

Under-Insurance. . . a 'trap' that can be avoided!

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Insurance of business assets is a necessary and prudent business decision. The importance of arriving at adequate insurance values should not be taken lightly and every business owner should consider accurate replacement costs of business assets.

You might consider the additional cost of increased insurance coverage too expensive, but failure to insure for replacement value can prove to be infinitely more costly to the business.

Most business insurances available in the market, provide 'reinstatement and replacement' cover for property. In other words, the policy pays the costs to replace second-hand items with brand new ones. However, to ensure that replacement costs are selected, the policy may contain clauses which impose a contribution if the sums insured do not in fact represent the replacement cost of the property. Such is the concept of 'under-insurance'. A simple example would be as follows:

ABC Business has their building insured for \$1,000,000. The true replacement cost is in fact \$2,000,000. Therefore, they are 50% under-insured. A violent storm blows the roof off the building and the replacement cost of the roof is quoted at \$400,000. The insurer would apply the under-insurance rate of 50% to the roof replacement, and pay only \$200,000, and ABC Business would be required to pay the other \$200,000.

(Note – Insurers do in fact apply some leeway to this calculation and recognize that the policy holder may not be 100% correct in their replacement cost calculation, so a margin for error is allowed. So, in the above example, the Insurer may in fact pay slightly more than the 50% figure.)

Many business owners use an informal method of assessing the replacement costs of property, and often overlook the true cost of replacement of buildings and business contents. Regular review of sums insured is not undertaken and often they remain the same for many years. The concern often becomes the cost of the insurance, however, this will be the least of their concerns if their business is destroyed.

Factors that can affect the reinstatement cost of buildings

- Steel prices have risen considerably in recent years.
- CPI over the past three years is also at an all time high.

- Older buildings will (usually) cost more to reinstate as there will be additional costs involved in reinstating the building to comply with changes in building regulations, for example timber floors may need to be replaced with concrete floors, additional car parking spaces may be required, or disabled toilets may need to be added.
- Professional fees such as architects, surveyors & engineers, may represent a considerable part of the reinstatement cost.
- The costs of removal of debris and cleaning up the site prior to reinstatement.
- Local authority permits and other approval charges.
- An escalation in costs can also occur during the policy period and the reinstatement period following the loss.

Factors that can affect the cost of replacement of plant and machinery

- Changes in exchange rates can affect the replacement cost of imported machinery.
- Specialised machines may need to be ordered, or tailor-made and it may take some time before production can resume. Contact your insurance advisors regarding Business Interruption insurance which will provide additional cover for loss of income or additional costs in the event that key items of plant are damaged.
- Older machines may be super-ceded by newer, more expensive models.

Other important considerations:

- Regular, professional valuations of business assets should be obtained (for buildings and other fixed assets, contents, plant and machinery) for **replacement** cost. Reliance on bank valuations which are based on **market value** could also leave you under-protected.
- Valuations should be up-dated at least every 3 years.
- Consult insurance advisors during the course of the policy period if substantial improvements are made to buildings, or additional, major items, are purchased.
- Tenants need to carefully review the terms of their commercial lease. Are you responsible for insuring the landlord's building and who ascertains the sum insured of the building. If the words 'replacement cost' are used...who ascertains this cost?
- In the event of a loss, do you have sufficient information to provide to the Insurer, for eg. An asset register detailing assets by location.

To Summarise:

To an SME, their business is often their sole source of income for one or more families, it is often in debt, and often ill-prepared for a major event that results in physical loss or damage to the business assets.

The following actions can assist in protecting the business and ensure survival beyond such events:

- Regular review of insurances, at least annually
- Be informed about insurance coverage, and how it works
- Review key business risks regularly
- Keep insurance advisors up to date with changes to business activities and assets
- Review sums insured at least annually
- Have a disaster plan in place
- Maintain an up-to date asset register

...All of the above measures take a little time and money before a loss...and save a lot of time & money after a loss.