Actual Cash Value vs. Replacement Cost

Insurance companies normally use one of two methods to figure how much you will be reimbursed for a loss if the amount is less than your coverage limits.

The most common calculation is the actual cash value, which is the replacement value minus depreciation. For example, if the video camera you bought for the birth of your child was stolen during his fifth birthday party at an amusement park, the amount the insurance company would pay might be fairly close to today's market value for a five-year-old video camera.

The second calculation is simply the replacement cost of the lost property with no depreciation, but usually with a maximum value. That means you would be paid whatever it cost to replace your video camera with a comparable model at today's prices, up to a preset limit. This is far less common and unless your policy specifically states it will pay the replacement value, it will only pay actual cash value.

Coverage limits play a major role in what you will be paid for a loss. The value of your dwelling sets a baseline from which other coverage levels are calculated. For example, compensation for additional structures on your land might be limited to 10 percent of the value of the dwelling. Your personal property might be limited to 50 percent of the dwelling value.

The method of loss can have an impact on your compensation, as well. If a valuable is stolen, you might receive less than if it was destroyed by fire. Most policies will place lower dollar limits on compensation for certain types of assets that are stolen, such as firearms or jewelry, to limit the insurance company's potential exposure to common thefts. Such items are far less likely to be destroyed than stolen, so insurers are more likely to cover them for actual cash value in case of destruction. This also creates an added incentive for the insured to protect assets from theft.

If you have something of tremendous value and you know the regular limits of your policy wouldn't come close to compensating you if it was lost or destroyed, you may be able to purchase additional coverage through endorsements and floaters, which are discussed in a separate article.