Depreciation as a Potential Saving

The optimal solution to the debate about "Depreciation as a Saving" would be for Insurers' underwriters to be specific about whether or not depreciation should be taken as a saving in the adjustment of Business Interruption losses. For that to happen, however, awareness of the issue has to be raised amongst all sides of the insurance world.

The question of whether or not depreciation should be regarded as a saving is not black and white. Although from a strict accounting perspective there may be an argument that it is indeed clear cut, this ignores the fact that, by taking depreciation as a saving, an Insurer is, in effect, depriving the Insured of cash that would have ordinarily accumulated in the balance sheet at the end of the maximum indemnity period, on the basis that this asset has been replaced by an equivalent asset.

Many US and European companies utilise EBITDA as the main measure of financial performance and accordingly their accountants would always resist any loss adjuster reflecting a saving in depreciation in the determination of a business interruption loss settlement.

Whether or not the replacement of cash in the balance sheet with, for instance, plant and equipment reflects a true indemnity to the Insured must surely depend on the individual circumstances of the Insured.

By way of example, an Insured who chooses to run their plant down with a view to retiring or selling the business a few years hence, when the assets have effectively worn out, will not want new assets following a material damage insurance claim and no cash in their balance sheet at the end of a period of interruption. Conversely, an Insured who has run their assets down and taken all the cash out of the business with nothing left to pay for new equipment would happily accept new equipment in place of cash – as the provision of new equipment simply saves him potentially imminent future expenditure that would have had to be met from cash by borrowings or cash injection to the business or ploughing back of future profits.

Further, an Insured who has old, fully depreciated assets fortuitously destroyed and replaced by material damage insurers will not only benefit compared to another similar Insured who owns brand new assets also destroyed and replaced by material damage insurers, but will also benefit from the business interruption insurers who cannot take a depreciation saving when none would have been charged in his accounts. Perhaps this situation should be regarded as "luck of the draw"

This compares with the Insured who had new assets which would have attracted high depreciation charges. A "double whammy" for the well – run model Insured compared to the old smokestack Insured and perhaps inequitable as between policyholders

This paper concentrates on the case where assets are destroyed and replaced at reinstatement value by material damage insurers. However, whilst this position is a common situation, other cases where the question of depreciation as a saving also arise can include undamaged assets that may be idle whilst damaged assets are reinstated, assets partially damaged, assets dealt with on an indemnity basis etc. These cases can be complex and should be dealt with on their specific merits.

We have grouped the various arguments raised into two categories – theoretical or philosophical arguments, and practical problems of applying any saving if considered to be theoretically correct.

Arguments against depreciation as a saving	**Arguments for a saving**
Theoretical / philosophical arguments	
1 "Depreciation is not a cash item"	
Savings wordings normally refer to a	"Payable" not only refer to cash

reduction in charges "payable" out of Gross Profit (as defined in the policy". The meaning of "payable" refers to cash. Items are only payable in cash and if not payable in cash, then they are not payable at all. The policy wording is silent on this matter and the *contra proferentem* rule should apply **against** the underwriter Thus depreciation is not "payable" and cannot therefore be saved.	payments. The policy wording is silent on this matter and makes no distinction between cash and non-cash items, and gross profit is designed to provide funds for all costs below the line. Depreciation is a cost for which funds ordinarily need to be allocated by a business in order to allow for the write off of the original capital cost.
2 "Increased depreciation from new assets should be allowed as an increased cost of working if reduced depreciation is taken as a saving"	
If the charge for depreciation increases during an Maximum Indemnity Period over and above what it would have had the claim incident not occurred then the extra charge should be paid by Insurers. As Insurers are reluctant to do this, they should not attempt to reduce the adjusted loss by taking a saving in depreciation.	As the extra depreciation applies to assets effectively purchased with Insurers' monies, they should not be expected to pay for the new asset and then pay to start writing it off as well. Any extra charge should be offset in the appropriation of amounts written out of the revaluation reserve set up when the new asset is capitalised.
3 "The depreciation charge reflects both the financial write off of an asset and an estimate of its wearing out – and usage"	
There is no conclusive way of splitting	Where assets are depreciated on a

