National Tooling & Machining Association

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Business Management Advisory

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ASSET APPRAISAL - A GUIDE FOR INSURANCE NEEDS

SUMMARY

The establishment of "values" is, of course, the prime purpose of an appraisal. An Asset Appraisal is an objective evaluation of physical assets based on sufficient supportable information and opinion that will provide an accurate, realistic value for an intended purpose. Asset values obtained by an appraisal are required for many purposes, such as insurance, financing, tax assessment, sale or purchase of assets, succession duties, mortgage security, and accounting. It is extremely important that the purpose of the appraisal be understood and that the value to be established is defined. This two-part BMA discusses asset evaluations for insurance purposes and as a means of improving cash flow.

WHY APPRAISE FOR INSURANCE?

The insurance appraisal will permit the owner to establish the amount of insurance to be purchased. The continual fluctuation in the purchasing power of money in previous decades eliminates the use of book values or historical cost of assets for insurance purposes. Insurable values must be related to the current costs of replacing the assets insured.

EQUIPMENT LEDGER CONTAINS BASIC DATA

If the individual shop owner does not already have an Equipment Ledger recording complete details of every major unit of equipment, it is recommended that such a record be started immediately. Once in existence, only a little time each year is required to keep it up to date, and it provides invaluable information to prove the existence of assets, should a loss occur. When properly set up, it balances at all times with the Asset Account in the General Ledger. Property ledger sheets or electronic data information systems should be kept to show the purchase date and installed price of each item of equipment, and full details of make, model, serial number, date of manufacture, power unit, the main attachments and accessories; thus the Equipment Ledger constitutes the starting point of an appraisal, and provides necessary figures at the time of resale. Appraisal organizations are available which can provide services to create equipment ledgers required for insurance and other purposes.

WHO SHOULD MAKE APPRAISAL?

Insurance companies and agents can make the appraisal, and as a general rule will do so. However, for all practical purposes, it is best to have your appraisal made by a third party, such as an independent appraisal company, or a reputable machinery dealer, even though the insurance company will accept the appraisal of the shop owner. Should litigation become necessary as a result of a loss, an independent appraisal by a qualified appraisal company would be more readily acceptable by the courts. The insurance laws of your state should be checked to see if any limitations are imposed; your insurer and the appraiser can help in this regard.

INSURABLE VALUE MUST BE DETERMINED

The owner is concerned, in the event of loss, with being reimbursed for the cost of restoring the asset which has been damaged or destroyed. Therefore, the first step is to examine carefully, with qualified independent insurance agents, the clauses in the policy defining values on which claims are to be paid.

Values related to insurance appraisals include replacement cost, cost of reproduction new, depreciated cost of replacement, actual cash value, and insurable value. Replacement cost as defined in most insurance policies infers the use of new materials of equivalent size, kind and quality to rebuild or replace the insured asset. Appraisers call this the cost of reproduction new, and define replacement cost as the cost of reproduction of a functionally equivalent asset, but not necessarily with equivalent size, kind, and quality of material.

Depreciation for insurance purposes has traditionally reflected only physical deterioration, and actual cash value has been typically considered identical with depreciated replacement cost. Some recent interpretations of cash value consider obsolescence in addition to physical deterioration.

It is important that the owner understand the definition of values and the interpretations and policy that the insurance company has concerning value, exclusions, and coinsurance. Coupling a good Equipment Ledger with properly determined values provides an insurable value which can be supported in event of a loss.

APPRAISAL OF BUILDINGS

Market or resale values normally are not considered in arriving at the insurable value. Land value, even though the property be in a strategic location, must be excluded. The only concern is the cost of replacing or rebuilding on the same site, and this is based on the local building costs for the type of building involved, The appraiser is therefore concerned with the cost of reproducing the building without regard to market conditions and their effect on property values. Consideration of the effect of the market on value for insurance purposes may be made if the insurance coverage or company policy requires such a determination. However, this is generally an exception, not a rule.

Insurance appraisers first consult the plans if available, and then, by inspection, carefully list every detail of construction. Thereafter it becomes the highly technical job of a person with training similar to an architect or contractor, using tables of building costs in that particular area. This gives "Cost of Reproduction New." To obtain Depreciated Value, a separate depreciation rate is applied to each physical component of the building because of the varying life of each; and indestructible items (such as wall footings and items normally excluded from insurance coverage) are subtracted. Thus, insurance values are struck with "supportable data" acceptable for insurance purposes.

EQUIPMENT APPRAISAL

One is very easily misled into thinking that there is an ever awareness of inflation and has, therefore, purchased additional insurance to cover equipment and tools. Although attendance at machinery shows and sales literature help to keep an owner informed on machine tool prices in general, it is impossible to be sure of the figures unless they are properly recorded. If an owner is prepared to carry out the work along the following lines, a useful listing can be made. The cost of reproduction of the equipment and a determination of depreciation must be made.

- All major items of equipment, with major attachments and accessories must be listed in the Equipment Ledger.
- Current catalog prices must be applied. Sometimes the exact model is now obsolete with that particular manufacturer, or the machine is of foreign make, in which case a comparable unit or functionally equivalent replacement must be priced. It is a tedious job.
- An annual depreciation rate acceptable to the insurance company must be deducted, starting from the date of manufacture, to obtain depreciated value.
- Some adjustment is considered for condition of equipment at time of appraisal.
- On very old equipment, if the figure arrived at is below any reasonable value, an arbitrary figure may be used.
- Small tools usually constitute a sizeable investment even in a very small plant. It is true they become worn and eventually will be discarded, but they must be replaced in case of loss. Since this is generally the accumulation of a number of years, and they have been written off, it is impractical to list items in detail, but such items can be grouped for a periodic physical inventory and a reasonable value placed on them.

DON'T CONFUSE MARKET AND REPLACEMENT VALUES

Market Values must not be confused with insurable or replacement values. An interesting point is raised if the market value of an older building is lower than insurable value due to functional obsolescence, zoning laws, or location. It seems uneconomic to place full insurance on a building which would not be duplicated because of these factors. But insurance must be related to some tangible value, and that would appear to be COST, no matter what the condition, utility or age of the structure. (Similar comments might be applied to equipment, but the terms of the policy must determine the action taken.) A policy must also be examined for the coverage in the event current laws and zoning and fire regulations prevent rebuilding or demand extensive improvements when rebuilding, as not all policies cover such contingencies.

NEEDED TO SUPPORT INSURANCE CLAIM

Picking up the bits and pieces in a tool room after a fire, and trying to assess them, can be a harrowing experience. The damaged and undamaged equipment remains to be counted, and items omitted in a poor survey and discovered at the time of a fire can impose an important loss. Therefore, having an acceptable appraisal and keeping it up to date, should be a prime concern to an owner/manager under today's conditions. It will cost something in time and money, but it puts a record in the owner's hands which determines, beyond any doubt, the basis for a claim.

MUST BE KEPT UP TO DATE

Unless an appraisal is kept up to date, the expense can be wasted, especially in view of rapidly changing values. Like all records, once it is complete an annual review is simple, and just as important as the review of other essential figures.

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