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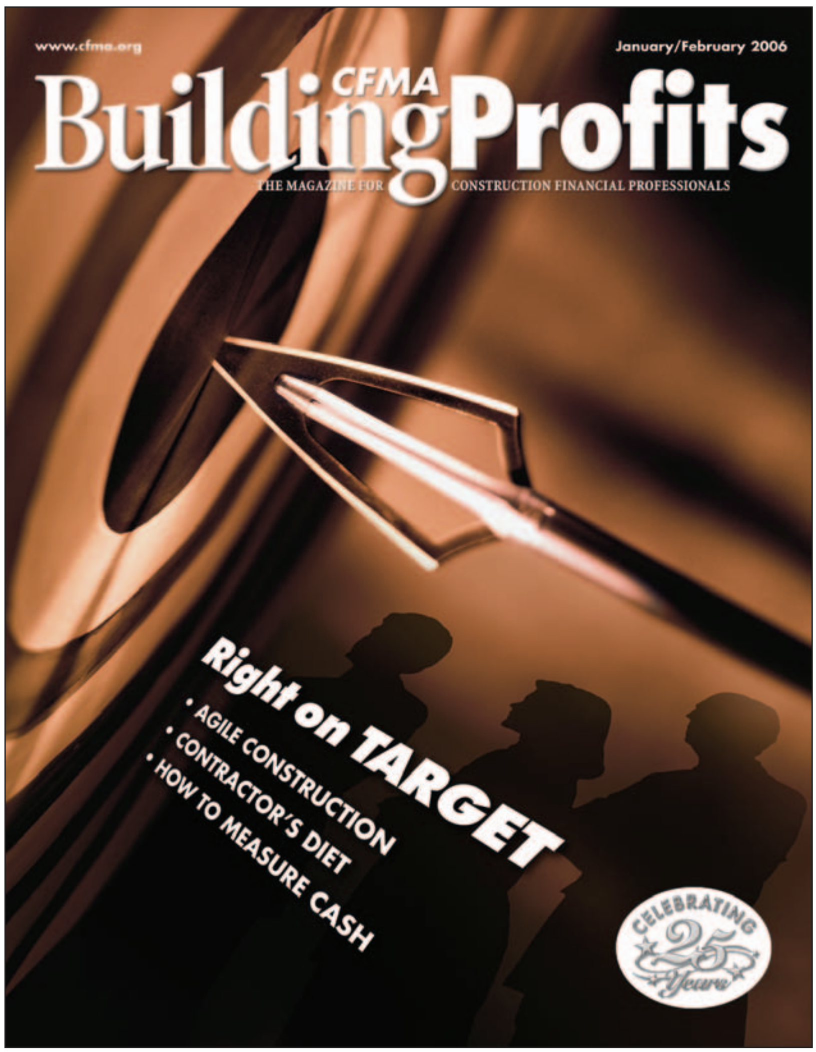

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QUANTIFYING DAMAGES AFTER A CATASTROPHE

Following one of the most active hurricane and fire seasons ever – with overall damages estimated at $100 billion or more – companies are coming to grips with their losses and the costs of recovery.

Many contractors in the affected areas were prepared for the loss measurement process, while others did not have the information or resources to effectively quantify their damages and file claims. Those contractors that experienced catastrophic loss were reminded of an important lesson: A little preparation goes a long way.

Companies must effectively manage, respond to, and quickly recover from catastrophic events. A successful loss measurement program enables a company to meet these objectives and helps ensure financial survival.

The program involves the development of a loss measurement plan, the creation of a loss measurement team, and a methodology to properly quantify and prepare claims.

The Loss Measurement Plan

A company's actions in the first hours after a loss are crucial. After a catastrophe, management must make decisions that can dramatically affect operations.

