Hot Topic: Coronavirus

Potential impacts of COVID-19 on insurance recoveries

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Insurance policyholders should consider potential accounting and disclosure impacts of COVID-19 on insurance recoveries.

Background

As the COVID-19 outbreak unfolds, many companies face business interruption and unprecedented economic losses. Spikes in workers claiming they were not adequately protected by their employers against exposure to the COVID-19 virus could also be expected in the near future.

In an effort to recover these losses and costs, companies are looking to their commercial insurance policies for coverage. For example, companies may hold event cancellation, business interruption or workers' compensation insurance.

Understanding the policies in place and the anticipated recovery is key to determine if the COVID-19 outbreak is an insured event and when an insurance recovery can be recognized. In some cases, recognition may need to be delayed until the insurance claim is settled. This Hot Topic highlights policyholder accounting considerations for potential COVID-19 related insurance recoveries.

Understanding policy coverage

Companies first need to assert that COVID-19 is a covered event under the insurance policy.

Business interruption insurance typically covers lost revenue from physical damage to a company's assets (e.g. from a hurricane or earthquake). Situations where a company is forced by law or willingly decides to close operations may not be covered, since there is no property damage. In addition, following the SARS outbreak of 2003, many insurance companies introduced exclusion clauses for infectious diseases and epidemics/pandemics. Policies with standard terms are more likely to exclude events like the COVID-19 outbreak, but there is a potential for future disputes or governmental involvement on this issue.

Similarly, workers' compensation insurance typically covers situations where there is a direct linkage between an employee's work and related injury. The COVID-19 outbreak could give rise to new types of employee claims where it is unclear if those are covered under the existing policy. For example, establishing direct linkage between COVID-19 exposure and work may be challenging. Similarly, the concept of ‘workplace’ may be evolving with the extension of remote working.

Companies should carefully review their insurance policies, understand what losses are specifically excluded and evaluate whether claims will qualify for recovery.

Determine when to recognize recoveries and gains

Does the loss recovery model apply to the insurance recovery?

Insurance recoveries should only be recognized in earnings to the extent that: [410-30-35-8, 450-20-25-1]

— costs and losses clearly attributable to the insurable event have been incurred and recognized in the financial statements; and

— those recoveries are probable (i.e. likely to occur) and estimable.

This probability approach is commonly referred as the ‘loss recovery model’.

The loss recovery model may allow companies to recognize an insurance recovery up to the costs and losses incurred, in the same reporting period that those costs and losses are incurred. However, this model is available only when the costs and losses have been incurred and are clearly attributable to the insured event (‘direct linkage’ criterion). This model is best suited for property and casualty insurance claims or recovering fixed costs. Lost revenue or lost margin insured under business interruption insurance typically fails the direct linkage criterion and therefore related insurance recoveries cannot be recognized in the period revenue is lost.

Assuming the loss recovery model is appropriate, judgment is required to determine the accounting based on the specific facts and circumstances of the claim. Given the unprecedented uncertainty of the current environment, it may be difficult for certain companies to reach the probability threshold until the claim is filed, processed or even settled. Settlement of a claim after the reporting date may indicate that the probability threshold was met at the reporting date. [855-10-25-1]

Insurance recoveries that are contingent gains are recognized when settled

If the anticipated recovery fails the direct linkage criterion or if the insured costs and losses have not yet been incurred, the loss recovery model does not apply. In that case, a company should delay recognizing the recovery until all contingencies have been resolved. In other words, the insurance recovery is accounted for as a gain contingency under Subtopic 450-30, and recognized when realized or realizable. This generally happens when the claim is settled – i.e. proceeds are received and are not subject to refund, or the insurer confirms the amount of proceeds to be received. [450-30-25-1]

Any excess recovery from the costs incurred is also accounted for as a gain contingency.

Under a contingent gain model, settlement of a claim that occurs after the reporting date but before the financial statements are issued (or available to be issued) is a nonrecognized subsequent event that should be disclosed. See KPMG’s coronavirus Hot Topic: Subsequent events, going concern, and risks and uncertainties disclosures. [450-30-25-1, 855-10-15-5(c)]

Other accounting considerations

Measurement

When measuring an insurance recovery eligible for recognition before its settlement (i.e. when the loss recovery model applies), management needs to consider which losses and costs (e.g. fixed costs) incurred and recognized in the financial statements are directly attributable to the insured event. This may also include considering the period of coverage, time value of money, deductible, transaction costs, etc. [410-30-35-10, 30-19]

Presentation

Balance sheet	Unless a right of offset exists, offsetting prepaid insurance premiums and a receivable for expected recoveries against the liability incurred is prohibited. [210-20-45-1, 720-20-45-1]
Income statement	We believe that business interruption insurance recoveries should not be included in operating revenues. Acceptable presentations include the following. — Recoveries to the extent that costs and losses may be reported as a separate line item, reducing total operating expenses. — Recoveries in excess of costs and losses for the accounting period (the gain) and recoveries for business interruption insurance may be presented as a gross amount on a separate line item between total operating expenses and operating income.
Statement of cash flows	Insurance proceeds are classified in accordance with the nature of the loss. Proceeds received for business interruption and workers' compensation are cash inflows from operating activities. [210-10-45-21B]

Disclosures

Companies should disclose contingencies that may result in a gain. However, careful consideration should be given to avoid misleading implications about the likelihood of realization. [450-30-50]

Specific disclosure about business interruption insurance recoveries is also required in the period the recoveries are recognized: nature of the insured event, amount of the recoveries and line item in the income statement in which the recoveries are presented. [220-30-50-1]

In addition, an insurance claim settlement may need to be considered for disclosure as a subsequent event. [855-10-25-3, 50-2, 55-2]

KPMG's coronavirus Hot Topic: Subsequent events, going concern, and risks and uncertainties disclosures provides additional guidance on the effect of COVID-19 on subsequent events.

Evolving information

The potential global and economic impacts of the coronavirus continue to evolve rapidly, and companies should monitor the situation. Companies are encouraged to maintain close communications with their board of directors, external auditors, legal counsel and other service providers as the circumstances progress. Stay informed at read.kpmg.us/coronavirus

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