

Business Interruption Insurance and Subsequent Events

Two topics that often catch practitioners off guard are covered here: the proper allocation of business interruption insurance proceeds and the rules around subsequent events. This course addresses how GAAP handles these issues for both public and nonpublic entities, including key definitions and timing considerations for the subsequent event period. If you advise clients on insurance recoveries or prepare financial statements that require subsequent event disclosures, this focused section delivers practical, authoritative guidance you can apply immediately.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify the basic accounting for fresh start reporting.
- Identify how web development costs are accounted for during certain stages of development.
- Recognize when an entity may elect the fair value option and identify the eligible items for which the option is available.
- Recognize the basic rule for the liquidation basis of accounting.

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TABLE OF CONTENTS

CHAPTER

01

Section 1 5

1.01 O. Dealing With Acts Of God, Natural Disasters, And Terrorist Acts..... 5

1.02 P. Accounting For Entities In Bankruptcy 19

1.03 Q. Accounting For Website Development Costs..... 20

1.04 R. Fair Value Disclosures 25

1.05 S. Subsequent Events Under Gaap..... 37

Test Your Knowledge..... 44

CHAPTER

02

Section 2..... 49

2.01 T. Development Stage Entities And Start Up Disclosures..... 49

2.02 U. Liquidation Basis Of Accounting 51

2.03 V. Using Pushdown Accounting 54

Test Your Knowledge..... 57

Final Exam Copy..... 63

Index 63

Section 1

Chapter Objective

After completing this section, you should be able to:

- Identify the basic accounting for fresh start reporting.
- Identify how web development costs are accounted for during certain stages of development.
- Recognize when an entity may elect the fair value option and identify the eligible items for which the option is available.

O. DEALING WITH ACTS OF GOD, NATURAL DISASTERS, AND TERRORIST ACTS

1. Accounting for Natural Disasters and Terrorist Acts

Question: When should a liability for non-impairment losses and costs related to a natural disaster, act of God or terrorist act be recognized?

Response: The provisions of ASC 450, *Contingencies*, should be followed in determining when to recognize losses and costs incurred.

- ASC 450 states that a loss accrual with a charge to income is required if it is:
 - Probable that an asset has been impaired or a liability has been incurred at the balance sheet date, and
 - The amount of the loss can be reasonably estimated.
- An entity should recognize a liability of a natural disaster, terrorist act, or act of God for operating lease rentals on temporarily unusable equipment or facilities provided that the period of time that the equipment or facilities will be unusable can be reasonably estimated.
- A liability should be recognized as of the date of a natural disaster, terrorist act, or act of God for salaries and employee benefits that will continue to be paid while operations are temporarily suspended, if the four criteria for ASC 710, *Compensation*, are met:
 - Employees' services have already been rendered,
 - Rights to the compensation vest or accumulate,
 - Payment of the compensation is probable, and
 - The amount can be reasonably estimated.
- Depreciation and amortization expense on capitalized equipment or facilities that are temporarily unusable or temporarily idle should be continued.

Note

FASB Concept Statement 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, states that liabilities should be recognized when the following criteria are met:

- The item meets the definition of a liability. Paragraph 35 of Concepts Statement 6 defines liabilities as “probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events” (footnote references omitted).
- The liability can be measured with sufficient reliability.
- The information about the liability is capable of making a difference in user decisions.
- The information about the liability is representationally faithful, verifiable, and neutral.

Question: How should insurance recoveries of losses and costs incurred as a result of a natural disaster, terrorist act, or act of God be classified in the statement of operations and when should those recoveries be recognized?

Response: Following are the rules:

1. Any insurance recoveries of losses and costs incurred should be classified in a manner consistent with the related losses within the income from continuing operations.
2. An asset relating to the insurance recovery should be recognized only when realization of the claim for recovery of the loss recognized in the financial statements is deemed probable.³⁷
3. A gain should not be recognized until any contingencies relating to the insurance claim have been resolved.

Note

ASC 610-30, Revenue Recognition- Other Income-Gains and Losses on Involuntary Conversions, clarifies the accounting for involuntary conversions of nonmonetary assets (such as property or equipment) to monetary assets (such as insurance proceeds). It requires that a gain or loss be recognized when a nonmonetary asset is involuntarily converted to monetary assets, even though an enterprise reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets.

