Charterfields

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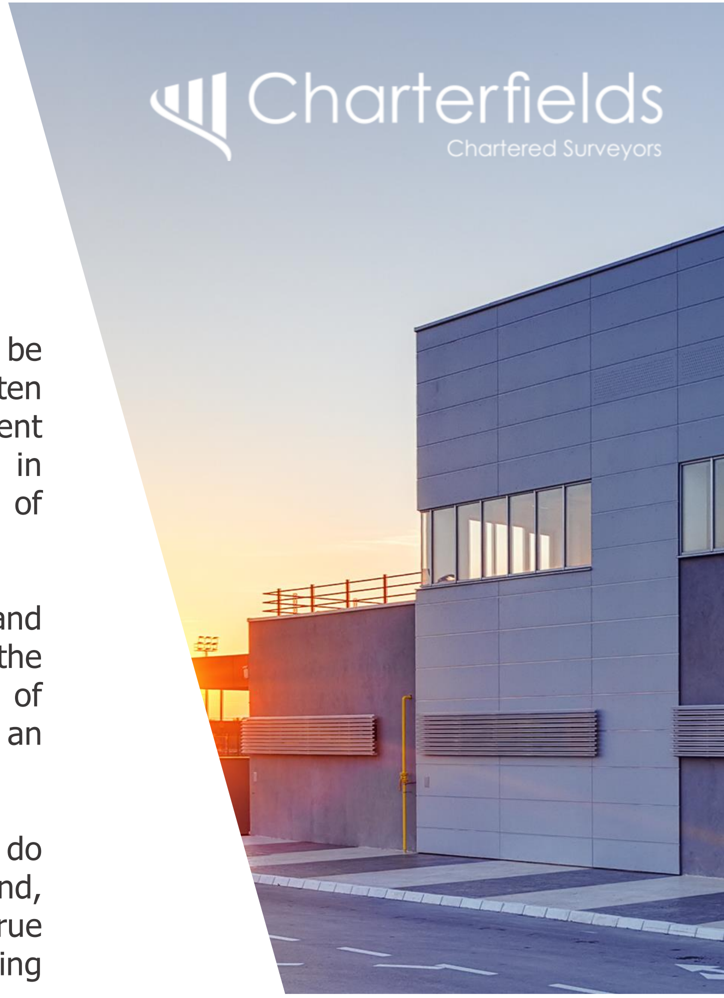
Using indices to estimate reinstatement costs for insurance

Key highlights

- Asset registers are designed for accounting purposes - insurable assets may differ from those included in financial statements
- Changes to supply chains, technologies and market sentiment can quickly influence costs
- Building regulations, environmental standards and construction methods are continually changing which may not be reflected in indexed historic costs
- Indices are generic by nature. Applying these to individual facilities or locations can present challenges and produce inaccurate results
- Modelling and indexation have a place when determining declared values, but caution is required and a regular independent review by qualified valuers can be an essential check and balance.



Do acquisition costs include for grants/incentives?

Authorities at national and local level can be highly supportive of new investment, often creating the right environment for investment in terms of incentives, reduction in administrative barriers and provision of associated infrastructure.

These cost rebates, development grants and other incentives that were available in the past, may not be available in case of reconstruction or reinstatement following an insured loss.

Acquisition costs in asset registers often do not reflect these grants/incentives and, therefore, may materially understate the true replacement cost if indexed as being representative of current prices.

Do acquisition costs include for one-off upfront payments?

Conversely, there are situations where firms may have had to pay one-off costs to local or national governments, particularly true for large scale property schemes, such as housing or industrial park development.

In these situations, developers or asset owners may have had to meet costs to reduce the impact of the construction on local communities. This could cover contributions towards infrastructure or neighbouring development (e.g., Section 106 planning or Section 278 highways payments in the UK).

These costs are typically one-off and would not necessarily be repeated if the assets were reconstructed. Often these costs need to be removed from any assessment based on the historic cost.

Have costs been expensed rather than capitalised?

The treatment of costs as capital expenditure or expenses may be defined in national financial reporting standards (FRS) rules. This can mean that the use of asset registers to establish historic replacement costs can be challenging since these FRS rules evolve over time. Occasionally, capital costs may have been expensed rather than recognised in the balance sheet. Therefore, indexing historic costs could underestimate the true replacement cost of a capital project.

