Lowry's payroll manager has just received the annual workers' compensation classification report from the company's insurance carrier. He knows that the clerical classification is by far

the lowest-cost category, while the manufacturing classification involves an insurance premium that is five times higher than the clerical classification.

He peruses the payroll records and realizes that the jobs of three people in the production planning department are entirely clerical. He shifts these three people and their compensation into the clerical classification from the manufacturing classification, and documents his reasons for doing so.

Reinsurance

An entirely different type of insurance is reinsurance; it is insurance for insurers. Insurers use reinsurance to offload selected risks to other insurers. This typically means that the primary insurer retains a certain amount of risk, after which the reinsurance firm becomes liable for additional payments. Such an arrangement is called a *nonproportional agreement*. If the two parties were to instead split the risk, it would be called a *proportional agreement*.

EXAMPLE

Gulf Coast Insurance writes a policy for the risk of loss on a $100 million office tower in Houston. Gulf Coast elects to retain $60 million of the risk and cedes the remaining $40 million risk to a reinsurer via a nonproportional agreement.

Later, a major hurricane causes massive damage to the office tower, creating a $65 million loss. Gulf Coast is responsible for the first $60 million of the loss, while the reinsurer is responsible for the remaining $5 million of the loss.

EXAMPLE

If Gulf Coast and the reinsurer had instead entered into a proportional reinsurance agreement, they would have evenly split the responsibility for the $65 million loss.

Reinsurance is usually covered by treaty arrangements, where the reinsurer agrees to take a designated amount of risk for all policies covered by the treaty. An alternate approach is facultative reinsurance, where the amount and proportion of risk that the reinsurer will take is decided on a case-by-case basis. The latter arrangement is most common when the risks are quite large.

Insurance for the Home Business

Many people have businesses that are based out of their homes. Examples are attorneys, authors, operators of Internet stores, personal trainers, general contractors, and franchisees. These situations have unique insurance

requirements that are not met by the standard homeowner's policy. The following risks relate to a home business, but do not appear in a homeowner's policy:

- No business liability coverage of any kind, such as for products, professional liability, or workers' compensation.
- Minimal amounts of coverage for business personal property, probably in the vicinity of $2,500. This means that a loss of property for any reason will likely receive no reimbursement. This can be a problem, considering the office furniture, computers, scanners, printers, copiers, supplies, and stored inventory included in a typical home-based business.

There are several ways to deal with these issues. First, in the likely event that the home business is contained within the family residence, ensure that the homeowner's coverage is sufficiently high to rebuild the house, including the cost to rebuild that portion set aside for the home business. Second, if the business is located on the premises but in a separate structure, obtain an endorsement to the homeowner's policy that allows for business use of this structure. In addition, increase the detached structure coverage enough to ensure that the structure can be rebuilt. And finally, obtain all of the preceding business insurance coverages needed to mitigate the risks that the business owner does not want to self-insure. This may require one to obtain commercial automobile insurance, commercial general liability insurance, professional liability insurance, perhaps property insurance, and workers' compensation insurance (if there are employees). A possibility is to obtain a home business endorsement to the homeowner's insurance that provides personal property coverage for home office equipment, as well as protection from liabilities arising from someone being injured on the premises. More comprehensive coverage can be obtained through a business owner's policy, which is designed for small businesses; it bundles general liability insurance and property insurance into a single policy, and may even include business interruption insurance.

Several additional issues are noted in the following bullet points:

- **Consignment inventory.** Who is responsible for consigned inventory? The manufacturer owns it, but the local business owner may be responsible for any damage to it. If so, add in the value of the consigned inventory when calculating the total amount at risk.
- **Automobile ownership.** If a vehicle is owned by the business, then obtain commercial automobile insurance for it. If the vehicle is personally owned, obtain a personal automobile policy. If employees use their own vehicles while on company business, obtain non-owned automobile liability coverage.

