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# *FAQs: The accounting implications of natural disasters*

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*What would you like to grow?*

# FAQs: The accounting implications of natural disasters

The recent fires, cyclones and floods have caused (and continue to cause) widespread damage and disruption to Australian business. The impacts of these disasters can give rise to a number of accounting implications that entities will need to consider.

While the effects on the financial statements will differ for each business, in this paper we share our insights and experiences into the questions we have commonly been asked by entities in the past few weeks.

## A question of timing

Pre-reporting date. Entities that were impacted by events that occurred during the reporting period will need to recognise this impact in the income statement and balance sheet. In some cases, judgement will be required to determine which events occurred during the reporting period and which events occurred after the end of the reporting period. For example, floodwaters further upstream may have been known by a business and caused some level of damage prior to the end of the reporting period, but the full extent of the damage may not have occurred until after the end of the reporting period.

This acts as a reminder to entities that a set of accounts are a "snapshot" at a particular point in time. The best business approach is to prepare them on the basis of what was known on the evening of balance date (as if the accounts are being prepared at that time), taking all relevant factors into account.

**Post-reporting date**. Entities impacted by events after the end of the reporting period will not need to adjust their profits or the balance sheet. These entities will only need to disclose the impact of the events on their business.

Under AASB 110 *Events after the reporting period*, entities must disclose material non-adjusting events in detail (eg, information about the nature of the event, an estimate of the financial effect arising from the event etc). Where entities are unable to reliably estimate the financial impact of the floods, they will need to disclose this fact and explain why.

## Q&As relating to property, plant and equipment (PP&E) and inventory

### 1 Can a provision be recognised under AASB 137 for the expected costs associated with cleaning and repairing damage to PP&E and inventory caused by these disasters?

If the damage occurs after the end of the reporting period: **No**, a provision is not recognised, but appropriate disclosure of the impact of the events is required.

If the damage occurs during the reporting period: **It depends**.

In order for a provision to be recognised under AASB 137 *Provisions, contingent liabilities and contingent assets*, an entity must have a present obligation as a result of a past event. The need to repair damage and clean-up equipment does not in itself represent a legal or constructive obligation because conducting these activities is at the entity's discretion. In these situations, entities should disclose their best estimate of the costs expected to be incurred in the future, in order to clean-up and/or repair the damaged PP&E and/or inventory.

However, where damage is caused to items of PP&E that are leased by the entity and there is a contractual requirement for the entity to restore the leased items to their original condition, this would constitute a present obligation as a result of a past event. In these circumstances, the entity could recognise a provision for the associated costs.

### Example: A leased warehouse that is damaged by floods

Entity A entered into a lease contract to rent a warehouse over ten years. Included in the lease contract is a clause that requires Entity A to "make good" the premise at the end of the lease term.

Entity A assesses its lease premises regularly to determine if a provision to "make good" is required as a result of its contractual obligation. Until now, Entity A has not made any provisions as there had not been any material damage or wear and tear that affected the leased premises' original state.

During the recent floods, the leased warehouse was damaged. This damage represents a present obligation for Entity A; Entity A is required to restore the warehouse to its original condition which will result in a cash outflow for the entity. Entity A can create a provision for the costs associated with restoring the warehouse if it can reliably measure this liability.

## 2 Inventories have been damaged and/or will require cleaning in order to return them to a saleable condition. Will these damages and/or cleaning costs impact the inventory value at reporting date?

If the damage occurs after the end of the reporting period: **No**, an adjustment should not be made to inventory values, but appropriate disclosure is required.

If the damage occurs during the reporting period: **It depends**.

The costs associated with bringing the inventory into a saleable condition must be taken into account when determining the net realisable value (NRV) of inventory. NRV is the estimated selling price less the estimated costs of completion and the estimated costs necessary to secure the sale. A write-down of inventory is required if the NRV is lower than cost; a write-down is not required if NRV exceeds cost. Where it is not possible to bring the items into a saleable condition, they will need to be written off.

**Note**. Costs associated with the clean-up and repair of inventory are typically expensed as incurred.

### Example: Cleaning inventory to ensure it can be sold

Entity A has inventory that is currently carried at cost of $100 per unit and has an expected selling price of $150 per unit. As a result of the floods, the units must be cleaned in order for them to be in saleable condition. The cost of doing so is estimated at $20 per unit.

The $20 cleaning cost is included in the net realisable value calculation. Net realisable value is $130 calculated as selling price less estimated costs to complete and make the sale.

Inventory is valued at the lower of cost ($100) and net realisable value ($130). Thus, no adjustment to the carrying value of the inventory is required.

In contrast, Entity B has inventory that is carried at a cost of $100 per unit and have a selling price of $110 per unit. The cleaning cost for Entity B is $20 per unit.

In Entity B's situation, the units will need to be written down by $10 per unit. That's because the net realisable value is $90 and the current carrying value is $100.

### 3 PP&E has been damaged. Will there be any impact on the PP&E's value at reporting date?

If the damage occurs after the end of the reporting period: **No**, an adjustment does not need to be made to PP&E values, but appropriate disclosure is required.

If the damage occurs during the reporting period: **Yes**, PP&E values are likely to require adjustment.

Items of PP&E are derecognised when there are no future economic benefits expected from its use or disposal. Therefore, if the disasters have damaged the assets to the extent that repair is not possible and the asset has no further use, the assets should be derecognised immediately.

In situations where only part of the asset is damaged, the damaged portion should be derecognised, even where it is not carried as a separate asset in the books. The replacement cost of the damaged part should be recognised in the carrying amount of the asset when it is incurred.

Under AASB 136 *Impairment of assets*, an impairment test is required where there is an indicator of impairment. For many entities the disasters represent an indicator of impairment, which will require them to perform an impairment test on the PP&E.

Refer to question 4 for further detail on impairment tests.

## Q&As relating to impairment testing

### 4 The natural disaster has impacted an entity such that significant clean-up is required and future profitability may be affected. Is an impairment test required and, if so, should these future impacts be taken into account in the impairment testing process?

If the natural disaster that will impact the business occurs after the end of the reporting period: **No**, there is no trigger event for impairment testing. However, appropriate disclosure is required.

If the natural disaster that will impact the business occurs during the reporting period: **Yes**, the effects of the natural disaster are an impairment trigger event. The affected cash flows should be taken into account when performing the impairment test.

Assets should be impaired where an asset or cash generating unit's carrying value is below its recoverable amount. Recoverable amount is deemed as the higher of value in use or fair value less costs to sell.

In measuring value in use, cash flows are required that represent management's best estimate of economic conditions that exist over the remaining life of the asset. As a result of the natural disaster, entities could be faced with a variety of impacts including clean-up costs, reduced revenues due to operational closures, increased risk in the cash flows, or inventory that can no longer be sold at its original intended value. All such cash flow impacts should be taken into account.

### 5 The entity's customers have been severely impacted by the disasters and their debt repayment capability is affected. Does this give rise to a provision assessment for the customers at reporting date?

If the events impacting the customers occurred after the end of the reporting period: **No**, a provision assessment is not necessary, but appropriate disclosure is required.

If the events impacting the customers occurred during the reporting period: **Yes**, a provision assessment is required.

Events that occurred during the reporting period are an impairment indicator; hence the debt owed by customers should be assessed for impairment.

**Note**. While an entity may only be aware of its customers' inability to repay debt post reporting date, if the natural disaster caused this inability and it occurred during the reporting period the carrying amount of the trade receivables must be adjusted accordingly (ie, the loss existed at reporting date and should be accounted for).

## Q&As relating to claiming insurance and debt repayment

### 6 Insured assets have been damaged by flooding. Can the insurance recoveries be recognised at reporting date?

If the insurance event occurred after the end of the reporting period: **No**, recoveries cannot be recognised at reporting date.

