

NEWSLETTER

Winter 2012

THE PERILS OF CASHING OUT A CLAIM

Fifteen years ago, depreciation shown in a Reproduction Appraisal Report under the section of Actual Cash Value, referred to the entire actual age of the building with some consideration for updated finishes, features, and services. That was up to the time that several incidents occurred that reflected in the remaining life expectancy of a building.

The first being the obsolescence of products, and the way they are applied which was constantly changing at the turn of the century which meant that, that product was obsolete in a few years and another product readily available was of equal value to take its place.

The second was the manufacturing sector relocating to China and other countries, which ran large batches of a product, finish, or feature, only for it to be obsolete before it even hit the shelves to be sold. This is designed obsolescence.

Finally, the British Columbia Building Code changed to the National Building Code in the province to correspond with the rest of the country that already had the National Building Code as their operating reference material for their engineering and inspection departments. This was a good move for British Columbia as it brought itself in line with the rest of the country and was no longer lagging behind in bringing their individual building code up to date.

Therefore the PRINCIPLE OF SUBSTITUTION came into play about five years ago on a regular basis because of this designed obsolescence. It simple means that when an economic principle is stating that the price of a commodity tends to be no higher than the price of a substitute having equal utility, available without undue delay. This is the basis of the Replacement Cost approach to value.

That meant that different features were often substituted for what was originally there mainly because that feature or finish was obsolete. The Actual Cash Value section in the Reproduction Appraisal Reports changed to reflect the weighted average of that feature in order to meet the criteria of Actual Cash Value in an insurance policy with consideration for both the insured and

insurer. The remaining life expectancy of the obsolete feature was applied to the replacement of the replacing feature rather than the entire building as a whole.

Last fall, we at Integral removed the Actual Cash Value section of our Reproduction Appraisal Reports, because our reports were being given to the insured, who in turn read the actual cash value and took it as being a cashed out price for the entire building. Today, we have now a separate report for Actual Cash Value simply referred to as an ACVR.

With the introduction of Guaranteed Replacement, this sheds a whole new light on the cashing out premise. Let us explore this even further.

WHAT IS REPLACEMENT COST VALUE?

When accepting an appraisal from a real estate appraisal firm, the replacement cost of a building is the total cost of construction required to replace the subject building with a substitute of like or equal utility using current standards of materials and design. These costs include labor, materials, supervision, contractors' profit and overhead, architects' plans and specifications, sales taxes and insurance. This allows the appraiser to value using any similar building for the appraisal. This is commonly referred to as a real estate appraisal which is what we are not looking for.

We are looking for a REPRODUCTION COST appraisal which is the reproduction cost of the current building. It is the total cost of construction required to replace the subject building with an exact replica in all salient characteristics or components. With newer structures, the terms 'reproduction' or 'replacement' will be somewhat synonymous, while with older structures, a reproduction approach endeavors to replace with like kind where possible and is more akin to the other method. In the case of totally obsolete or unavailable components, a true reproduction in its strictest sense may not always be possible or desirable.

For example, most people are familiar with having an appraisal for jewelry. That appraisal is for the exact replica of that piece of jewelry. No similar piece was used in the determining its value. The same goes here.

For example:

SINGLE FAMILY HOME
Average Quality
Life Expectancy 55 years
Built 30 years ago
Completely Updated 5 years ago

Depreciation for Reproduction Cost Appraisals are based upon the updated age of the building and is the method to value obsolete features and finishes when determining the Principle of

Substitution Actual Cash Value for that feature or finish that is not going to be replaced in the rebuild.

| | |
|-----------------------------|---------------------|
| REPRODUCTION COST VALUE | \$400,000.00 |
| ACTUAL AGE: | 30 years (E) |
| UPDATED AGE: | 5 years (E) |
| CONDITON: | Average |
| PERCENTAGE OF DEPRECIATION: | 4 % |
| AMOUNT OF DEPRECIATION: | \$16,000.00 |
| ACTUAL CASH VALUE: | \$384,000.00 |

Depreciation for Reproduction Cost Appraisals is based upon the actual age of the building and is the method to value the building when it is not going to be rebuilt.

| | |
|-----------------------------|---------------------|
| REPRODUCTION COST VALUE | \$400,000.00 |
| ACTUAL AGE: | 30 years (E) |
| UPDATED AGE: | 5 years (E) |
| CONDITON: | Average |
| PERCENTAGE OF DEPRECIATION: | 36 % |
| AMOUNT OF DEPRECIATION: | \$144,000.00 |
| ACTUAL CASH VALUE: | \$256,000.00 |

Here is what the real estate market is producing. If you purchase a comparable residence in the same area, they would starting at about \$275,000 with all or more of the amenities that the existing home had but it isn't a replica of that home. It makes more sense to the insured if he gave up the existing home and lot because it would be much higher in price to rebuild, find a nicer home and lot, cash out with enough money to purchase outright or have a low mortgage, and sell the other lot.

What the insure saw with our old ACV format contained in a Reproduction Appraisal Report, they would assume that they would be cashed out for \$384,000, but that is not the case as this figure represents a feature in the home that is possible obsolete because the home was updated 5 years ago. That figure represents all the salient features and finishes in the home.

What they didn't realize that if they were not going to rebuild, then it reverts to an actual cash value basis for the building which in turn is not a reproduction because they are not rebuilding, therefore the \$256,000 would take precedence.

If you approach a real estate firm to determine the ACV, remember that firm is basing its value on comparable properties that really reflect the economic factor in the region, not the remaining life expectancy. For example

| | |
|---|-----------|
| The real estate listing for a comparable home | \$323,000 |
| The assessment role for the land is | \$123,000 |
| This leaves a real estate or market value or | \$200,000 |

The Assessment Role for the property is \$205,000 for the building and \$123,000 for the land for a total of \$328,000. The assessment value has nothing to do with market, real estate, or insurance appraisals for the building. It is the means which to value building for the computation to derive the mill rate for taxes. However, when you want to deduct the replacement value of land anytime use the assessment role because it is really accurate for determining this value.

Now when you ask the real estate firm what the ACV is, they will give you the \$200,000 as the actual cash value. There will be no referral to remaining life expectancy, or any allowance for depreciation because they look at actual cash value differently.

If you did look at the depreciation factor of 36% then the true actual cash value that includes depreciation would be \$128,000 and that is based upon remaining life expectancy, but if the building burned down and was completely demolished including foundations, then there is no building only raw land for the real estate firm to sell. The realtor is in a win, win situation. He sells the new property to the insured, and he lists and sells the other lot.

In summary, for insurance purposes Actual Cash Value has some value connected with it and in this case it would be the remaining life expectancy, not economic conditions, or a value as set for a mill rate. You need to get accurate actual cash value using the reproduction method to determine value.

For further information, please call or email Sarah Bennett, cellular (604) 615 – 9573 or sarah.integral@shaw.ca for any of our following reports and services.

- Underwriting Appraisal Reports (UAR)
- Loss Appraisal Reports (LAR)
- Damage Assessment Reports (DAR)
- Actual Cash Value Reports (ACVR)
- Forensic Restoration Research (FRR)
- Work in Progress Audit Report (WIPAR)
- Project Manager Services (PMS)
- File Audit Report (FAR)

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