Summary

Of the preceding insurance policies, the ones that are considered to be core coverage are commercial general liability insurance and property insurance. In addition, it will likely be necessary to add additional umbrella coverage to the commercial general liability insurance. If a business is publicly held, then directors and officers insurance should also be considered part of the core coverage (it will be hard to attract board members if this coverage is not present). Finally, a professional organization will find that professional liability insurance is an essential risk management tool. The other types of insurance may be layered onto this core grouping, depending on the circumstances.

The amount and type of insurance that a business purchases should be determined at the *end* of a comprehensive risk analysis. By waiting for the analysis to be completed, management can first determine which risks can be mitigated or avoided through internal activities. Any residual risks can either be accepted or transferred to an insurance carrier. This approach should be repeated at regular intervals, and especially when the underlying business changes, so that incremental alterations in insurance coverage can be made.

Review Questions

1. What type of business would be most likely to acquire boiler and machinery insurance?
    A. A trucking firm
    B. A consulting firm
    C. A software developer
    D. A manufacturer

2. D&O insurance covers directors and officers for which of the following?
    A. Acting within the scope and capacity of their positions
    B. Criminal acts
    C. Punitive damages
    D. Fraud

3. What is covered under an inland marine insurance policy?
    A. Expropriated assets
    B. Injuries to third parties caused by company vehicles
    C. Damage to personal property
    D. Musical instruments

4. Which of the following is <u>not</u> additional coverage for property insurance?
    A. Debris removal
    B. Theft of electronic information
    C. Pollutant clean-up
    D. Property preservation

Review Answers

1. A. The rolling stock owned by a trucking firm is not covered by this insurance.
   B. A consulting firm has few (if any) fixed assets, and so would have no use for this insurance.
   C. Incorrect. A software developer does own a large amount of computer equipment, which is covered by the policy, but most of the other coverage would not be applicable.
   D. **Correct.** A manufacturer owns a large amount of the equipment targeted by this policy, and so would be most likely to acquire it.

2. A. **Correct.** D&O insurance provides coverage for the decisions taken by directors and officers within the scope and capacity of their positions; that is, their normal operating decisions.
   B. Incorrect. The insurance does not cover criminal acts, which might otherwise result in substantial insurer losses.
   C. Incorrect. Punitive damages can be several multiples of the actual amount awarded in court, and so would represent a massive loss for an insurer.
   D. Incorrect. The insurance does not cover fraudulent acts; otherwise, directors and officers could engage in illegal acts with impunity.

3. A. Incorrect. Losses on expropriated assets are covered by political risk insurance.
   B. Incorrect. Injuries caused by company vehicles are covered by commercial automobile insurance.
   C. Incorrect. Damage to personal property is covered by property insurance.
   D. **Correct.** Despite the name of the insurance, inland marine actually does provide coverage for damage to musical instruments.

4. A. Incorrect. Debris removal coverage pays for the cost of removing debris from a damaged facility.
   B. **Correct.** The theft of electronic information is covered by cyber risk insurance, not property insurance.
   C. Incorrect. Pollutant clean-up coverage pays for the cost to remove pollutants from the premises if the pollution was caused by an event that damaged the property.
   D. Incorrect. Property preservation coverage pays for damage to property while it is being transported to a safe location or being stored there.

Chapter 3
Insurance Management

Learning Objectives

- Recognize a concern with insurance riders
- Determine why an insured entity would avoid filing claims for smaller amounts
- Spot an example of a situation in which self-funded insurance works well

Introduction

Insurance can be expensive, and so must be used prudently. In this chapter, we explore a number of ways to manage the cost of insurance and administer claims. We also note the relatively simple accounting for insurance payments and claims receipts, and several related issues.

Managing the Cost of Insurance

Depending on the risk profile of a business and the types of risks being transferred to insurers, the cost of insurance can be quite high. If so, there are a number of steps that can be taken to keep this cost as low as possible, as described in the following sub-sections.