Do acquisition costs include for one-off upfront payments?

Asset registers often include several items that would be considered as non – insurable. These can include one-off non-repeatable costs like licences or approvals but can also include road registered vehicles and similar assets insured elsewhere.

For some locations, construction of new buildings or refurbishment of existing properties may have involved the investigation of possible site contamination or the removal and treatment of existing contamination or hazardous materials. These costs would likely not be repeated in the event of rebuild but could typically appear on the current asset register costs.

Increasingly for large projects, contracts are awarded based on a fixed Engineering, Procurement and Construction (EPC) contract. In some cases, this means the asset owner has little transparency on the actual costs of the different elements of the project, or the ultimate genuine cost. Indexing historic EPC costs may, therefore, be dangerous as a means of estimating current replacement costs.

Are there assets on site which you have an obligation to insure?

Asset registers often omit third party assets where the liability for insurance may rest with the borrower or location owner. For example, on a full repairing and insuring lease, a tenant may be responsible for insuring the building. This issue can equally apply to leased or rented equipment, mobile plant, pallets and other similar asset groups.

Has the infrastructure or have regulations changed, so increasing or decreasing current replacement costs?

Increased expectations or regulations on noise and emissions could significantly drive up the cost to replace an existing facility post loss, or even restrict the ability of the facility to be reinstated at the same location. These changes would not be reflected if the original costs are indexed. Conversely, there may have been changes to local infrastructure, e.g., new roads or port facilities, which could reduce the cost to rebuild assets.

Have global or regional markets shifted, so affecting access to products or services?

With the globalisation of manufacturing, many international suppliers and producers moved or expanded operations to take advantage of access to new markets and lower manufacturing costs.

In practice, this means that products and equipment may be supplied from new locations/suppliers. Combined with the general reduction in import duties, firms could be able to replace machinery and equipment at prices below those incurred originally.

Conversely, due to the impact of Covid-19 on supply chains and transportation costs, certain assets have seen rapid cost increases. These specific cost increases may not fully be reflected in generic indices based on a range of assets.

For imported assets, has currency exchange impacted costs?

Particularly for plant and equipment (including building services), imported assets can make up a large proportion of a reinstatement position.

Currency exchange rates have been volatile over the last decade – for example the United States Dollar to the British Pound exchange rate hit a peak of 2.08 in Oct 2007 but a low of 1.23 in March 2020.

Depending on when assets were acquired, and the source of assets, there could be a significant shift in costs just based on currency movements alone.

National indices may not always reflect the impact of currency movements, so caution needs to be applied when using indices for imported assets.

Which indices can you use and how dependable are they?

There are numerous indices produced on costs. Which indices should you use? That can be a hard issue to resolve.

Government official statistics tend to be focused on national economic data, e.g., the consumer price index (CPI), retail price index (RPI) or producer price index (PPI), rather than construction tender prices or specific equipment costs.

Over the last ten years there have been instances where these statistics have been amended several months or even years after original publication. In this context, the use of indices needs to be treated with caution.

By their nature, government produced indices show spot prices for a basket of goods rather than longer term trends. In practice, as has been seen during Covid-19, some indices can be highly volatile and may not reflect the longer-term price trends for large scale construction projects.

Conclusions

Accurate assessment of reinstatement costs using asset registers is always challenging, especially if the base accounting data is limited in terms of description or if the entries are not fully representative of the insured assets.

Even if the historic records are accurate, and sophisticated models are used based around applying the correct index to individual asset register entries, the resulting estimated values need thorough analysis, benchmarking and appraisal before they can be used as the basis for declared values.

For example, computer equipment has fallen in cost over the last decade on a like for like basis, while at the same time the cost of production equipment has increased. So, how do you index a computer-controlled machine tool? Choosing the right index is not always straightforward and requires a detailed knowledge of the subject assets and an understanding of the indices available.

Conducting a regular independent and detailed insurance assessment is still the most defendable way to ensure that declared values submitted to insurers are correct and defendable.

T: +44 (0) 330 202 0116
E: enquires@charterfields.com
W: charterfields.com