Grant Thornton

Accounting considerations for insurance recoveries

Background

Reporting entities often purchase insurance to manage business risks. However, recognition and measurement of casualty losses, contingent losses, and certain expenses are not impacted by the existence of insurance coverage. While potential recoveries under an insurance contract are dependent on the occurrence of events under the policy, the recognition of a receivable for future insurance recoveries is separate from the accounting recognition and measurement for the insurable events. Recognition of a receivable for insurance is triggered by the recognition of losses for the insurable events. Potential insurance recoveries in excess of recognized losses are evaluated as gain contingencies and are precluded from recognition until the gain is realized or realizable.

The rest of this bulletin addresses the accounting for the insurable event, as well as the accounting for the insurance recoveries, including examples illustrating common scenarios that we see entities encounter.

"We continue to see reporting entities struggle with the accounting for insurance events and insurance recoveries. We hope this bulletin helps clarify the accounting for routine events giving rise to insurance proceeds."

Lynne Triplett
Partner-in-Charge, Accounting Principles Group

Accounting for insurable events

When discussing the accounting applicable to common events that might be covered by insurance, it is important to understand that the recognition and measurement of insurable events are not impacted by the existence of insurance coverage.

Casualty loss

A reporting entity may suffer a casualty loss to tangible assets such as inventory or property, plant and equipment. For instance, a fire may destroy inventory or equipment. ASC 330-10-35, *Inventory – Subsequent Measurement*, provides guidance on measurement of losses to be recognized when inventory is impaired due to damage. Inventory should be measured at the lower of cost or net realizable value (or the lower of cost or market for inventory that is measured at LIFO or the retail inventory method), with any loss recognized in earnings in the period in which the loss occurs. ASC 360-10-35, *Property, Plant and Equipment – Subsequent Measurement*, provides guidance on measurement of impairment losses to be recognized on long-lived assets, whether held for sale or to be disposed of other than by sale.

Litigation claims

A reporting entity uses the guidance in ASC 450-20, *Loss Contingencies*, to assess the recognition and measurement of a loss for pending or threatened litigation as well as actual or possible claims and assessments. A contingent loss should be recognized when it is probable that a liability has been incurred and the amount of loss is reasonably estimable. The estimated amount of loss should be recognized, and, if the estimated loss is within a range, either (a) the best estimate within the range should be recognized or (b) the lowest amount within the range should be recognized if no amount within the range is a better estimate than any other amount.

Apply ASC 330 to measure losses for damaged inventory

Apply ASC 360 to measure impairment losses on other long-lived assets

Apply 450 to measure losses related to litigation

Accounting for insurance recoveries

Recognition of a receivable

As discussed previously, the recognition and measurement of insurable events are not impacted by the existence of insurance coverage; however, recognition of a receivable for insurance is triggered by the recognition of losses for the insurance events.

ASC 410-30, *Environmental Obligations*, provides guidance on recognition of recoveries from third parties, including insurers, and is often used by analogy by reporting entities in determining when to recognize receivables for insurance coverage. When a reporting entity has enforceable insurance in place and recognizes a loss associated with the insurable event it should recognize a receivable for an insured event if realization is probable. If the enforceability of the insurance is subject to dispute, litigation or threatened litigation by the insurer, there is a rebuttable presumption that realization is not probable. If a reporting entity recognizes an insurance receivable for which realization is probable, the receivable should be measured at the lesser of (a) the recognized loss from the insurable event or (b) the probable recovery from the insurer. If the amount of recovery is subject to estimation, the recognized receivable should be limited to the lowest estimated amount that is probable of realization.

Any amounts that might be recovered from the insurer in excess of the recognized losses would be evaluated as gain contingencies under ASC 450-30, *Gain Contingencies*. Gain contingencies are not recognized until realized, which is when a reporting entity receives cash or has an undisputed claim to cash that is probable of collection.

Casualty loss

A reporting entity may suffer a casualty loss to tangible assets such as inventory or property, plant, and equipment, recognizing a loss in earnings when the loss event occurs, as previously discussed. If the reporting entity has a contract with an insurer that insures the tangible property against loss from the event causing the loss, the entity should first evaluate whether the insurance contract is enforceable, taking into consideration whether the insurer has disputed or is likely to dispute the claim. If the insurance is enforceable and not subject to dispute, the entity should recognize a receivable from the insurer. The receivable would be measured at the lesser of casualty loss recognized or the probable recovery under the contract.