Broker Training

The company's insurance broker should have an excellent knowledge of the entity's operations, which should result in the best possible tailoring of insurance products to the needs of the firm. Otherwise, there is a possibility that some insurance will be purchased that is not necessary. A high level of broker knowledge can be achieved when there is a long-term relationship between the broker and the business. This may mean sticking with a specific broker who knows the business, even if that broker switches to a different employer.

Tip: Do not switch brokers too frequently, as the business will build a reputation for skipping around, which could make it difficult to obtain reasonable coverage at a good price.

Odds Analysis

Review coverage to see if certain risks being covered are highly unlikely to occur, not only historically for the company, but also for the industry as a whole. If the amount of loss associated with these risks is relatively low, it may not make sense to continue obtaining insurance coverage. Instead, such items would be good targets for self-insurance. An analysis of the odds of occurrence is particularly effective when an entity has changed its location or there has been some other major change to its business.

EXAMPLE

A business had previously been located in a flood plain, and paid for quite expensive flood insurance for many years. It has recently relocated to an area for which there is no record of a flood ever having occurred. Given the reduced odds of flooding, the company might consider eliminating its flood coverage.

Insurer Messaging

If the cost of a particular type of insurance continues to rise over a period of time, this means that the insurer believes there is a high probability of loss and resultant payouts to policy holders. If so, and rather than continuing to pay the insurance, consider whether the company should restructure its business to mitigate the risk. After all, the insurer is using its pricing to tell management that a business activity is excessively risky. For example, if flood insurance rises to absurd levels, take this as a warning that the company needs to move its operations to a safer location.

Covered Items Analysis

Review existing insurance contracts to see if the company is still paying for the coverage of assets that no longer exist, or for inconsequential risks. Of course, a result of this review could well be an increase in insurance costs, if it is found that some assets are not being covered, or major risks are not being addressed.

Double Coverage Analysis

Compare the coverage of all insurance policies to see if the company is paying for different insurance contracts that provide overlapping coverage of the same asset or risk. If so, eliminate the overlap when the contracts are up for renewal.

A concern with insurance riders is that they can provide duplicate coverage, so be sure to examine the terms of the basic policy to see if each rider is really needed.

Split Limits Elimination

When providing coverage, an insurer may provide different levels of coverage for certain sub-categories of incidents. The insurer tries to maintain lower levels of coverage for those categories most likely to occur, so that its payout is reduced. This exposes the insured party to a greater risk of loss. Consequently, try to impose a single limit on all categories of incidents listed in a policy. For example, a commercial automobile insurance policy might provide for $300,000 of coverage per accident, and a $100,000 injury limit per person. The real cap on the coverage is $100,000, since injury awards to individuals can vastly exceed $100,000.

EXAMPLE

A business has a commercial automobile insurance policy that contains an injury limit of $100,000 per person and an accident limit of $300,000. An employee driving a company delivery van rear-ends a passenger car, sending its two occupants to the hospital. A jury awards $125,000 to each of the occupants. Though the total of this award is $250,000, the overriding limit is the $100,000 injury limit imposed by the insurer. In this case, the insurer only pays out $100,000 per occupant, leaving the business to pay for the remaining $50,000.

Continual Policy Updates

The risk profile of a business changes throughout the year, so the accompanying insurance policies should change, too. This means establishing a clear line of communication from the business unit managers to the person responsible for insurance coverage, and from there to the insurer. This may result in selective increases and decreases in coverage. In cases where coverage is increased, the net cost to the business may still decline, since the intent of the coverage is to guard against unintended losses.

Unlikely Rider Payouts

Many policy riders cover events that are very unlikely to happen. Consequently, make a reasonable estimation of the actual need for a rider before paying additional cash for it.

