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The risks in using accounting records to set declared values for insurance

Valuations | Business Recovery | Asset Advisory

Key highlights

- Property damage insurance policies are generally written on a replacement with new basis
- Insurable assets can be significantly different to those shown on fixed asset registers
- Acquisition costs or book values do not represent current replacement with new costs
- Reinstatement costs can differ from historic costs for a wide range of reasons
- Even if historic costs are accurate, the application of indices to these costs is challenging and, for older assets, rarely results in correct values being reported.

Insurance policies are usually written on a "Replacement with New" basis

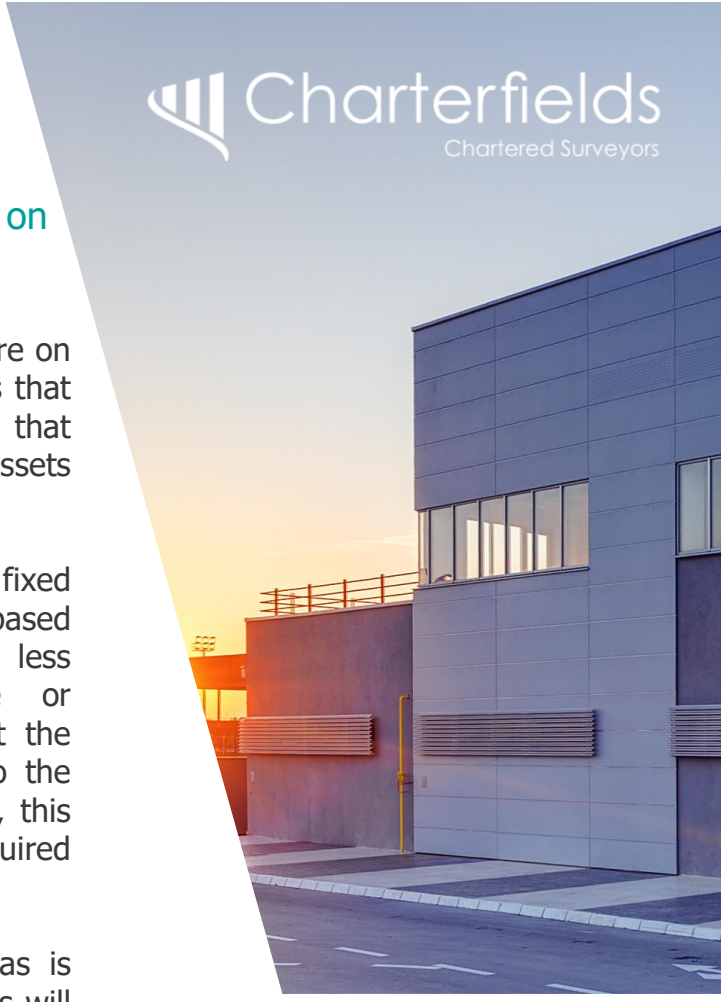
Most property damage insurance policies are on a replacement with new basis. This means that the insured must declare a value at risk that reflects the current cost to replace the assets with new on a like for like basis.

Unless revalued, the net book value of a fixed asset in the company accounts is typically based on the acquisition cost of the asset, less depreciation. While this book value or depreciated replacement cost may reflect the perceived value or worth of the asset to the business from an economic point of view, this does not match with the new cost as required under a property damage insurance policy.

When costs are rising due to inflation (as is currently the case) historic acquisition costs will understate the current replacement cost of an asset.

In applying depreciation to the original acquisition costs, any net book value is likely to be materially below the cost to replace the assets. For older facilities this would mean the risk of massive underinsurance if net book values were used.

In short, the appropriate value to be declared to the insurance company is not always directly correlated to the original cost, market value, second hand value or economic worth of the assets to the enterprise.



Asset registers do not always correlate with insurable assets

A key reason why the use of asset registers to establish replacement costs can be challenging is that the treatment of cost as a capital expenditure or an expense may be defined in local general accepted accounting practice. These rules evolve over time.