out a charge for depreciation between usage and time – elapsed, so any attempt at defining a "true" usage depreciation saving leads to inequity between different policyholders.	machine-usage methodology, then providing the assumptions regarding cost and life expectancy are reasonable, then this may be regarded as an equitable method of calculating the saving. To the extent that an asset's life is shortened by usage, then some reflection of that usage saved may be equitable.
4"The Insured will face a large tax bill on the excess of the proceeds of disposal and the tax written down value of the asset. This will mean that there will be financial hardship when extra tax becomes payable."	
To reduce a settlement calculation by notional savings in depreciation penalises the Policyholder who will need to find the money to meet tax liabilities. Taking savings for depreciation will leave the Insured with less money to pay tax bills, and could possibly lead to cash flow difficulties or even insolvency.	Replacement fixed assets of the same type will be added to the pool for writing down allowances which will balance with the proceeds also credited to the pool. In other words, a tax liability only crystallises should the assets not replaced, in which case the Insured will have the cash to pay for a tax charge in any event.
5 "The policy is designed to put the Insured in the same financial position as if the incident had not occurred"	
If savings in depreciation are taken, then there will be less cash in the Policyholder's bank account at the end of the business interruption than there would have been had no incident occurred.	The financial position of a company includes not just the cash at bank, but also debtors, creditors and other assets and liabilities.

	The value of fixed assets in the balance sheet will be increased by their replacement at new values, and this increase will more than offset any reduction in cash due to a depreciation saving.
6 "Decided legal case law (Polikoff) supports the deduction of depreciation as a saving"	
Polikoff was determined on its facts and wordings, and the particular circumstances of the case. It is not representative of current thinking. Also, it was a material damage issue under consideration, not a business interruption matter. Polikoff was concerned with net profit plus standing charges. Where an asset is destroyed it is difficult to argue that a depreciation charge on it can continue as a standing charge.	The case of Polikoff seems to have supported the contention that depreciation should be deducted as a saving.
7 "Insurance treatment of losses should be consistent irrespective of the method of funding (i.e. purchase vs. hire)"	
The insurance treatment is inconsistent between different policyholders solely on the basis of their individual depreciation policies if savings are taken into account. Accordingly this "consistency" argument does not hold.	If a fixed asset is rented (rather than purchased) and is then destroyed, the rental period usually (but not always) comes to an end and the consequent reduction in charges constitutes a saving.

	Why should this situation be any different from the case where a fixed asset which has been purchased, and is therefore being depreciated, is destroyed? Why should the treatment after an insurance claim be different between the two situations?
8 "Taking a saving may be appropriate to provide "an indemnity" as not to do so results in a Policyholder being paid twice"	
The purpose of the business interruption policy is to provide an indemnity in the form of the same amount of funds being received by the Insured following a claim as would have been generated by operations if no loss / claim had occurred. The material damage "new for old" reinstatement policy wording already overrides the principle of indemnity. There is no such provision in the business interruption policy to address this benefit enjoyed by the fully insured policyholder.	As the Insured is receiving a replacement asset, he should not also receive insurance proceeds to enable him to recover his depreciation charges on the old equipment after it has been destroyed. The policyholder is, in effect, being paid to write off the old asset as well as to buy the replacement item.
9 "Taking a saving may be regarded as a backdoor method of re-applying the principle of indemnity to the new for old material damage policy"	
When policies are written on a "new for old", reinstatement, basis the "clawing back" of depreciation as a saving is an	The gain made by an Insured through the difference between replacement and indemnity values accurately reflects the

inequitable method of reneging on the replacement concept which has been paid for by the policyholder in the material damage premium.	state/ condition of the asset at the point of destruction. The contention concerning depreciation as a saving relates to deductions which arise after the point of destruction. Thus the two aspects occur at different points in time and can be regarded as entirely separate.
10 "The savings, if any, may arise after the end of the Maximum Indemnity Period"	
The extension of the economic lifecycle of a business resulting from the replacement of its assets is the key argument that a saving has occurred. This extension is most likely to be after the Maximum Indemnity Period has expired and should not be taken into account in the business interruption adjustment.	In cash flow terms, the replacement of the fixed asset means that the business defers the need to fund asset replacement until a later date than would have been the case had the incident not occurred. In accounting terms however, the saving occurs during the indemnity period.
11 "Once a fixed asset is purchased, the cost becomes fixed and the allocation of the cost is irrelevant"	
As the original cost of the fixed asset was incurred pre loss, the cessation of the allocation of these costs, which is always subjective in any event, is irrelevant.	The purchase of a fixed asset does not represent a "sunk" cost, but merely an acquisition of value at the time of purchase (i.e. the change from one form of asset – cash – into another form of

