

## COMPLEXITIES IN BOOKING INSURANCE CLAIMS

**By  
Allen Melton,  
Robert Beard and  
Brad McCloskey**

Fires, hurricanes, earthquakes and floods cause millions in damage to businesses every year, leading to hardship and headaches. But they can generally be managed, with the business returning to normal operations quickly.

Accounting for such a loss, however, presents significant challenges for financial executives, including how to correctly book losses, liabilities, recovery costs and settlement income. How such complex claims affect a company's financial statements — in light of typical circumstances that arise in booking losses and settlements following property damage and business interruption loss — has not received enough public attention.

This article addresses several of the critical accounting considerations facing financial executives, through examination of a typical case study based on actual challenges faced by several different companies.

### A Case for Review

It's late September. A hurricane whips through the Gulf of Mexico, with Category-3 force winds lashing the South and Midwest. Our hypothetical company, UL Beverage Co, is a soft-drink concentrate manufacturer whose Kentucky plant is damaged by high winds. The facility's two production lines had been running 24/7 before the windstorm hit; a third line had been idle.

UL is in a bind. Its most important facility is shut down, most equipment is destroyed and little is repairable. But outsourcing production is not an option, because the company's soft-drink recipe, ingredients and syrup production process are trade secrets, and the only facilities with the ability to contract for added production also have privileged relationships with UL's competitors.

UL quickly shifts production, ship-

ping ingredients and moving personnel to its smaller facility in California and rents storage space for undamaged inventory and materials. But output is 75 percent lower there than what the Kentucky facility could produce, and labor costs are higher. By year's end, batches of pre-mixed ingredients are still trucked daily from storage to the California plant. And UL must pay more to ship finished product east.

UL Beverage starts to rebuild its Kentucky plant immediately — to restore two lines in full. To keep its experienced team, the company continues to pay its employees after the loss. By year-end, reconstruction is well underway. But now the chief financial officer must consider how to calculate the company's losses, address different insurance coverage, and plan for anticipated settlement income in the months ahead.

#### **Determining the Loss**

The first objective is to determine the company's specific losses — including lost revenues, damaged or lost equipment, extra expenses and personnel costs. UL would have a complicated equation to address: Increased production costs, storage and transportation expense, calculation of lower revenues from existing contracts, additional labor, among other considerations.

Let's say UL Beverage had typical property insurance coverage on its facilities, such as replacement cost coverage for damage to its property, plant and equipment, and business interruption coverage, including ordinary payroll. And that the company had a \$1 million blanket per occurrence deductible for losses due to physical damage.

Being in the soft drink business, UL's business is likely cyclical. Most such companies in the industry do more than 70 percent of their annual sales between May and October. Monthly revenues during peak months for UL are more than three

times what they are in the winter months. With damage occurring in September, the company can of course base its projections on its revenues by month based on sales in previous years.

But the impaired revenue stream is complicated by the California facility's picking up some — but not all — of the slack. With some contracts cancelled and others renegotiated, revenues further differ from projections — and the impact promises to have a long tail for some long-standing customers.

In other words, the loss creates a headache in the CFO's office — not only in preparing the claim but also in figuring out how to book the insurance settlement. Typically, a company in UL's position would seek reimbursement for replacement of its two damaged production lines. The damaged inventory will be covered at prices that were negotiated with wholesalers and/or at current replacement prices.

Extra expense coverage would be invoked to defray the incremental cost of shifting production, worker overtime, storage, freight and logistics for sourcing work to the California plant. After its \$1 million deductible, UL's net losses would therefore include the building loss, equipment replacement costs, inventory losses, ancillary repairs and certain extra expenses.

#### **Extraordinary Event:**

##### **The Impossible Standard**

One important determination is whether losses belong in operating expenses, or as an extraordinary item. The applicable guidance is APB Opinion 30/FASB ASC Subtopic 225-20, *Extraordinary and Unusual Items*, which identifies an extraordinary event as both unusual and infrequent.

For any individual company, the likelihood of a fire, flood, windstorm or hurricane would seem extraordinarily low, but Opinion 30 sets a difficult standard. Companies slammed by Hurricanes Katrina, Rita and Wilma in

**Natural disasters can leave millions of dollars in damages in their wake. Cleaning up the physical mess is one thing. Preparing the insurance claim and accurately accounting for the damage can be a whole other matter.**

2005 were not permitted to invoke APB 30 under U.S. generally accepted accounting principles.

Geography plays a role. An event or transaction frequent in the environment where the entity operates cannot, by definition, be considered extraordinary regardless of its financial impact. In coastal areas such as the Gulf of Mexico it is clear that such weather is not extraordinary or infrequent enough to qualify. UL's facility in Kentucky would also not meet the criteria to be classified as an extraordinary event because hurricanes are not unusual or infrequent in occurrence.

Even the terrorist attacks on 9/11, in FASB's judgment, did not meet the standard of being both unusual and infrequent. The World Trade Center had previously been attacked by terrorists, and the rising incidence of terrorism warranted that kind of risk being included as part of operations. EITF Issue No. 01-10: *Accounting for the Impact of the Terrorist Attacks of September 11, 2001* (Issue 01-10) required that losses from the terrorist attacks be classified in the statement of operations within income from continuing operations — in other words, not extraordinary.

In sum, qualifying for an extraordinary item under Opinion 30 is rare, and the losses faced by most companies in UL's situation would not qualify. Instead, a company would disclose the effects, including a description of losses incurred and where they are reported, in notes to its financial statements.

### Recognizing Gains and Losses

CFOs often ask how quickly an organization must book losses. When and how money received from insurance should be recorded in the financial statements is equally important. It's a question especially pressing when management prefers that gains and losses arising from an insurance claim balance in the year a loss occurs.

In UL's case, the loss occurs late

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enough in the year to guarantee that some recovery will occur in the succeeding year. With its books closing and the claim unsettled, management may want to book not only actual costs but projected future costs as a liability in the current year, offset by recording as an asset the projected amount of the insurance recovery.

For example, let's say that UL faced total losses of approximately \$60 million and that by fiscal year-end, UL had received advances of \$42 million from its insurer. Management may prefer to book the remaining anticipated settlement payment of \$18 million as income on the balance sheet in the current fiscal year, in order to have revenues and losses roughly balance and therefore not skew company results.

Even though rebuilding is underway and the company fully expects reimbursement for rebuilding costs, accounting standards may not allow such decisions. Given the specifics of a company's recovery plan, period of indemnity and the timing of a commitment from an insurer to pay on any given claim, standards may not allow a company to book a loss for recovery costs and a gain from a settlement in the same year.

According to FASB Statement 5/FASB ASC Topic 450, *Contingen-*

*cies*, a loss should be recognized based on when it is probable the loss occurred and can be reasonably estimated. FAS 5 also requires disclosing losses that are reasonably possible but not yet probable. FASB Interpretation 14/FASB ASC Subtopic 450-20, *Loss Contingences*, further suggests how such estimates can reasonably be made.

For example, inability to establish a point estimate is not a reason to delay recognition of a liability. If a company can estimate a range of potential liability, and no point within that range is a better estimate than any other, the minimum amount in the range should be recognized.

Not only that, but under FAS 5, the cut-off is clear. If the loss is still open at the end of the year, future costs must be recognized in financial statements as they are incurred. Without formal approval of a settlement from the insurer (often referred to as a "comfort letter"), UL cannot book a receivable either.

### Property Damage: Treating Involuntary Conversions of Assets

A common question when a company's assets are destroyed is how to account for the difference between the costs of a nonmonetary asset that is involuntarily converted and the monetary assets received. Should that difference be recognized in income as a gain or loss? Or should it be an adjustment to the acquisition cost of the replacement asset?

Under FASB Interpretation 30/FASB ASC Subtopic 605, *Gains and Losses*, a gain or loss is recognized when nonmonetary assets are involuntarily converted to monetary assets, even though an enterprise reinvests, or is obligated to reinvest, the monetary assets in replacement nonmonetary ones. When a nonmonetary asset is destroyed or damaged in one accounting period, and a settlement amount cannot be determined until later, the loss is recognized when incurred.

With the damage to its building and equipment amounting to a total loss, UL has experienced an involuntary conversion. It must recognize a gain or loss in the period of the involuntary conversion of its nonmonetary assets to monetary assets, regardless of whether it reinvests settlement monies.

#### **Additional Considerations**

Among other considerations are property damage, extra expense, business interruption and payroll claims.

**Property damage.** Insurance settlements should not be recognized prior to recognizing the related loss. Under FASB Interpretation 30, recoveries for property losses should be recognized only when the claim is deemed probable as defined by FAS 5. Moreover, a gain from a claim should not be recognized until all contingencies have been resolved, supported by evidence such as receipt of proceeds for the loss, a receipt of a sworn proof of loss or cash advances accompanied by correspondence from the insurer.

Even though recognizing a gain should be deferred until the amount is determinable, timely disclosure of an expected recovery is appropriate. Care should be taken to avoid misleading implications regarding the amount or likelihood of realizing the potential recovery.

If the loss recovery meets the recognition criteria after the balance sheet date but prior to issuing the

financial statements, the recovery is considered a recognized subsequent event and is recognized in the yet-to-be-issued financial statements. Recovery in excess of recognized losses is accounted for as a non-recognized subsequent event.

**Extra expense.** Treatments of recovery of extra expenses, such as temporary relocation or increased freight costs, are similar to those for property losses and should also be recognized in accordance with Statement 5 — that is, when it is probable the carrier will settle the claim.

**Business interruption.** Business interruption coverage requires careful analysis, due to the variety of policies and the types of losses incurred. For example, initial estimates of lost revenue often do not actually prove out, due to higher-than-expected revenue from make-up sales in subsequent months.

Settlement income for recovery of lost revenue is a gain contingency, and as said earlier, all contingencies must be resolved prior to recognizing the recovery. In such cases, the company will have either received the proceeds of an insurance settlement or, if the company has filed a claim but not yet received payment, it will have obtained confirmation from the insurer about the receipt of a claim, proof of coverage and that the estimated recovery under the policy is not likely to change.

**Payroll.** Payroll represents a significant proportion of a typical business interruption claim, since keeping key personnel on the payroll is often critical so a company can quickly return to operating once its facilities are restored. If a claimant has ordinary payroll coverage, it can recover for wages paid during the timeframe the facility is being restored.

But, in some cases, the company promises to pay compensation for up to 12 months, it must also book a liability for the additional nine months of payroll. Under FASB Statement 43/FASB ASC Topic 710, *Compensation*, if management has communicated to employees that compensation will be provided for time not worked and the employee has vested in that compensation — and if the amount of compensation can be reasonably estimated — a liability should be recognized for that amount.

Additional paid overtime is also part of a business interruption claim. Under Statement 43, additional overtime and payments for extra labor should be recorded as extra expenses as they are incurred.

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*The authors are all with Ernst & Young LLP's Americas Assurance Services group. ALLEN MELTON, CPA (allen.melton@ey.com), is a partner, and BRAD McCLOSKEY, CPA (brad.mccloskey@ey.com), is a manager, in Dallas. ROBERT D. BEARD, CPA (bob.beard@ey.com), a partner, is in Orlando.*