Casualty Loss

Scenario 1

If a reporting entity recognized a casualty loss of $800 based on the guidance in either ASC 330 or 360 and the probable recovery was $1,000 based on replacement value under an enforceable insurance contract, the entity would recognize a receivable of $800. Assuming the entity subsequently collects $1,000 in cash from the insurer, the entity would recognize a $200 contingent gain in that reporting period.

Commissions based on multiple metrics

Casualty loss continued...

Scenario 2

If a reporting entity recognized a casualty loss of $800 based on the guidance in either ASC 330 or 360 but the insurer disputes whether the loss was covered under the insurance contract, the entity would not recognize a receivable. The insurer, in a subsequent reporting period, acknowledges that the casualty loss is covered under the contract but has not agreed to a settlement amount. If the reporting entity estimates that the minimum amount of recovery that is probable under the contract is $600, the entity would recognize a $600 insurance receivable and a gain in that subsequent reporting period. Assuming the reporting entity subsequently collects $900 in cash from the insurer in a later reporting period, the entity would recognize a $300 gain in that subsequent reporting period.

Litigation claims

A reporting entity may recognize a contingent loss in earnings associated with pending, threatened or actual litigation as previously discussed. If the reporting entity has a contract with an insurer that provides coverage for the litigation claim, it would first evaluate whether the insurance contract is enforceable, taking into consideration whether the insurer has disputed or is likely to dispute the claim. If the insurance is enforceable and not subject to dispute the entity would recognize a receivable from the insurer. The receivable would be measured at the lesser of the contingent loss recognized or the probable recovery under the contract.

Litigation claims

Assume a reporting entity determines that it is probable it will incur a loss in a pending litigation matter and estimates the loss at a range between $1,000 and $1,500 with no amount within the range a better estimate than any other. The entity would recognize a $1,000 contingent loss in earnings. Also assume that the reporting entity has insurance in place that covers the litigation with a $250 deductible. If the reporting entity determines that the insurance claim is probable of recovery as well as enforceable, taking into consideration whether the insurer has disputed or is likely to dispute the claim, it would recognize a $750 insurance receivable.

Business interruption

Business interruption insurance provides coverage to an entity when business operations are idle due to the occurrence of events specified in the policy. The policies often reimburse for lost profits or specific expenses incurred during the down time and an entity must distinguish between the two as the accounting for each differs.

If a business interruption policy covers lost profits, any potential recovery would be accounted for as a gain contingency. In other words, no insurance receivable would be recognized until it was realizable, which would be when the insurer has acknowledged the enforceability of the claim and confirmed the amount to be paid, and the reporting entity deems collection probable.

If a business interruption policy covers specific expenses incurred by the reporting entity while business operations are idle, a reporting entity would first evaluate whether the insurance contract is enforceable, taking into consideration whether the insurer has disputed or is likely to dispute the claim. If the insurance is enforceable and not subject to dispute, the entity would recognize a receivable from the insurer. The receivable would be measured at the lesser of expenses incurred that are covered by the insurance policy or the probable recovery under the contract.

Business interruption

A reporting entity experiences a fire in its main manufacturing facility, bringing manufacturing to a halt for six months while the entity rebuilds the facility. The reporting entity's insurance policy covers lost profits up to $5 million. The policy also covers certain operating expenses that are unavoidable, such as certain salary expenses up to $1 million.

The reporting entity estimates lost profits of $6 million and unavoidable insurable operating expenses of $500,000. The reporting entity determines it is probable that it will recover the $500,000 of unavoidable expenses incurred.

The reporting entity does not recognize a receivable for the lost profits potential recovery until the insurer acknowledges the claim is enforceable and confirms the amount to be paid, and the reporting entity deems collection to be probable.

The reporting entity recognizes a receivable for $500,000 for the covered specific expenses as incurred while business operations are idle because it deems the insurance contract to be enforceable and not subject to dispute.

"Distinguishing between recoveries of lost profits and those of specific expenses incurred by a reporting entity while operations are idle is an important step in properly accounting for insurance proceeds as the two amounts are accounted for differently."

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