Non-Comparability

The terms and fees associated with riders are customized to the specific needs of the insured entity, so it can be difficult to compare competing insurance offers. Insurers can use the non-comparability of policy terms to build additional profits into their offerings, so be certain that riders are really needed before adding them to a basic policy.

Deductibles Analysis

An insurance provider may offer different prices, depending on the amount of the deductible that an organization is willing to absorb. The correct deductible to select can be calculated in a two-step process, which is:

1. Determine the historical average loss experience of the business, and multiply this amount by the proposed deductible to arrive at the amount of the loss that the business is likely to absorb at the designated deductible level.
2. Compare the estimated loss to the premium savings associated with the deductible. If the loss is less than the premium savings, then the proposed deductible is a good deal for the organization.

EXAMPLE

The insurance provider for Horton Corporation is proposing that the deductible on the company's commercial vehicle insurance policy be raised from the current $250 level to $500. In exchange, the provider proposes to drop the per-vehicle annual insurance cost by $50. Horton currently insures 30 vehicles.

To see if this is a good deal, a company analyst notes that Horton has had an average of five vehicle-related claims per year for the past decade. In all cases, the amount of the claim exceeded $500, so the full amount of the deductible would always be applicable. The increase in deductible would cost the company an additional $1,250 per year (calculated as five claims × $250 additional deductible/each). The cost savings from a reduced insurance premium will be $1,500 (calculated as 30 vehicles × $50 premium savings/each). Since the savings exceed the projected loss by $250, Horton should accept the proposed deal.

Small Claims Avoidance

When a business continually files claims for small amounts, the insurer may not have to pay out much for actual claims, but will need to incur a significant amount of administrative costs to investigate each claim. The administrative cost may exceed the cost of the claims paid. When a policy comes up for renewal, an insurer may increase the price of coverage, either to offset the expected future administrative cost of the multitude of small claims, or to send a message to the insured entity that it no longer wants to do business. Thus, it can make sense for the insured party to avoid a continuing series of minor claims. The company's agent can provide advice regarding the minimum threshold below which many claims could trigger a subsequent rate increase.

Tip: If the decision is made to avoid filing small claims, it makes sense to have higher deductibles. The increase in deductibles reduces the total cost of insurance.

Inventory Reduction

It may be possible to shift more inventory back onto suppliers until just before they are needed. If so, this greatly reduces the inventory on hand for which coverage would otherwise be needed. Better yet, see if suppliers will agree to a drop shipping arrangement, where they deliver products straight to the company's customers. Doing so completely eliminates the inventory asset, and therefore the amount of insurance coverage.

Delayed Payments

Some insurers allow premium payments to be made at intervals over the coverage period, rather than in advance of the coverage period. If so, and there is no inherent interest rate associated with these delayed payments, take advantage of the delayed payment offer. Doing so allows the business to invest the excess cash and earn a small amount of interest income. A larger organization that spends significant amounts on insurance premiums may be able to impose this payment schedule on its insurers.

Self-Funded Insurance

A very large business is likely to have many more insurance claims than a smaller organization. With a larger number of losses, such a large enterprise has enough information to statistically predict its losses. When these losses occur with high frequency and a low cost per claim, there is an opportunity to reduce costs by self-funding claims from an established reserve. The cost savings arises from the elimination of the selling costs and profits that an independent insurer must build into its prices. However, the organization must now pay for the administrative cost of settling claims, and may also need to pay for legal representation to defend it against spurious claims. An additional concern is that the business may be placed in the potentially uncomfortable position of denying claims from its own employees, depending on the type of insurance.

Examples of situations in which self-funding works well are automobile damage claims and workers' compensation claims. These situations present little risk of major losses, so a larger business can likely absorb these costs as part of its ongoing operating expenses, without imposing any material burden on its profits.

In situations where self-funded insurance is used, there may be a low risk of large claims. If so, a business can purchase stop loss insurance that provides coverage once an employee's annual claims experience exceeds a certain predetermined amount.

