Accounting implications of natural disasters

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Introduction

Floods, fires, cyclones and earthquakes are common examples of natural disasters impacting Australia and New Zealand. These disasters often have significant impacts on business (both directly and indirectly) which need to be accounted for. The information in this guide is designed to help businesses, as well as business advisors and auditors, to deal with the accounting impacts of natural disasters.

Initial practical help

The Australian Taxation Office (ATO) can provide a range of assistance to those affected by natural disasters, including allowing lodgement deferrals and giving additional time to lodge and pay taxes. It can also help reconstruct records for those who have lost their records due to a natural disaster. The Inland Revenue (IR) provides similar support in New Zealand.

We have also published a checklist for small businesses impacted by natural disasters. This checklist can be used by members who have been impacted by natural disasters themselves or to help advise clients who have been impacted.

Financial statement preparation

Natural disasters can have an impact on many different elements of the financial statements posing a number of significant challenges to preparers, not the least of which may be the initial recovery of the records themselves. Once this has been done, it is likely that many elements of the financial statements will need careful review.

Assets may be impaired, clean-up/make-good provisions required and grants, insurance payouts and recovery assistance available. The timing of the disaster relative to the entity's balance date will also affect the nature and amount of work required for any given reporting period. The following highlights some important considerations in these areas.

1. Assets and expenses

Impairment of property, plant and equipment

Paragraph 12e of AASB 136 / NZ IAS 36 *Impairment of Assets* includes the physical damage of an asset to be an indicator of impairment. Therefore, if there has been physical damage to an asset as a result of a natural disaster, an impairment test is required, and careful consideration will need to be given to assessing the asset's recoverable amount. The treatment of compensation from third parties for items of impaired property is also covered in paragraph 65 of AASB 116 / NZ IAS 16 *Property, Plant & Equipment*, requiring that it must be included in profit or loss when the compensation becomes receivable. Note that the receivable is a separate asset and must not be offset against the impairment.

Impairment of goodwill and intangible assets

Goodwill and intangible assets with indefinite lives require annual impairment testing regardless of impairment indicators, but for any other intangible assets, paragraph 12(g) of AASB 136 / NZ IAS 36 includes as an impairment indicator evidence that the economic performance of an asset is, or will be, worse than expected. In determining the recoverable amount, the future cash flow estimates need to reflect the impact on revenue and any limitation on production due to damaged property, plant and equipment.

Impairment of financial assets

Customers may have also been affected by the natural disaster and so the impairment of any debtor balances must be considered in accordance with the impairment requirements of AASB 9 / NZ IAS 9 *Financial Instruments*. Section 5.5 requires an assessment of whether the credit risk of a financial instrument has increased significantly since initial recognition and if that is the case, assess the expected credit losses for that instrument by identifying any change in the risk of default over the life of the instrument. In performing this assessment, it is important to consider whether other financing arrangements can be arranged for the repayment of debt or if the impact of the natural disaster was so severe that the debt cannot be repaid. Any investments in entities that were impacted by the natural disaster will need to be assessed to determine the impact on its valuation. This is particularly important for unlisted investments and equity investments.

Inventories

Paragraph 9 of AASB 102 / NZ IAS 2 *Inventories* requires inventories to be measured at the lower of cost and net realisable value, and paragraph 28 states that when it has been damaged, the cost may no longer be recoverable. In some cases, the inventory will need to be written off completely, or it may be sold at a discount.

2. Liabilities and income

Clean up costs

A provision for the cost to clean up after a natural disaster can only be recognised when each of the following three conditions in paragraph 14 of AASB 137 / NZ IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* are met: (1) a present obligation exists; (2) it is probable that an outflow of resources is required to settle the obligation; and (3) it can be reliably estimated.

Insurance claims

Insurance claims for damage and loss caused by a natural disaster are accounted for in accordance with AASB 116 / NZ IAS 16 in relation to property, plant and equipment or in accordance with paragraph 53 of AASB 137 / NZ IAS 37, which requires recognition as a separate asset only when it is virtually certain that the reimbursement will be received. Given the uncertainty in determining what can be claimed in such events, evidence will usually be required from the insurer about what the claim includes before a reimbursement can be recognised. Note that any insurance receivable is recognised as a separate asset.

Reimbursements

Reimbursements in the form of government grants are accounted for in accordance with paragraph 53 of AASB 137/ NZ IAS 37, which requires recognition only when it is virtually certain that the reimbursement will be received. Consideration should also be given to AASB 120/ NZ IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* if the entity is a 'for-profit.' If the entity is a not-for-profit AASB 1058 *Income of Not-for-Profit Entities* and NZ PBE IPSAS 23 *Revenue from Non-Exchange Transactions* are relevant.

Onerous contracts

Lease and supply contracts should be examined to determine whether there is a 'force majeure' clause that would relieve the entity of onerous contracts. Where this clause does not exist however, the entity would need to determine whether the expected economic benefits are less than the unavoidable costs of the contract. If so, an onerous contact obligation may arise (see AASB 137 / NZ IAS 37 paragraph 66 onwards).

Debt covenants

A consequence of impairment expenses, missed payments or a decrease in the carrying amount of assets as a result of the natural disaster may cause the entity to not meet its debt covenants. The entity would therefore need to either renegotiate terms before the reporting date or else will probably need to classify the debt as current.

3. Post balance date events

The timing of the natural disaster, as compared to the balance date of the entity whose financial statements are being prepared can also pose some specific issues. Reference needs to be made to the requirements of AASB 110 / NZ IAS 10 *Events After the Reporting Period* regarding its treatment as an adjustable or non-adjustable event.

Adjustable events are those that provide evidence of conditions that existed at the end of the reporting period, and so the standard requires that their effect be recognised in the financial statements by adjusting the relevant items in the financial records (paragraph 8). Non-adjusting events are those that are indicative of conditions that arose after the reporting period and therefore are not to be adjusted - but may be required to be disclosed (see paragraphs 10 and 21).

If a natural disaster occurs after the reporting period but before the financial statements are authorised for issue, then this will be a non-adjusting event because it does not represent a condition that existed at the end of the reporting period. If the impact is material, then paragraph 21 requires disclosure in the financial statements of the nature of the event and an estimate of the financial effect, or a statement that such as estimate cannot be made. When disclosing the nature and effect, care should be taken if mentioning the insurance coverage in relation to the loss, particularly if the extent of coverage has not been confirmed by the insurer in writing subsequent to the claim being lodged. If the impact of the natural disaster has been so drastic that the entity is no longer considered to be a going concern, then paragraphs 14-16 require the financial statements to be prepared on a non-going concern basis, with certain disclosures required.

Paragraph 22 provides a list of examples of non-adjusting events after the reporting period that would generally result in disclosure only. The natural disaster example given is that of a fire that destroys an entity's major production plant.

Auditors should also refer to ASA 560 / ISA (NZ) 560 *Subsequent Events*. Which deals with auditor's responsibilities relating to post balance date events in the audit of a financial report.

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