ACCOUNTING FOR INSURANCE PROCEEDS FOR NATURAL DISASTER RELIEF

Question one -Timing of insurance proceeds:
During the recent floods, our land and buildings were extensively damaged and most of our inventories were destroyed. We are currently preparing financial statements for our year ended 30 June 2011. We have written off all damaged inventory and buildings, which were insured. Due to the large number of claims being received by our insurer, they have not yet processed our claim and therefore have not yet determined the effect of the averaging clause and are unable to provide a final estimate of proceeds. Can we recognise a receivable for insurance proceeds to be recovered in our 30 June 2011 financial statements?

Answer one:
The accounting standards do not include any specific guidance about the timing for recognition of insurance proceeds related to asset losses. However, AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* requires that in the absence of an Australian Accounting Standard that applies specifically to a transaction, management must use judgement to develop and apply accounting policies that are relevant to the economic decision-making needs of users and that are reliable. To do this, management must first consider the requirements of Australian Accounting Standards dealing with similar or related issues and then look to guidance in the Framework.

The following references could be argued to deal with similar or related issues in Australian Accounting Standards:

- AASB 116.66(c) says that compensation claims from third parties for impairment or losses of property, plant and equipment are recognised in profit or loss when the compensation becomes 'receivable'. However, the term 'receivable' is not defined in AASB 116.
- AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* includes guidance for accounting for reimbursements of expenditure incurred to settle provisions and requires that such reimbursements are only recognised when they are **virtually certain** of being recovered.
- The future recovery of insurance proceeds could meet the definition of a **contingent asset** under AASB 137 P*rovisions, Contingent Liabilities and Contingent Assets*, i.e. "….a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity". AASB 137 requires that contingent assets not be recognised in the financial statements.
- AASB 139 *Financial Instruments: Recognition and Measurement* defines 'receivables' as having fixed or determinable payments.

Given the insurer is yet to process your claim, and although you may think (or hope) that you are adequately insured, you should not recognise a receivable at 30 June 2011. In part, this is because insurance contracts often include legal exclusions (such as for a river flood) and averaging clauses, such that it would be hard to argue that insurance proceeds are probable of recovery or fixed or determinable (quantifiable) at 30 June 2011. It would be very difficult to argue that recovery is virtually certain.
Therefore, insurance proceeds should not be recognised in your financial statements until the insurer:

- Has acknowledged that they will pay your claim, and
- Has quantified the payment.

The above should be documented in writing.

Note: AASB 137.35 requires that contingent assets be continually assessed to ensure that developments are appropriately reflected in the financial statements. If it becomes virtually certain that an inflow of economic benefits will arise, the asset and related income are recognised in the financial statements in the period that the change occurs. This means that we are likely to see a mismatch in profit or loss of entities subject to natural disasters where impairment losses are expensed in the period when damage occurred, with delayed insurance proceeds being recognised in profit or loss in later periods.

Question two – Offsetting disaster expenses and insurance proceeds:
Same facts as for Question one above, except that insurance proceeds have been confirmed by the insurer prior to 30 June 2011 (i.e. virtually certain). Can we offset insurance proceeds income against relevant losses and expenses in profit or loss in our 30 June 2011 financial statements?

Answer two:
Accounting Standard AASB 101, paragraph 32, requires that an entity cannot offset income and expenses unless required or permitted by an Australian Accounting Standard. As such, unless another standard allows the insurance proceeds to be offset, AASB 101 prohibits such offsetting.

AASB 137.54 does allow an expense relating to a provision to be presented net of the amount recognised for a reimbursement (insurance proceeds could be one type of reimbursement). However, because your expenses do not relate to provisions recognised under AASB 137 (because you have already incurred the expenses and they are known), we do not believe that you will be able to offset because AASB 137 does not apply to your reimbursement.

Also, AASB 116.66 says that compensation claims from third parties for impairment or losses of property, plant and equipment and any subsequent purchase or construction of replacement assets are separate economic events and must be accounted for separately as two events, not one.

Although the inventories standard (AASB 102) is silent on this issue, recent articles in the accounting literature support this view, not only for property, plant and equipment, but also for other asset losses.

It is also worth noting that various accounting standards require disclosure of asset losses and impairments. As these are separate events from any insurance recovery, the relevant losses and impairments disclosures must exclude the insurance proceeds. Such proceeds should be disclosed as other income.