An added benefit of self-insurance is the detailed level of information available to the company concerning the types of claims being filed. With this information, it may be possible to create risk reduction programs that target the types of claims being filed.

Captive Insurance Company

A variation on the self-funding concept is to create and fund a captive insurance company. The captive insurance concept involves purchasing insurance coverage from an insurance company that is owned and controlled by the insured entity. The insurance premiums paid by the insured entity are tax deductible. In addition, the premiums collected by the captive are tax-free. This approach is less expensive than buying insurance from an independent insurance entity, which must include a provision in its pricing for sales costs and an adequate profit.

The tax effects associated with a captive are important. From the perspective of the insured entity, all of its premiums paid to the captive are tax deductible. Thus, if it pays $100,000 in premiums to the captive and its tax rate is 35%, it has just reduced its tax liability by $35,000. In addition, the U.S. Internal Revenue Code, section 831(b) states that the first $1.2 million of premium income received by the captive in each year is tax exempt. In essence, this means that an insured entity can take a tax deduction on an insurance premium that it has paid to itself (the captive), while not owing any income tax on those funds—and this tax advantage continues to accrue, year after year.

Because of this tax advantage, it is possible for a business owner to buy more insurance coverage than it normally would from a third-party insurer, on the grounds that it can take a tax deduction on these premiums, while still retaining the funds within the captive (to the extent that there are no offsetting claims). Since the insured entity owns the captive, this represents a net profit increase for the insured entity.

The captive processes all claims forwarded from the insured entity, so that no administrative issues need to be handed off to a regular insurance company. In addition, the captive participates in a reinsurance pool with other captives to reinsure each other's risks. Doing so protects it from bankruptcy if it were to receive a catastrophic claim that would otherwise wipe out its reserves. In addition, participating in a reinsurance pool is part of the qualifications required of a captive, so that it meets the risk distribution requirements for an insurance company.

Captive insurance companies are set up within governmental jurisdictions that have provided favorable captive insurance laws, and which have a favorable business climate. Historically, several Caribbean and nearby island governments have been the best locations for captives, including Grand Cayman, the British Virgin Islands, St. Lucia, Anguilla, and the Bahamas. Several state governments have created favorable laws for captives as well, but operating costs in these states are higher than the island-based alternatives (partially because the states also impose state income taxes on the earnings of captives). Examples of states with captive-friendly laws are Delaware, Tennessee, and Vermont. There are advisors in these locations that provide complete packages to start up a captive, including an actuarial assessment of the business, licensing a captive, arranging reinsurance for it, preparing an operations manual, arranging for annual audits, and maintaining the captive over time. They can also invest any funds held by a captive, though investment management can also be handled by a third party.

Tip: Create a trust that owns the captive, and set up the children of the owners of the insured entity as the beneficiaries. When the owners eventually die, the captive is excluded from the estate of the owners, so there is no applicable estate tax.

If a captive accumulates a large amount of profits over a period of time, one of the more tax-efficient ways for the insured entity to gain access to those profits is to liquidate the captive, which qualifies the insured entity to recognize a long-term capital gain on the captive's profits.

Given the costs to set up and manage a captive insurance company, as well as the cost to obtain an insurance license, this approach is usually only cost-effective for mid-sized or larger organizations, or entities engaged in high-risk activities, and which therefore pay significant premiums. A variation is the rent-a-captive approach, where several medium-sized organizations share a captive and centrally manage funds in order to reduce the total administrative cost per business.

Insurance Claim Problems

An insured party can have problems collecting from an insurer when there is a concurrent cause of loss. This means that more than one peril was involved in a loss. For example, in a property claim, damage might have been caused by a combination of flooding and a windstorm. If so, coverage might have been provided for the windstorm peril but not the flooding

peril. When coverage only applies to a sub-set of the perils causing damage, settlement of the related claim could be lengthy. A likely outcome is a negotiation between the insurer and insured party to arrive at a reduced settlement amount.

Another claim problem can arise when the insurance coverage provided by two insurers overlaps, so that either one could pay a claim. In this case, payment will eventually occur, but may be delayed until the insurers reach an agreement regarding the proportions to be paid by each party.

Insurance Claims Administration

The administration of insurance claims is important, since the response time to these claims can be lengthy, and there is a high risk of claim rejection if the paperwork is not filled out properly. This issue can be mitigated by adhering to a specific claims administration process.

The core of this process flow is a checklist of activities that must be completed before any claim can be filed. The presence of a checklist keeps the company from missing a key step that could interfere with claim settlement. Other steps should also be included to record the associated transaction and to mitigate the risk of future losses of a similar type. The checklist should include the following items:

- **Contact information.** Write down the name and contact information for the person reporting the issue, as well as the date and location of the reported incident.
- **Photos.** Take photos of anything that will substantiate the claim.
- **Itemizations.** List the estimated cost, replacement cost, and appraised cost of each item to be included in the claim, as well as the sources of this information.
- **Cost buildup.** Aggregate all of the related costs sustained by the company during the event, for which it may be possible to claim reimbursement.
- **Adjuster contact information.** Pull from the records the name of the claims adjuster to be contacted, and verify that this information is still correct.
- **Internal notifications.** Notify those people inside the company who may need to record the associated loss, and/or notify investors or senior management of the situation.
- **Problem analysis.** Review the cause of the claim and investigate whether steps can be taken to keep this type of loss from arising again.

- **Asset protection.** Ensure that no further damage to the damaged asset can occur. For example, move a water-damaged asset to a dry location. Otherwise, the insurer will only pay for the amount of damage initially sustained.

To ensure that these steps are followed, institute an occasional internal audit to review compliance with the checklist.

It is possible that a company focusing on other issues will have a third party administer its insurance claims. If so, be sure to have a monitoring process to verify that claims are submitted accurately and on time, and that a high proportion of the submissions are paid out.

Core Reports

The management team should always be provided with a periodic losses report and incidents report. The losses report notes the amount of money lost in the period from different causes, while the incidents report summarizes the incidents that occurred in the period, irrespective of the amount of money lost (if any). An insurance claims report is used to summarize the types, amounts, and dates of claims. These reports are described in the following sub-sections.

Losses Report

All types of losses can be reported to management. These losses should be a central focus of the management team, since they should either be recognized as the offshoot of a high-risk strategy or as losses for which mitigation tactics might be employed, such as buying insurance. However, reporting losses does not mean that the report recipients should be buried with detail. Instead, pare away all minor losses that do not meet a certain threshold. Also, consider aggregating losses into different categories for easier perusal, such as losses linked to customer credit, commodity prices, and exchange rates. Additional useful information could be to track losses against expectations, both for the reporting period and on a cumulative basis. These extra refinements are useful for highlighting unusual losses that require further investigation.

Incidents Report

The problem with the preceding losses report is that it only focuses attention on activities that actually lose a notable amount of money. Other events may not immediately lose money, but could do so in the future, and so should also be presented to management. Incidents that might appear in

such a report are the theft of inventory or petty cash, the filing of a lawsuit against the company, a network failure during non-working hours, an equipment fire that was immediately extinguished, and an employee injury that was covered by workers' compensation insurance. These incidents could be indicative of larger problems that may require the use of insurance, so it can be useful to attach an analysis that points out trends or perhaps correlations between different incidents.

Insurance Claims Report

Some risk will be offloaded to insurers, so it makes sense to summarize in a claims report the types of claims made and the settlement amounts. By doing so, one can see the size and frequency of insured losses. It can be useful to issue this report as a summary page, with details on attached pages regarding the nature of the various claims. Management can then spot an item on the cover page and drill down through the attachments to locate additional information. A sample insurance claims report summary page follows.