There is no change to the reality of the situation, the cost was incurred pre – incident and is not changed in any way by the incident.	asset – e.g. plant and machinery). The reinstatement based material damage policy replaces the cost of the fixed asset with a new fixed asset, so no amounts should be included in the business interruption settlement for depreciation of the damaged assets as well.
12 "Replacement assets immediately lose much of their value when installed"	
The replacement of cash by a new fixed asset does not provide a true indemnity as that fixed asset will immediately lose value. The only measure of a true indemnity can only be represented in cash or its equivalent.	For many policyholders, the replacement of cash in their balance sheet by new assets saves them imminent expenditure so they are provided with an equitable indemnity even when deducting depreciation as a saving.

Practical problems associated with taking a saving if considered theoretically correct	
13 "Taking a saving is inequitable as between different Policyholders who share the same circumstances but operate differing depreciation policies"	
One Policyholder may write assets off over a different time period than another, despite both sets of equipment at the different premises being identical. The calculations of savings would be different simply due to accounting issues and this appears inequitable.	Where accounts show that the depreciation charge is not accurately being recorded in the Insured's books then a re-assessment of the relevant charges should be made and substituted for the Insured's charge when calculating the savings computation in the loss adjustment.
14 "Taking a depreciation saving penalises those who have had new assets destroyed in comparison to those who have old assets destroyed"	
Taking a saving in depreciation actually increases the relative gain made by an Insured with old equipment compared to an Insured with new plant. An Insured with old equipment will gain not only under the material damage settlement by having new for old, but also will do relatively better under the business interruption claim as there will be little saving in depreciation on old (and possibly no saving at all if the assets are fully written off) equipment.	Each loss must be looked at individually, and as no two circumstances are the same, so there can be no direct comparison. Some policyholders will emerge as winners and some as losers. Such is life.

By contrast, the Insured who had new equipment installed immediately before the incident will, under the material damage settlement, merely have replaced what he had before, whilst under the business interruption settlement will have larger savings deducted than if he had old equipment. This is a serious flaw in the application of taking savings. Surely Insurers should not intend to penalise newly equipped policyholders as compared to those with old equipment?	
15 "There can be scenarios where the deduction of depreciation as a saving results in no payment at all under the business interruption policy"	
Where an asset is to be written off entirely during a period of indemnity, then its entire cost would be taken as a saving, thus meaning that the provision of a new asset under the material damage would be the only benefit that insurance provides to the Insured. The Insured would be paying a business interruption premium for no benefit!	This situation takes one end of the argument to extremes as, if the asset were to be wholly written off at the end of the interruption period, presumably it would need replacement then anyway. Thus to replace the asset (material damage insurance) and not deduct depreciation would result in the Insured having a new asset and the entire cash cost of the destroyed asset (assuming

	profits were sufficient to justify this) – double indemnity.

The above arguments for and against taking savings in depreciation are presented to stimulate further debate.

Conclusion

Whilst there are clearly good theoretical reasons to determine whether a saving should be taken for depreciation, the level of subjectivity and inequity as between policyholders that this decision could produce in practical terms may mean that Insurers would not wish to associate themselves with the insistence on taking a saving. Conversely, to insist on a saving clearly reduces settlement amounts of business interruption claims, introducing, as it does, a "saved" charge which formerly was not considered.

As previously debated by the BI SIG committee it is imperative that the BI Adjuster should carefully explain the pros and cons of the issue to their principal, be that the insurer or the policyholder/ broker. It is the principal who should be party to the decision to apply or not apply depreciation as a saving in material cases.

As always the underwriter/ policy drafter must always have in mind the maxim of *contra proferentem* when policy issues are considered and of course the Financial Services Authority are keen that the policyholder is treated fairly by the regulated insurer.

BI Specialist Interest Group -Next steps

This paper is presented for comment, with the input of underwriters, BI brokers, loss adjusters and claims consultants and forensic accountants being welcomed.

Further coverage will be included on the CILA BI SIG website and in the insurance press, as appropriate, following collation of responses and consideration by the CILA BI SIG committee in due course.