If the insurance event occurred during the reporting period: **It depends**.

Insurance recoveries can only be recognised when the entity is virtually certain that they will be received (eg, the insurance company has confirmed in writing that it has accepted the claim).

If the events occurred during the reporting period and the insurance recoveries in relation to these became virtually certain prior to signing the accounts, then recognition would be appropriate as this would be an adjusting post balance sheet event. Upon recognition, the recoveries must be accounted for as a separate asset.

### 7 As a result of the disasters, the entity is unable to service its borrowings and consequently breaches its loan covenants at reporting date. Are there any accounting implications that should be considered?

If the disaster occurred after the end of the reporting period: **Yes**, there are implications. There will be no impact on the classification of debt at balance date, however, substantial disclosure would be necessary highlighting if the debt is no longer non-current and the extent of the problem. Continuous disclosure obligations should also be considered. The loan covenant breaches should further be considered as part of the entity's ability to continue as a going concern. See Question 9 for further detail.

If the disaster occurred during the reporting period: **Yes**, there are implications.

Often when a loan covenant is breached, the entity's lender may have the right to demand immediate repayment of the debt. Therefore, the classification of the loan may change from non-current to current.

The impact of any breaches should also be considered as part of the entity's going concern assessment. Refer to question 9 for further detail.

**Note**. In situations where a waiver for a breach is granted post reporting date, the entity will need to classify the loan as current and meet the associated disclosure requirements.

## Q&As relating to hedging

### 8 Could the impact of the natural disasters affect an entity's current hedge accounting?

If the disasters occurred after the end of the reporting period: **No**, there will be no effect on the balance sheet or income statement (although there may be an effect on the entity's future hedging strategy). Disclosure should also be made where appropriate.

If the disasters occurred during the reporting period: **It depends**.

Depending on the type of instrument being hedged, the impact of the disasters pre year-end may mean that existing hedging arrangements are no longer effective, or the hedged cash flow is no longer highly probable. In some cases hedge accounting is discontinued.

#### Example: Hedge ineffectiveness as a result of the floods

An entity has taken out a cash flow hedge to hedge a **highly probable** sale that is expected to occur. However, due to the floods before year end, there is uncertainty as to whether the highly probable sale will occur. If it is **still likely** that the transaction will occur and within the designated time period (but no longer **highly probable**), then all future gains/losses are recognised in the income statement. The cumulative gain or loss previously recognised in equity will remain there until the forecast transaction occurs. If the forecast transaction is **no longer expected to occur**, the cumulative gain or loss on the hedging instrument will be taken to the income statement immediately.

### 9 Should the impact of the disasters be considered in the entity's assessment of going concern?

Yes. Natural disasters can impact various operational areas of an entity directly or indirectly. These factors should be taken into account when determining the entity's ability to continue as a going concern. The going concern assessment continues until the date of signing the financial report. So it may be impacted by events after balance date. If the going concern basis is not appropriate, the accounts may have to be prepared using a different basis, for example using a liquidation basis.

#### Example: Aspects of a business that may be impacted

For example:

- Ability to recover debt owed by customers affected;
- Delays in the supply chain arising as suppliers are affected;
- Ability to service existing contracts that are entered into prior to the disaster;
- Additional costs associated with replacing or restoring assets to normal operating capacity which was not budgeted for;
- Unexpected decline in revenue or increases in costs; and
- Impacts on an entity's ability to service its loan commitments.

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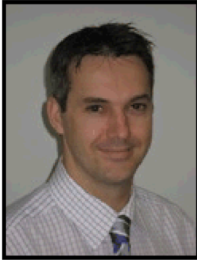

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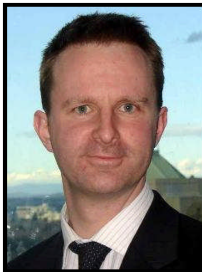

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