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Eight reasons why Net Book Values cannot be used to arrive at replacement costs for property damage insurance

Key messages:

- Does an asset register match insurance policy terms?
- Can net book values reflect current replacement costs?
- Do the original costs accurately reflect the assets?
- Has the infrastructure around the subject location changed, so increasing or decreasing current replacement costs?
- Have global or regional markets shifted, so affecting access to products or services?
- Which indices can you use and how reliable are they?
- Are economic and labour market changes fully reflected in costs or indices?
- Do acquisition costs properly reflect current approaches?

1. Does an asset register match insurance policy terms?

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

Importantly on a replacement as new basis this means that the sum declared to the insurance company should not reflect the market value, second hand value or economic value of the assets.

2. Can net book values ever reflect current replacement costs?

Net book values are the original cost of an asset depreciated over the expected economic life of an asset.

In an economic climate where asset costs are rising (as is usually the case) this means that original costs would certainly understate the current replacement cost of an asset.

In applying depreciation to the original costs, the net book value is likely to be significantly below the current cost to replace the assets and for older facilities it could be massively underinsured if net book values are used.

3. Do the original costs accurately reflect the assets?

Many governments have been highly supportive of fixed asset investment, often creating the right environment for investments in terms of incentives, reduction in administrative barriers and provision of associated infrastructure.

Many of these incentives and support mechanisms for businesses are temporary and may have been withdrawn or scaled back.

Accordingly, it may be harder to secure the same level of cost rebates, development grants and other incentives that were available in the past.

Besides direct incentives, companies may occasionally have been provided with disguised benefits during initial construction or set up, including subsidized local infrastructure, contractor worker subsidies, interest free loans, and administration and project management support.

In new industrial zones, governments may have subsidized costs by providing construction of fencing/land boundaries or financing connections to utilities.

Most of these payments would not be available in the event of a post loss reconstruction.

Original costs in asset registers fail to reflect these grants/incentives and therefore would materially understate the true replacement cost at today’s prices.

4. Has the infrastructure around the subject location changed, so increasing or decreasing current replacement costs?

Increased expectations or regulations on building standards, noise and emissions limits 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 all at the same location. How has this been reflected in the declaration to the insurers?

On the other hand, urbanisation has often been matched with infrastructure investment including improved utilities, road and rail links. For some locations this can now mean easier or cheaper access to both materials and labour so potentially reducing construction, delivery or installation costs.

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

One of the changes to occur with the growth of Asia as a global manufacturing hub is that many international suppliers and producers moved operations to the region to take advantage of access to the Asia market and lower manufacturing costs.

In practice, this now means that products and equipment that were only available from overseas markets when factories were constructed are today readily available from (cheaper) Asian based producers and suppliers.

Combined with the removal of import duties and reduced transportation costs as infrastructure has improved and many firms would be able to replace machinery and equipment at prices significantly below those incurred originally.

6. Which indices can you use and how reliable are they?

But surely if an insured decides to use asset register book value or original cost, but apply an index to arrive at an estimated cost today, this will work?

There are numerous cost charts and indices produced on different asset types. Which indices should you use? That can be a hard issue to resolve.

For example, statistics from the National Bureau of Statistics in China tend to be focused on national economic data rather than construction costs and broad construction cost indices rarely reflect the nuances of local price differentials across different cities, regions and provinces.

Over the last ten years there have been a number of instances where statistics have been reviewed and subsequently amended several months or even years after original publication. Often this was due to either overzealous local administrators trying to match what they thought were required central government targets or the core underlying information was subsequently found to be questionable and amended. In this context, the use of indices needs to be treated with caution, especially in diverse cities and locations.

Varying commodity and producer prices across countries and regions 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 localized spot prices. Across different countries there can be huge regional differences in pricing depending on whether you are close to production hubs for commodities and materials. As a result costs (and indices) in individual cities or regions could be significantly different to the generic published rates.

7. Are economic and labour market changes fully reflected in costs or indices?

As emerging economies have matured so have labour laws and protection of workers' rights. Employment laws and minimum wage legislation have changed dramatically the cost of manual labour.

The increased prosperity in traditionally rural locations has also meant that in some areas there are now labour shortages which can slow down construction periods so driving up overall costs.

Many emerging markets have also shifted their economic focus from manufacturing and investment driven growth to consumption-driven growth and this is having an effect on the manufacturing sector and labour markets.

Key elements of this new strategy are a shift towards services, real wage growth and improved welfare (i.e. healthcare). This shift does not just mean higher wages but is likely to influence the way manufacturers and suppliers focus their sales, in turn influencing costs.

8. Do acquisition costs properly reflect current approaches?

One reason why the use of asset registers to establish replacement costs can be challenging is that the treatment of costs as capital expenditure or expenses may be defined in local general accepted accounting practice (GAAP).

These rules continually evolve over time and occasionally fixed asset costs are expensed rather than recognized in the asset register. This can mean indexing up historic costs could materially undervalue the true replacement cost of a capital project.

Asset registers often include a number of items that would be considered as non – insurable for the purposes of property insurance. These can include one-off non-repeatable costs like licences or approvals but can also include road registered vehicles and similar assets insured elsewhere. Likewise asset registers can often omit third party assets where the liability for insurance may rest with the borrower.

As with many emerging economies, a combination of localized government power, lack of strict enforcement of regulations, weak legal clarity and local customs meant that 20 years ago the practice of facilitation payments and similar one-off enabling costs were common place. These costs are often reflected in historic asset register costs yet it would be unlikely that these would be incurred in a replacement scenario.

Conclusion

Accurate assessment of replacement costs using asset registers is probably the most challenging it has ever been. This is creating problems for insurers, owners of assets, lenders and insurance brokers alike. More sophisticated indexing models based around historic costs may address some of these challenges but historic costs are rarely reliable. Carrying out a regular detailed insurance valuation remains the primary and most defendable way to ensure that replacement costs reported to insurers are accurate and realistic.

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