

## Accounting for insurance proceeds (Lecture A853 – 9.09 minutes)

Sometimes, things happen in business whether they are expected or unexpected and it may require a claim on the company's insurance. Other businesses may have insurance cover for losses triggered by a specific event, such as business interruption or third-party claims.

The key question for preparers and auditors is whether it is appropriate to recognise the expected proceeds from an insurance claim and, if so, whether they are recognised in full in the accounting period; or whether some is deferred to be carried over into a subsequent accounting period. To make this judgement call, the entity will need to consider the nature and timing of the insured event.

Under UK and Ireland GAAP, the accounting for insurance proceeds depends on whether the entity recognises a provision for the insured event. The relevant area of FRS 102 is that of Section 21 *Provisions and Contingencies* but then there is more consideration as to the detailed technical accounting issues that may arise which we will examine later in this section.

### Reimbursement assets

When an external event happens, a business may struggle to fulfil its legal or contractual obligations. Many examples of this were noted during the Covid-19 pandemic when work on construction sites had to be suspended indefinitely due to government restrictions being imposed on non-essential businesses. Consideration then had to be given as to whether the business needed to recognise a provision or disclose a contingent liability at the balance sheet date. However, the business may have had insurance from which to claim reimbursement for some, or all, of the expenditure necessary to settle the provision.

Insurance proceeds to settle a provision are accounted for as reimbursements under FRS 102, Section 21 (and FRS 105, Section 16 *Provisions and Contingencies*).

Care must be taken with reimbursement assets, particularly where there is uncertainty at the balance sheet date as to whether the reimbursement will be made. This is because in order for a reimbursement asset to be recognised, its receipt must be **virtually certain**. This is a higher hurdle to pass than the probability criterion for the recognition of a liability. For a liability, there must be a *probable* requirement to settle the liability; whereas for a reimbursement asset, its receipt must be virtually certain.

FRS 102 does not define the term 'virtually certain' but it should be taken to mean that the entity has received written confirmation that the insurer or third party will reimburse the entity for some, or all, of the expenditure necessary to settle the provision.

#### Example – Receipt is probable

On 26 November 2023, Watson Ltd suffered a fire at its main warehouse which damaged 40% of its stock. The company has had to incur a significant amount of money in cleaning up the damage. Watson Ltd has a financial year end of 31 December 2023.

On 30 November 2023, an insurance claim was lodged. A loss adjuster has been out to the business to survey the damage and to look at the costs currently incurred by the

business in cleaning up the damage as far as possible.

The insurance company has said that the claim is in the process of being looked at in detail, and they estimate an eight-week turnaround time for a decision on whether, or not, it will pay out on the claim.

The first thing to think about, before even considering appropriate accounting treatments for an insurance claim, is impairment. In this scenario, 40% of stock has been damaged and hence an impairment write-down will be needed. In addition, there may be damage to the building which will also need to be considered for impairment. Keep in mind that impairment reviews should occur on the date of the damage.

The finance director has estimated that the insurance proceeds will be £0.7m and has recognised a sundry debtor with a corresponding income for insurance claim in profit or loss. She has justified this on the grounds that the event is an insured event, there has been a visit by the loss adjuster and the claim was submitted on a timely basis.

The finance director is incorrect to recognise a reimbursement asset in this example. There is no confirmation from the insurance company by the balance sheet date that they will pay out on the claim. Hence, the finance director cannot justify that the receipt is virtually certain.

Consequently, the finance director must remove the reimbursement asset and corresponding income. She should, however, disclose a contingent asset which presents:

- a description of the nature of the contingent asset at the balance sheet; and
- if practicable, an estimate of the financial effect. If it is impracticable to disclose this information, that fact shall be stated.

### Example – Lost profits

On 16 December 2023, Padgate Ltd had to close its business due to water and gas works that had to be completed as a matter of urgency. These works were beyond the control of Padgate and an insurance claim for loss of profits has been lodged with the company's insurers.

Compensation for business interruption is not a reimbursement right under FRS 102, Section 21 because a loss of profits, by themselves, do not give rise to a provision. However, a loss of profits would invariably trigger the impairment requirements of FRS 102, Section 27 *Impairment of Assets*.

However, a company can recognise the reimbursement asset for business interruption as a debtor when it has an unconditional right to receive that compensation.

This would usually arise when:

- the entity has an insurance contract under which it can claim for compensation; and
- the loss event that creates a right for the company to assert a claim at the balance sheet date has occurred and the claim is not disputed by the insurance company.

### Other accounting issues

There may be situations when an insurer agrees to pay out on a claim but the rectification work which gave rise to the original claim may span two accounting periods. Consider the following example:

#### Example – Car demolishes a restaurant

On 16 December 2023, an out-of-control vehicle smashed into the front of a restaurant causing a considerable amount of damage. No diners or staff were injured in the accident because it occurred when the restaurant was closed.

The insurance company has agreed to pay out on the claim and the proceeds were received on 20 February 2024. Work to repair the building is expected to commence on 26 February 2024 and is expected to take 10 weeks to complete. The restaurant's year end is 31 March 2024.

For the purposes of this example, costs incurred in repairing the damage are recognised in profit or loss as and when they are incurred. The insurance proceeds are recognised as income in profit or loss at the year end depending on how much work has been completed. Therefore, if at 31 March 2024, it is estimated that 70% of the rectification work is complete, then 70% of the insurance proceeds are recognised in income with the remaining 30% being recorded as deferred income in the balance sheet and presented as an amount falling due within one year. The 30% will then be recognised on full completion of the rectification work expected in the year ending 31 March 2025.

Accounting for insurance proceeds can be a tricky area for the financial statements. Auditors must ensure that any reimbursement asset that has been received has been recorded correctly (i.e. that the receipt is **virtually certain** rather than probable – remember, the 'probability' criterion only applies to provisions for liabilities). It is quite an easy area of the financial statements to manipulate and management may have the incentive to do this, particularly if an external event has had a significant and detrimental impact on the business.