Occasionally costs such as management time, design and other fees, and preliminaries are expensed rather than capitalised in the asset register. In this situation indexing up historic costs could materially understate the true position.

Secondly, asset registers often include items that would be considered as non – insurable. These can include one-off non-repeatable costs like licences or approvals, but can also include land remediation, road registered vehicles, software, licences, permits, and assets that may be insured under a separate policy wording.

Thirdly, asset registers tend to omit third party assets where an equity position is not held but liability for insurance exists with an insured. Examples can include licenced production equipment, vending machines, forklift trucks, tooling, jigs and fixtures.

Original costs may not accurately represent the reinstatement cost of the assets

Changes to regulations on building standards, noise and emissions limits are likely to affect the cost to replace an existing building or facility after an insured event. In some cases, it may even restrict the ability of the asset to be reinstated at all at the same location.

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Reinstatement insurance policies are designed to put the insured in the same position after reinstatement as they were before, no better, but in practice betterment may be unavoidable. These would need to be reflected in the assessed cost to replace an asset. These additional costs would not be included in the existing acquisition cost of an asset.

For some locations infrastructure investment including improved utilities, road and rail links can mean easier or cheaper access to materials and labour so potentially reducing construction, delivery or installation costs.

Separately, changes in import duties and documentation can increase or decrease expected replacement costs for commodities and equipment compared to the situation when the assets were originally procured.

The application of appropriate indices to historic costs is challenging and rarely accurate for older assets

If an insured decides to use their asset register book value or acquisition cost, surely, they just need to apply an index to arrive at an estimated cost today?

Notwithstanding the issues outlined above, the problem is which indices can you use? There are numerous cost charts and indices produced on different asset types. Which indices should you use and how representative are they of the subject assets?

For example, construction indices from the Royal Institution of Chartered Surveyors' Building Cost Information Service (BCIS) may include good information on the average change in materials and tender rates costs for buildings and civil works. But if the subject location is a specialist site that requires expertise from a limited number of contractors (e.g., power stations, chemical plants, etc.) then BCIS indices may have limited relevance. Certainly, any index on building costs will have little correlation to the cost of process equipment.

By their nature, published indices are 'averages' of cost movements. They will not reflect the characteristics of individual sites and the more bespoke or unique a location, the less relevant these indices will be.

Published indices also tend to be national, meaning that they do not always take into consideration the impact of currency exchange movements, which are relevant to industrial facilities where a large proportion of costs may relate to imported goods.

Varying commodity and producer prices across countries and regions also continue to make the use of indices challenging. By their nature government produced indices are often based on longer term and regional/national trends rather than site specific prices. As a result, costs (and indices) in individual cities or regions could be significantly different to the generic published rates.

What happens if assets are insured for Indemnity or Actual Cash Value?

Occasionally, particularly for older assets, an insured may choose to insure these items for 'Indemnity' or 'Actual Cash Value'. However, it is rare for these Indemnity or Actual Cash Values, as defined by insurers, to match to current book values.

For example, in arriving at Indemnity Values for equipment assets, the full costs of installation and commissioning may need to be reflected, without any depreciation applied.

For frequently traded equipment such as machine tools, Actual Cash Values may be determined by second hand prices in the market. But these market prices are driven by supply and demand and values can rise as well as fall, as was seen in late 2021 with the price of second-hand vehicles rising owing to silicon chip shortages across the automotive sector.

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Conclusions

Accurate assessment of reinstatement costs using asset registers is always challenging.

Historic costs or net book values have little correlation with the correct values to be declared to insurers under replacement as new policies.

More sophisticated analysis of the contents of fixed asset registers and indexing of historic costs using composite and focused specific indices may address some of these challenges but will not address all the reasons why historic costs may not reflect replacement.

This is especially true if the base accounting data is limited in terms of description or if the entries are not fully representative of the insured assets.

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

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