That guidance generally requires that an asset relating to the insurance recovery should be recognized only when realization of the claim for recovery of a loss recognized in the financial statements is deemed probable (as that term is used in FASB ASC 450). In addition, under FASB ASC 450-30-25-1, a gain (that is, a recovery of a loss not yet recognized in the financial statements or an amount recovered in

excess of a loss recognized in the financial statements) *should not be recognized* until any contingencies relating to the insurance claim have been resolved. It is important to note that in some circumstances, losses and costs might be recognized in the statement of operations in a different (earlier) period than the related recovery.

Additionally, FASB ASC 220-30-45, *Income Statement-Reporting Comprehensive Income- Business Interruption Insurance*, states that any entity may choose how to classify an insurance recovery in the statement of income, provided that the classification is not contrary to existing GAAP.

Observation

An entity is not allowed to record an insurance proceeds receivable due from the insurance company until realization of the amount of insurance is probable. The reason is because the receivable is considered a gain contingency until the amount of the insurance to be received is settled with the insurance company. What that means is that there could be a fire or other calamity that occurs in the middle of a year, but is not settled with the insurance company by year-end. The entity is not allowed to record a receivable for the estimated insurance receivable until the company has settled the claim with the insurance company. Recording a “best estimate” as a receivable is not allowed because to do so would result in the company recording a gain contingency, which is not allowed under GAAP.

Following are examples that illustrate the applications just discussed:

Example 1: Company X’s equipment was heavily damaged on August 31, 20X1 from a terrorist act. X maintains insurance on the equipment that provides for recovery of its replacement value. The equipment has a net book value of \$1,000 and an estimated replacement value of \$1,500 as of August 31, 20X1. Prior to its December 31, 2001 year-end, X files a claim with its insurer for recovery of \$1,500. Based on discussions with the insurer, X concludes that it is probable that the insurer will settle the claim for at least \$1,200. However, as of December 31, 20X1, the insurer has communicated to X that the amount of final settlement is subject to verification of the identity of the equipment damaged and receipt of additional market data regarding its value.

Conclusion: Because the insurance claim has not been resolved, a gain on the insurance claim cannot be recognized in X’s December 31, 20X1 year end income statement. X should record a claim receivable limited to the \$1,000 net book value of the damaged asset because it is probable that there will be a recovery of the loss. The book value should be credited for \$1,000 as the equipment is removed. Any remaining recovery beyond \$1,000 should be recognized as a gain only when the insurance claim (contingency) has been resolved. That is, when the identity of the damaged equipment and the market data have been finalized to the satisfaction of the insurance company.

Example 2: X owns and operates a retail store in downtown New York City and maintains insurance to cover business interruption losses. Under the policy, the Company receives compensation for lost profits in the event of a business interruption. In 20X1, X had a fire in its store. As of September 30, 20X1, X has filed a claim with its insurer to recover its estimated lost profit through September 30, 20X1. X has not previously filed a claim under its insurance policy and is uncertain of the final settlement amount. X believes there could be a dispute regarding the scope of coverage under the policy. The parties have not agreed on a settlement as of the date that X issues its financial statements for the period ended September 30, 20X1.

Conclusion: X should not recognize a gain because contingencies related to the recovery remain unresolved. X should recognize a gain when those contingencies are resolved.

Question: How should federal assistance provided as a result of a natural disaster, act of God, or terrorist act, in the form of direct compensation, be classified in the statement of operations, and when should the assistance be recognized?

Response

1. Federal assistance provided to a victim of an act of God, or terrorist act, in the form of direct compensation, should be classified as *part of income from continuing operations* in the statement of operations.
2. Any federal assistance recognized in the statement of operations should not be netted against losses and costs incurred as a result of the events. Further, such assistance should not be recorded as operating revenue and thereby included in gross margin.
 - a) Federal assistance provided to victims should be reported on a “gross” basis in the victim’s statements of operations. For example, a proper presentation is to present the items as a separate line item in the other nonoperating income section.
3. Federal assistance should be recognized when the compensated losses are incurred, provided that collection of the federal assistance is probable and the victim has the right to retain the assistance.
 - a) The amount of assistance recognized by a victim should not exceed the *lesser of* its actual direct and incremental losses incurred or its maximum allocation of the aggregate compensation.

