

Insurance 101: Property – Replacement Cost vs. Actual Cash Value

There are several different methods by which your insurance company may calculate the amount it will pay you for a loss. Payment based on the replacement cost of damaged or stolen property is usually the most favorable figure from your point of view, because it compensates you for the actual cost of replacing property. If your camera is stolen, a replacement cost policy will reimburse you the full cost of replacing it with a new camera of like kind. The insurer will not take into consideration the fact that you ran three rolls of film through the camera every day for the last two years, causing a considerable amount of wear and tear.

In contrast, actual cash value (ACV), also known as market value, is the standard that insurance companies arguably prefer when reimbursing policyholders for their losses. Actual cash value is equal to the replacement cost minus any depreciation ($ACV = \text{replacement cost} - \text{depreciation}$). It represents the dollar amount you could expect to receive for the item if you sold it in the marketplace. The insurance company determines the depreciation based on a combination of objective criteria (using a formula that takes into account the category and age of the property) and subjective assessment (the insurance adjuster's visual observations of the property or a photograph of it). In the case of the stolen camera, the insurance company would deduct from its replacement cost an amount for all the wear and tear it endured prior to the time it was stolen.

What Does "Replacement Cost" Mean?

The term "replacement cost" is defined or explained in the policy. Simply stated, it means the cost to replace the property on the same premises with other property of comparable material and quality used for the same purpose. This applies unless the limit of insurance or the cost actually spent to repair or replace the damaged property is less. Refer to your policy for the exact definition and explanation of replacement cost.

What is "Actual Cash Value"?

The term "actual cash value" is not as easily defined. Some courts have interpreted the term to mean "fair market value," which is the amount a buyer would pay a seller if neither were under undue time constraints. Most courts, however, have upheld the insurance industry's traditional definition: the cost to replace with new property of like kind and quality, less depreciation. Courts have varied in their rulings as to whether or not depreciation includes obsolescence (loss of usefulness as a result of outmoded design, construction, etc.).

So What's the Difference?

The only difference between replacement cost and actual cash value is a deduction for depreciation. However, both are based on the cost today to replace the damaged property with new property.