Some of these decisions can and should be made before a loss occurs, including the formation of a loss recovery plan, which helps companies manage a loss more effectively. Although each company needs a tailored loss recovery plan, consider these basic proactive steps:

- Assign responsibility for gathering data.
- Understand insurance policy coverage.
- Ensure that vital records are properly safeguarded.
- Develop and maintain a detailed asset inventory.
- Decide on the need for a property valuation.
- Consider who will quantify the damages.

The Loss Measurement Team

With these basics in mind, the next step is to identify the personnel and resources required in times of crisis to effectively execute your plan. It's important to establish roles and responsibilities in advance, and to identify as many of the team members as possible.

Individuals from both inside and outside your company can be part of your loss measurement team. Generally, consider the need for a:

- Risk manager
- Onsite construction manager/foreman
- In-house finance/accounting appointee
- Insurance policy consultant
- Forensic accountant with claims expertise
- Forensic engineer
- Construction scheduler
- Independent construction specialist
- Attorney

Regardless of the specialties of those on your loss measurement team, the group should be able to:

- Fully identify and measure damages.
- Manage the repair and replacement of damaged facilities and assets.
- Minimize delay and interruption to operations.
- Interact with the insurance team.
- Prepare and present claims to obtain full recovery.
- Pursue third-party recoveries.

After a Loss

After a loss, secure the safety of your employees and then set the loss recovery plan into motion. The objective is simple: To recover financially, with minimal interference to operations. Meeting this objective requires an effective structure, defined process, and timely execution. Generally, you want to accomplish the following as soon as possible:

- Protect property from further damage.
- Create and activate the claims team.
- Assess and document the damages.
- Complete notification procedures.
- Establish special work orders, job numbers, general ledger accounts, and other accounting procedures to identify and capture all claims costs.

Accurate and complete record-keeping for damages typically requires additional accounts. Here are some examples of claim cost categories to add to general ledgers:

- Protection and preservation
- Temporary repairs and replacement
- Permanent repairs and replacement
- Extraordinary and expediting expenses

Remember, these are account categories. After evaluating the types of damage sustained, management should develop more specific account codes within each category.

Method to Quantify Damages

Anyone surveying the wake of destruction following the hurricanes of 2005 could easily determine that damages had been sustained. However, there is a significant difference between showing damages, and identifying and categorizing them. Generally, damages are either property or time-related.

Property damages include:

- Real property, such as buildings or leasehold improvements (excludes land)
- Furniture, fixtures, and equipment
- Technology and communications
- Inventory/stock (including raw materials), work in progress, and finished goods

Time-related damages include:

- Extended overhead
- Business interruption
- Extra expense, as a result of the loss

Categorizing damages is half the battle. The other half is properly presenting these costs in a claim.

To fully recover costs, it is *essential* to employ the correct measurement procedures to prepare the claim. The methods used to calculate a claim depend on: **1)** the type of damage sustained (property or time-related), **2)** how or if the damage can be repaired, and **3)** what period of time the loss affected. In addition, an understanding of your policy's coverage is important.

Coverages

A property insurance policy typically applies to completed projects, while a builders' risk policy often protects ongoing projects.

If the loss was incurred through the fault or negligence of a third party (such as another contractor on a project), recovery may occur through that entity's insurance. If coverage is expected to fall short, recovery may involve a formal claim against the third party.

Property Related Damages

After buildings, equipment, and other fixed assets are damaged or destroyed, the loss measurement team must assess the extent of damage. Questions should include:

- Will the asset be repaired or replaced?
- If the asset must be repaired, what will it cost?
- Does the insurance policy cover replacement cost value or actual cash value?

If a building is damaged, claim preparation could entail documenting the actual cost of repairs, including invoices that delineate labor and material costs. In such a case, the actual repair/replacement cost is the measure, not the book value.

It is also common to obtain a formal appraisal of the damages. Appraisals are especially useful when the cost and time to repair is significant. In addition, if the building was unique or historic and similar replacement is not possible, the appraisal could become the primary measure of damages.

Claims for business property and equipment also use replacement cost as the measure, which is substantiated using purchase orders, invoices, and other receipt documentation. Once again, don't use book value.

Also include a current asset listing, which details furniture, fixtures, IT equipment, and other property. This listing helps prove property loss, especially if the destruction prevents reconciliation.

To measure inventories, you must determine which items were "on hand" at the time of loss. To prepare an inventory, take the last physical inventory prior to the loss event, add purchases, and subtract sales at the time of the loss.

Policyholders are obligated to mitigate their losses by resuming complete or partial operations as quickly as possible.

Next, adjust this inventory for damaged or destroyed items, which should be separately identified and valued after the loss. In addition, include any out-of-sight items that were lost, as well as the salvage values of any items.

The difference between the pre-loss and post-loss inventories is the basis for the claim. Insurers require an analysis of a company's inventory records, so safeguard important documents prior, during, and after a loss.

Scope & Time Issues

Ongoing construction projects affected by a catastrophic event present a particular challenge – identifying the added scope and time resulting from the loss.

In order to reduce mobilization time, have the project's vendors perform the repairs when possible. In addition, carefully separate loss-related work from the base work and change orders normally submitted for payment.

This separated work should be well-documented and submitted regularly for insurance reimbursement or third-party claims. The method of measuring the loss is the actual cost of repair and mitigation (such as acceleration).

Catastrophic events can also affect the schedule of a construction project. Accordingly, management and the loss measurement team should know the planned schedule baseline and assess its accuracy at the time of the loss, including any cost and resource loading.

Next, update the schedule to include necessary activities for repair. Also, modify and adjust durations for future activities to account for labor inefficiencies or loss of productivity.

Carefully track actual contractor performance and, if necessary, conduct a time impact analysis to show how the loss event affected the construction schedule. Damages resulting from delays may include delay, disruption, acceleration, extended overhead, loss of productivity, cumulative impact, and contract-default costs.

Time-Related Damages

The objective of time-element claims is to put the insured in the same financial position as if no loss had occurred.

Reimbursement for loss of earnings and extra expense is quantified for the "period of interruption" stated in the policy. Policyholders are obligated to mitigate their losses by resuming complete or partial operations as quickly as possible. For example, the project can be accelerated by working overtime, offering performance incentives, using offsite fabrication, or adding new vendors and/or subcontractors.

Time-element claims can be difficult to document, so adjusters often employ professionals (such as accountants, contractors, and engineers) to determine the scope of damage, audit the claim, and review financial records. A good loss recovery plan will include a similar roster of technical and financial professionals who will advocate for your company during the preparation and adjustment of your claim.

Business Interruption

To measure business interruption for an insurance claim, you need to project revenue streams and profits. Consider the length of the indemnity period for insurance purposes or the total impacted period when seeking recovery against a third party.

After identifying the period of interruption, estimate earnings as if the loss had not occurred and then compare these projections to the actual financial results to determine the claim. In addition, include contractual obligations in the calculation, such as penalties incurred and incentives missed due to the loss.

Extra Expense

The costs incurred to reduce business interruption losses are often recoverable under a policy's extra expense coverage. Extra expenses should be measured at actual cost when possible. For example, if an office building was unusable and temporary trailers were rented, the cost of the trailers could be claimed as an extra expense.

Contractors can also compare a company's normal project costs against actual costs, with the difference forming the claim. Remember to add operating inefficiencies and expediting costs to this assessment.

With regard to labor, straight time labor is often part of property damage claims, while overtime is usually part of the time-element claim. Also, it is possible to recover the cost of salaried repair labor, although you should make such an agreement with your adjuster prior to a loss.

Finally, instruct employees and outside vendors to include detailed time descriptions on timecards and invoices. This will ensure that loss recovery labor is sufficiently documented in your claim.

Conclusion

Financially surviving a catastrophic event takes advance planning. Be proactive and develop an appropriate loss recovery plan, rather than reacting after a loss. Be prepared to engage a properly qualified loss measurement team to identify and quantify damages. With advance planning and focused execution after a loss, your company will be prepared to recover financially through the claims process. BP

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