Sample Insurance Claims Report

Claim Date	Claim Description	Event Location	Claim Amount
1/05/XX	Boiler claim | Steam valve broke and flooded area	Thornton facility	$48,000
1/28/XX	Auto claim | Rolled over in high winds	On Interstate 25	42,000
2/09/XX	Directors liability claim | Shareholder awarded damages	Headquarters	100,000
2/10/XX	Property claim | Hail damage to warehouse roof	Little Rock facility	63,000
2/17/XX	Property claim | Fire damage to office furniture	Miami office	15,000
3/07/XX	Inland marine claim | Sales exhibition destroyed in transit	In transit to Dallas	30,000
3/15/XX	Business interruption | River flooding shut down subsidiary	Omaha retail store	120,000

If there are many claims, it can make sense to not include in the report any claims below a threshold level. Doing so keeps the reader focused on the largest loss events.

An option to consider for this report is to also include the deductible loss that the company absorbed, as well as any additional losses for which no insurance claim could be made. If these amounts are minor, it may not be worth the administrative effort to accumulate the additional information.

Accounting for Insurance

The accounting for insurance is relatively easy. In the following two subsections, we note the accounting for insurance payments (cash outflows) and claims receipts (cash inflows).

Insurance Payments

When a premium is paid within the period being covered by the insurer, the amount paid is charged directly to expense in that period, reflecting the immediate consumption of the insurance. If a premium is paid that covers multiple future periods, it is first recorded as a short-term asset in the prepaid expenses asset account. As each successive period in the coverage period is reached, the insured entity charges a proportionate amount of the insurance asset to expense, leaving a progressively smaller residual amount in the prepaid expenses asset account.

EXAMPLE

Radiosonde Balloons spends $12,000 in advance for liability insurance coverage for the next twelve months. The company records this expenditure in the prepaid expenses account as a current asset. This is considered unexpired insurance. In each of the next 12 successive months, the business charges $1,000 of this prepaid asset to expense, thereby equably spreading the expense recognition over the coverage period.

If an insurance premium relates to a production operation, such as the property coverage for a factory building, this expense can be included in an overhead cost pool and then allocated to the units produced in each period. Doing so means that some of the insurance expense will be included in ending inventory and some will be assigned to the units sold during the period, so that the expense appears in the cost of goods sold.

Claims Receipts

When a business suffers a loss that is covered by an insurance policy, it recognizes a gain in the amount of the insurance proceeds received. The most reasonable approach to recording these proceeds is to wait until they have been received by the company. By doing so, there is no risk of recording a gain related to a payment that is never received.

An alternative is to record the gain as soon as the payment is probable and the amount of the payment can be determined; however, this constitutes a form of accrued revenue, and so is discouraged unless there is a high degree of certainty regarding the payment. If the gain is recorded

prior to cash receipt, the offsetting debit to the gain is a receivable for expected insurance recoveries.

A gain from insurance proceeds should be recorded in a separate account if the amount is material, thereby clearly labeling the gain as being non-operational in nature. For example, the title of such an account could be "Gain from Insurance Claims."

Though a gain is being recorded, the likely total outcome of an insurance claim is a net loss, since the amount of such a claim is offset against the actual loss incurred, net of an insurance deductible.

It may be necessary to disclose the nature of events resulting in insurance proceeds, the amount of the proceeds, and the income statement line item in which the resulting gain is recorded.

Summary

The blend of insurance policies that a business uses is constantly in flux, as some policies are added or terminated to reflect changing business conditions. Further, coverage amounts and riders may be altered. This means there is an ongoing need to review policies to ensure that the risk profile of a business is properly reflected in outstanding policies, and that there is no coverage overlap. A likely outcome of this ongoing analysis is that an organization will achieve a highly cost-beneficial insurance profile, with no money wasted on unnecessary insurance.

Review Questions

1. What does the presence of split limits on a policy mean?
    A. The insured party is exposed to a greater risk of loss
    B. The insured party has the option to renew for multiple years
    C. All risks are covered
    D. A cash value is accumulating

2. What is a key benefit of setting up a captive insurance company?
    A. Being able to defer the tax recognition of premium payments
    B. The tax exempt status of a portion of its premium income
    C. Storing cash in an international location that is invisible to the Internal Revenue Service
    D. Being able to move certain employees to the payroll of a lower-tax region

3. Of the reports used by management to monitor insurance-related issues, which is the most useful for spotting looming problems that may later require insurance?
    A. Losses
    B. Incidents
    C. Claims
    D. Income statement

Review Answers

1. A. **Correct.** The insured party is exposed to a greater risk of loss, because the payout is reduced for certain sub-categories of incidents.
   B. Incorrect. An option to renew is not granted, since the insurer wants the option to terminate coverage for a policyholder that has a hefty loss experience.
   C. Incorrect. An all perils policy provides complete coverage of all risks.
   D. Incorrect. A whole life policy accumulates a cash value over time. This feature is not available on other types of insurance.

2. A. Incorrect. Deferring an expense to a later period increases the amount of taxable income in the current period, which is not a benefit.
   B. **Correct.** Section 831(b) of the Internal Revenue Code states that the first $1.2 million of premium income for this type of entity is tax exempt.
   B. Incorrect. Moving cash to an offshore location to hide income is illegal.
   D. Incorrect. No employees are moved to a different region when a captive is formed.

3. A. Incorrect. The losses report itemizes the more expensive losses. Since it tends to crop off smaller loss amounts, this report does not provide the best information about smaller issues that may grow in size.
   B. **Correct.** The incidents report provides insights into failures that are not yet causing notable losses, but which might do so in the future.
   C. Incorrect. The claims report details the status of claims made and settlement amounts, and so provides more information about existing insured problem areas.
   D. Incorrect. The income statement provides a general overview of revenues, expenses, and profits/losses, and so would tend to hide any incipient loss issues.

Glossary

Agent. A legal representative of an insurance company.

Broker. An individual that represents the client, and assists the buyer in shopping for the best combination of coverage and price.

Captive agent. An agent that only represents a single insurer.

Claim. A demand made by the insured entity on the insurer, asking for the payment defined in the related insurance contract that relates to a loss.

Claims-made policy. An insurance policy that provides coverage for claims made during a specific date range.

Coinsurance. A penalty imposed on an insured party if it under-insures the value of property.

Copay. A fixed amount paid by an insured for each doctor visit or drug purchase.

Deductible. An initial loss amount that must be absorbed by the insured party.

Direct writer. Insurance company that sells insurance through its own distribution network.

Endorsement. An attachment to a contract that either adds or restricts coverage.

Exclusive representative. An insurer representative who is required to first approach its designated insurer about a prospective insurance policy, which has the right of first refusal.

Experience rating. A rating assigned by a state government to an employer, based on the recent history of unemployment claims by its employees.

Financial strength rating. An assessment of an insurer's ability to meet its payment obligations to policy holders.

Indemnity. A payment by an insurer for the monetary value of a loss.

Insurance. A contractual arrangement in which an organization pays an insurance carrier in exchange for the assumption of risk by the carrier.

Limit of insurance. The maximum amount that an insurer will pay.

Loss. An unexpected and unintentional drop in the value received by an entity that is caused by an occurrence that causes damage or injury.

Occurrence policy. An insurance policy that provides coverage for events occurring within a specific date range.

Personal property. Property that is movable; it can be defined as all property other than real property.

Real property. Any property that is directly attached to the land, plus the land itself.

Rider. An adjustment to a basic insurance policy.

Risk. Uncertainty regarding a future outcome.

Self-insurance. When claims are paid by the entity experiencing losses.

Stop loss. A policy that pays all claims above a certain threshold.

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