Question: What disclosures should be made in the notes to financial statements regarding the losses and costs incurred as a result of a natural disaster, terrorist act, or act of God?

Response: Entities should follow the guidance of ASC 220-20-50, *Income Statement- Reporting Comprehensive Income- Usual or Infrequently Occurring Items- Disclosures*, and other disclosure requirements.

At a minimum, entities should disclose the following information in the notes to financial statements in all periods affected by the events:

- a. The nature and financial effects of each event or transaction that is unusual in nature or occurring infrequently, or both.

2. Involuntary Conversions under GAAP

Question: For tax purposes, the IRC section 1033 provides a special rule to deal with disasters under the involuntary conversion rules.

IRC section 1033 states that if property is damaged due to a condemnation, theft, seizure, or destruction, and a taxpayer receives insurance proceeds, the gain or loss from the involuntary conversion is not taxable if reinvested in qualified replacement property within a period of time. Specifically, the gain from receipt of insurance proceeds is non-taxable to the extent that the insurance proceeds are used to purchase qualifying replacement property (e.g., property that is similar to, or related to in use to, the property that was lost or taken) within a two-year period that ends two years after the close of the first tax year in which any part of the gain on the conversion is realized (three years for certain condemned property). Under the involuntary conversion rules, in lieu of recording a gain, the insurance proceeds reduce the basis of the replacement property.

Do the non-recognition rules for involuntary conversions found in the IRC also apply to GAAP?

Response: No.

ASC 610-30, *Revenue Recognition- Other Income-Gains and Losses on Involuntary Conversions*, states:

“An involuntary conversion of a nonmonetary asset to monetary assets (e.g., cash) and the subsequent reinvestment of the monetary assets is not the equivalent to an exchange transaction between an entity and another entity. The conversion of a nonmonetary asset to monetary assets is a monetary transaction, whether the conversion is voluntary or involuntary, and such a conversion differs from exchange transactions that involve only nonmonetary assets. To the extent the cost of a nonmonetary asset differs from the amount of monetary assets received, the transaction results in a gain or loss that shall be recognized.”

Thus, the non-recognition of gain rules found in IRC section 1033 do not apply to GAAP. Therefore, for GAAP purposes:

- a. An involuntary conversion is treated as a monetary transaction involving the sale of the converted property and a gain or loss recognized on the income statement.
- b. Deferred income taxes must be recorded on the basis difference for GAAP and tax purposes.
- c. For tax purposes, the basis of the replacement property is lower than GAAP because of the reduction in the tax basis for the non-recognition of the gain.

Dealing with the Timing of an Involuntary Conversion

The GAAP for involuntary conversions requires that the transaction be recorded as a sale of the asset when the asset (building, etc.) is converted to a monetary asset. That means a gain or loss on the transaction is recorded when the entity receives cash or records a receivable for the insurance amount that is settled with the insurance company.

However, it can take an extensive amount of time to settle with the insurance company and that timeline can extend over one or more reporting periods. In such a situation, the entity is precluded from recording a receivable for the insurance settlement and a gain or loss on the transaction. Further, until the transaction is settled and a gain or loss is recognized, the entity cannot remove the underlying fixed asset from its records.

What should an entity do with the damaged asset while it waits for the insurance settlement?

Existing GAAP for involuntary conversions found in ASC 610-30, *Revenue Recognition-Other Income*, implicitly assumes that an involuntary conversion is settled with the insurance company and recorded within the same reporting period in which the underlying event occurs. This assumption is not realistic in today's slow-moving insurance industry.

Let's look at an example:

Example 1: Company X has a fire on September 30, 20X1 that damages its plant, making it inoperable.

X's year end is December 31, 20X1.

The plant's carrying value at the date of the fire was:

Cost	\$1,500,000
Accumulated depreciation	<u>(600,000)</u>
Book value	<u>\$900,000</u>

- At December 31, 20X1, the company is still negotiating with the insurance company and has received an advance in the amount of \$100,000 to start repairing the facility. The company expects to receive approximately \$500,000 in total from the insurance company, but has not settled on that amount at December 31, 20X1.
- At December 31, 20X1, the company has spent about \$200,000 for miscellaneous improvements to secure the property. No new renovations were started until 20X2.
- At December 31, 20X1, the company estimates that the fair value of the damaged building is \$500,000, the amount it expects to receive from the insurance company.

Conclusion: