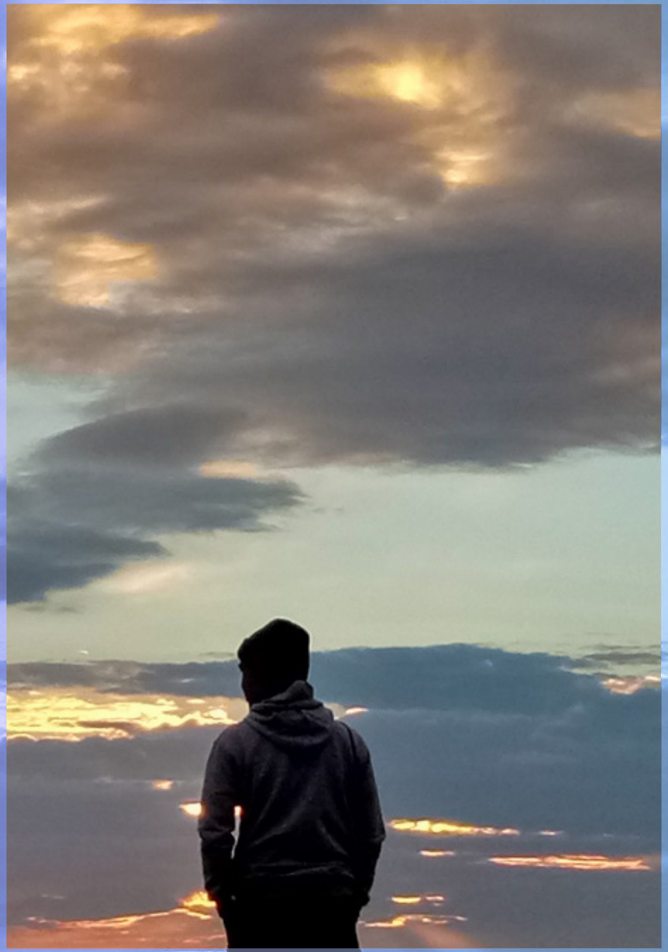
Accounting for natural disasters

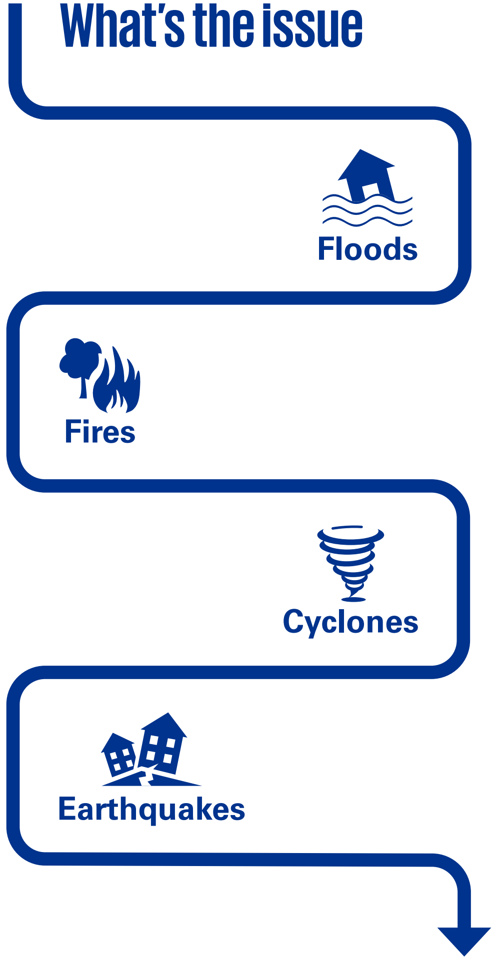
Proposed accounting for natural disasters under NZ IFRS

May 2023



Get ready to account for natural disasters

What's the issue



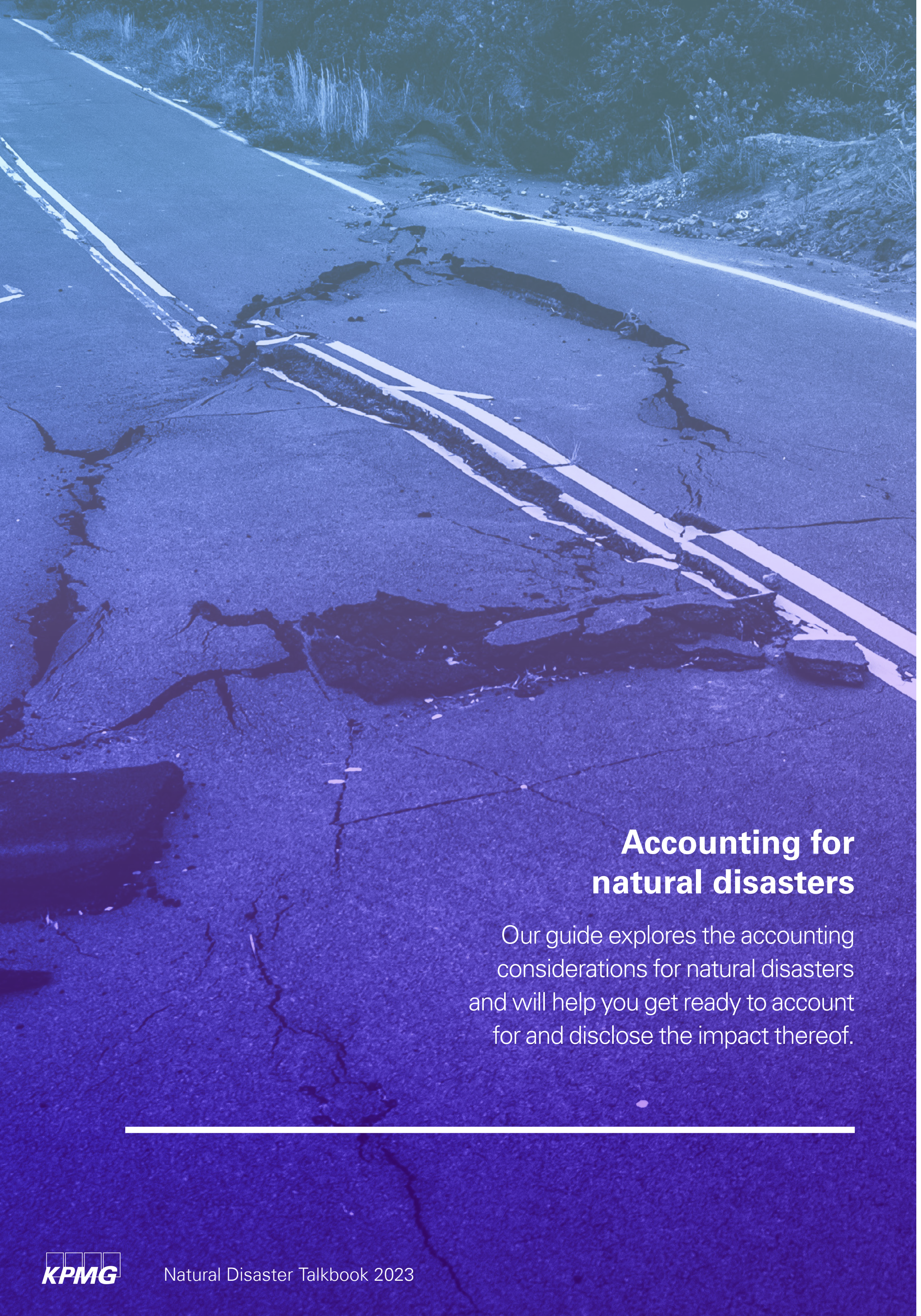
are all **common examples** of natural disasters impacting New Zealand on a recurring basis.

What's the impact

Many entities will or may be impacted either **directly,** with damage to property and business interruptions, or **indirectly** through business relationships that they have with affected entities. Along with a myriad of other business implications, **accounting considerations** related to natural disasters continue to surface as an area of attention for many organisations.

What's next

This publication highlights some of the **key financial reporting issues** that may arise as a result of natural disasters.

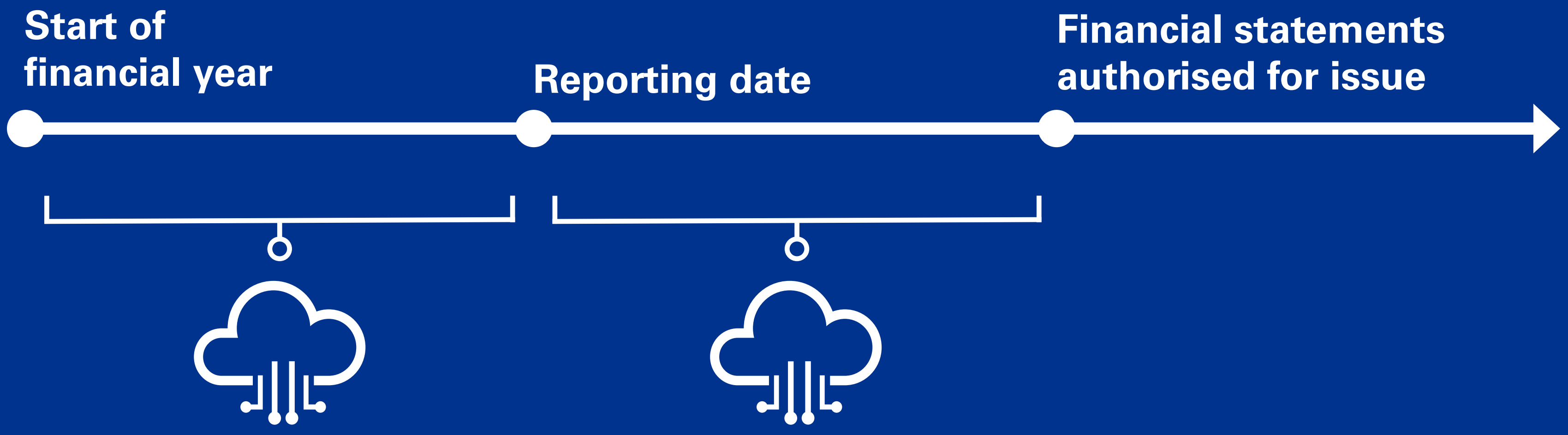


Accounting for natural disasters

Our guide explores the accounting considerations for natural disasters and will help you get ready to account for and disclose the impact thereof.

Contents

01 When do we recognise the impact of a natural disaster in the financial statements?



Adjusting event

Adjusting 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 statements in that year.

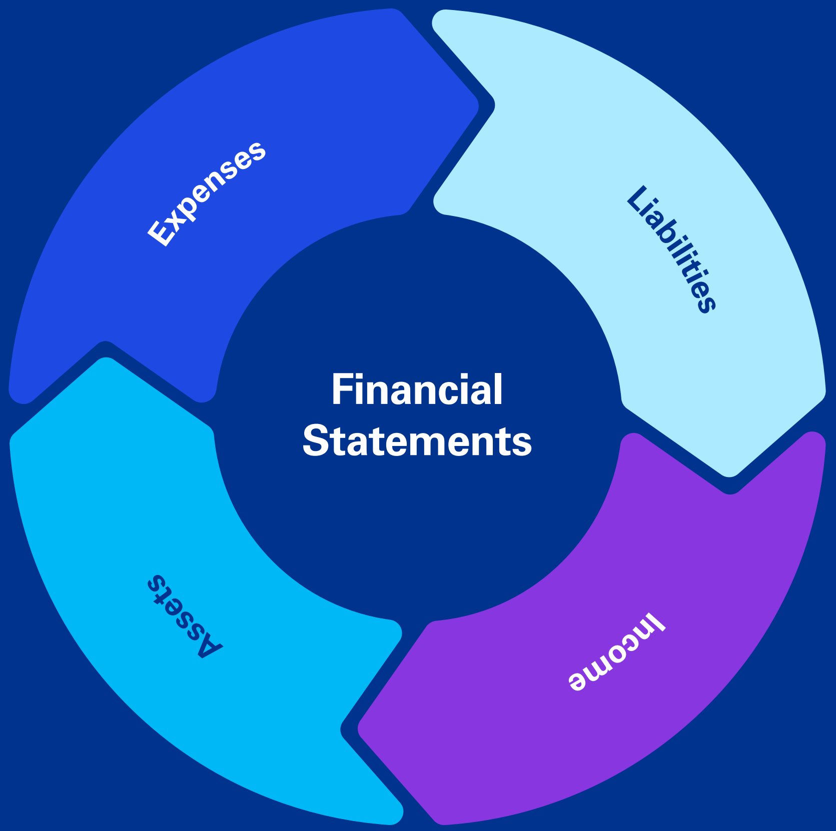
Non-adjusting event

Non-adjusting events are those that are indicative of conditions that arose after the reporting period but before the financial statements were authorised for issue and therefore are not to be adjusted – but may be required to be disclosed if the impact to the entity is considered significant.

Refer to NZ IAS 10, *Events After the Reporting Period* regarding the timing of a natural disaster and its treatment as an adjusting or non-adjusting event.

02 What are the impacts on the financial statements?

Assets may be impaired, clean-up/make good provisions required and grants, insurance pay outs and recovery assistance may have been received or are receivable. The timing of the disaster relative to the entity's reporting 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:

Assets and expenses

— Impairment: Property, Plant & Equipment
— Impairment and valuation: Investment Property
— Impairment and valuation: Intangible Assets
— Net realisable value: Inventory
— Impairment: Financial Assets and Contract Assets

Liabilities and income

— Clean up Costs
— Onerous Contracts
— Insurance Claims
— Reimbursements
— Debt Covenants

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.

03 Assets and expenses

Depending on the degree of damage incurred, entities may need to consider impairing or writing off existing assets. Even if an entity does not directly suffer damage, indicators of impairment may exist for tangible or intangible assets.

Even where no impairment is recognised other issues with the current measurement may be problematic for some entities. Impairment assessment and measurement issues will differ depending on the specific nature of the asset, some examples of which are highlighted on the following pages.

Property, plant & equipment

NZ IAS 36, *Impairment of Assets* (NZ IAS 36) includes the physical damage of an asset as 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 and useful economic life.

NZ IAS 16, *Property, Plant and Equipment* also provides specific guidance on compensation for the impairment of property, plant and equipment.

Some assets may be damaged, but still usable after being repaired. Such items may need to be impaired, if their recoverable amount is assessed to be lower than their carrying amounts.

If, however, an asset (or a component thereof) suffered significant damage to the extent that it can no longer be used or is uneconomical to repair, the asset (or component thereof) should be derecognised in its entirety.

If affected property, plant and equipment is held at revalued amounts, it may be necessary to make a full revaluation outside of the usual periodic valuation cycle (i.e. 3 year cycle).

Investment property

Investment property at fair value must reflect the current market conditions at the measurement date and should not include any subsequent restoration or enhancement work.

Immediately after a natural disaster there may be difficulties in valuing damaged assets, However, there is no option to revert back to the cost basis simply because the market becomes less active or market prices become less readily available.

Accordingly, the annual valuation process may require the use of different valuation techniques and other judgements. In this case entities will need to ensure the valuation technique used, if different from previous years, is still compliant with the requirements of NZ IAS 40, *Investment Property* and NZ IFRS 13, *Fair Value Measurement.*

It is important to note that impairment or losses to property and related claims or compensation from third parties (insurers) are separate economic events and must be accounted for separately – refer to page 10 for more information on insurance receivables.

Intangible assets

Similar to property, plant and equipment, NZ IAS 36, requires intangible assets with a finite useful life to be assessed for any indication of impairment at each reporting date.

Examples of circumstances that may indicate impairment include significant changes with an adverse effect on the entity that have taken place during the year.

Intangible assets with an indefinite useful life (such as goodwill) need to be assessed for impairment annually, regardless of whether an indication of impairment exists, and whenever there is an indicator of impairment.

Inventories

Inventory must be carried at lower of cost and net realisable value (NRV). Net realisable value represents the estimated selling price in the ordinary course of business less the estimated costs of completion and sale.

If the net realisable value of damaged inventory is lower than its cost, the carrying value will need to be written down and an expense recognised in profit or loss for an equivalent amount.

NRV must reflect the inventory's present location and condition at that date.

Financial assets and contract assets

The recoverability of financial assets and contract assets may also be directly or indirectly impacted by natural disasters, for example where, because of the natural disaster, customers are facing cash flow and financial viability issues.

Contract assets are rights to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditional on something other than the passage of time i.e. unbilled revenues.

Contract assets are assessed for impairment under the requirements of the financial instruments standard, NZ IFRS 9, *Financial Instruments*.

Entities must assess whether the credit risk of the financial asset has increased significantly since the initial recognition and assess the expected credit losses (ECL's).

The assessment is generally made for a specific instrument rather than a specific counterparty and considers the severity of the impact of the natural disaster on the recoverability of the instrument. The assessment considers changes in the risk of default instead of changes in the amount of ECLs.

There is limited guidance on how to perform the impairment assessment of contract assets.

For contracts with multiple performance obligations, a question arises over whether the impairment should be performed at the contract level or the performance obligation level.

In our view, in cases where contracts contain multiple performance obligations the impairment assessment of contract assets should be performed at the contract level.

This is because the net contract asset/liability position best represents the entity's real exposure to the credit risk of its customer.

04 Liabilities and income

Entities which suffer losses due to damage or damage to property itself, need to reflect the financial impact. They may need to recognise a provision for clean-up costs, or for any contracts which have become onerous as a result of the disaster.

An impairment test is performed first before recognising a provision for an onerous contract. The recognition of such costs associated with natural disasters are recorded as expenses.

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 NZ IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* (NZ IAS 37) are met:

- a present obligation exists;
- it is probable that an outflow of resources is required to settle the obligation; and
- it can be reliably estimated.

Provisions for clean up costs should only include directly attributable clean-up and restoration costs, and should not include the effect of any loss of profits or reduction of business from ongoing operations.

In our experience, making the estimate may require specialised knowledge of environmental issues - e.g. the quantity and type of contaminants involved, the local geography and remediation costs. The estimates typically need to be made with input from environmental experts and may require significant judgement.

Onerous contracts

An 'onerous contract' is one in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under the contract. In assessing whether a contract is onerous, it is necessary to consider:

- the unavoidable costs of meeting the contractual obligations, which is the lower of the net costs of fulfilling the contract and the cost of terminating it; and
- the economic benefits expected to be received.

Entities should consider whether projections of costs and benefits for the onerous contracts test need to be updated. Management should ensure that the assumptions are consistent with projections made for other purposes – e.g. the impairment analysis.

Entities should review lease and supply contracts to determine whether there is a constructive or contractual obligation that would oblige them to repair environmental damage as a result of a disaster.

Entities should also consider whether such contracts contain clauses such as a 'force majeure' clause that may relieve the entity of onerous contracts or components thereof.

For additional guidance when assessing loss making contracts under IFRS consider **KPMG's 7-Step guide.**

Considerations regarding the recognition and measurement of losses are made independently of those relating to any compensation that might be a receivable from an insurance policy. These benefits may only be recognised much later than the time the associated costs/losses are recognised.

Insurance claims

Compensation for insurance recoveries, including the loss or impairment of property, plant and equipment, is recognised in profit or loss when receivable.

The loss or impairment of the property, plant and equipment is recognised in profit or loss as an expense when it occurs.

Under NZ IAS 37, entities may only recognise as a separate asset when and only when it is virtually certain that the reimbursement will be received.

Recognition of the loss or impairment may occur at a different point, and even in a different period, from the recognition of the compensation.

In our view, income related to the compensation for damaged assets should be recognised when the damage giving rise to any loss or impairment has occurred and the entity has an unconditional contractual right to receive the compensation.

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

Generally reimbursements are accounted for in accordance with NZ IAS 37, which requires recognition only when it is virtually certain that the reimbursement will be received.

Consideration should also be given to government grants which are accounted for in accordance with NZ IAS 20, *Government Grants* (NZ IAS 20), which requires recognition only when there is reasonable assurance that:

- The entity will comply with the conditions attaching to them; and
- The grant will be received.

Where entities incur additional obligations as a result of natural disasters and repair environmental damage, such costs may be recovered from a third party. It is important to identify where reimbursements originate from.

- Where these are covered by insurance contracts, NZ IAS 37 will apply.
- However, where national / regional government agrees to reimburse entities, this is assessed in terms of the government grant requirements in NZ IAS 20.

Entities may be able to elect accounting policy choices for such reimbursements if no prior policy has been elected. i.e. where the government grant is in the form of a non-monetary asset.

Debt covenants

Under NZ IAS 1, *Presentation of Financial Statements,* the classification of certain liabilities with covenants as current or non-current is not always straight-forward.

Under existing NZ IAS 1 requirements, entities classify a liability as current when they do not have an unconditional right to defer settlement for at least 12 months after the reporting date.

The upcoming amendment to NZ IAS 1 removes the requirement for a right to be unconditional and instead now requires that a right to defer settlement must exist at the reporting date and have substance.

Further covenants with which the entity must comply after the reporting date (i.e. future covenants) do not affect a liability's classification at that date. Only covenants with which an entity must comply on or before the reporting date affect the classification of a liability as current or non-current.

This amendment is effective for all periods beginning on or after 1 January 2024.

The resulting impact of natural disasters whether direct or indirect may result in entities balance sheets reducing through impairment, lower future profitability forecasts, and ultimately missed payments on debt.

Such impacts on typical debt covenant ratios may result in the necessity to renegotiate terms with lenders or the entity may request a waiver of affected covenants.

If a natural disaster occurs shortly prior to a reporting date, this may result in a covenant breach as there may be insufficient time to negotiate with lenders or obtain a waiver, which may result in the need to reclassify some debt as current.

For example, with recent flooding events in January and February 2023, preparers with March year ends may not have had sufficient time to renegotiate terms or obtain waivers ahead of their reporting date.

Entities should review projected covenant compliance in different scenarios.

The impact on debt covenants may also need to be considered when assessing an entity's ability to continue as a going concern – refer to page 12 for more information.

05 Going concern

Financial statements are normally prepared on the assumption that the entity will continue to operate into the foreseeable future (i.e. that it is a going concern).

If management is aware of material uncertainties related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, then the entity should disclose those uncertainties together with management's plan to ensure the business is able to meet its obligations.

In considering the impact of natural disasters, management may conclude that there are no material uncertainties related to events or that the conditions may cast significant doubt on the entity's ability to continue as a going concern. Reaching that conclusion may involve significant judgement. In these cases, the judgements made in reaching these conclusions should be disclosed (material uncertainty and a 'close-call' scenario).

Where the financial statements are not prepared on a going concern basis, the financial statements will need to be prepared in a manner appropriate to the circumstances and the Standards should be applied accordingly. The basis must be disclosed in the financial statements regardless of whether the natural disaster occurred before or after the reporting date.

In our view, there is no general dispensation from the measurement, recognition and disclosure requirements of the Standards even if the entity is not expected to continue as a going concern. We believe that even if the going concern assumption is not appropriate, the Standards should be applied accordingly but with particular attention paid to the requirements of :

- NZ IFRS 5, *Non-current assets held for sale and discontinued operations* – to the extent assets are being held for sale and not abandoned,
- NZ IAS 32, *Financial Instruments: Presentation* – with respect to the classification of an entity's debt and equity instruments,
- NZ IAS 36, *Impairment of Assets,*
- NZ IAS 37, *Provisions, contingent liabilities and contingent assets.*

External events that create economic uncertainty may have a significant impact on a entity's ability to continue as a going concern and potentially require robust assessment and entity-specific disclosures.

Given the recent weather events in New Zealand, together with current geopolitical instability, market volatility and economic uncertainty is likely to have a significant impact on many entities, and have accounting and disclosure implications for their financial statements.

Consider browsing through the **KPMG Financial reporting in uncertain times resource centre** for additional resources to help you identify the potential financial statement impacts that the current environment may have on your business.

06 Tax impacts

The tax implications will also need to be considered. These issues include, but are not limited to, consideration of:

Whether expenditure incurred in repairing or otherwise rwemediating earthquake, fire or flood damaged buildings and/or plant or equipment is tax deductible?

Whether any repairs will be paid for by insurance? If so, the insurance proceeds may be taxable, depending on the nature of the repairs. GST may also be payable on insurance payments received. To the extent that the insurance proceeds are not spent on repairs, this may affect the tax book value for depreciation purposes and/or result in additional tax to pay. Unlike the Christchurch earthquakes there are currently no specific rules to mitigate adverse tax consequences (although we understand the Government may introduce measures as part of a 2023 Tax Bill).

Compensation for loss of profits or trading stock. This will generally be taxable (although it is possible some form of rollover relief may be introduced by the Government as part of a 2023 Tax Bill).

Cyclone tax relief measures in latest Tax Act. A variety of measures, introduced in a mid-March Supplementary Order Paper (SOP), were included in legislation enacted on 31 March 2023. KPMG's summary of these measures is available **here**.

Inland Revenue (IRD) guidance – The IRD are aware many tax payers will have been affected by flood and other weather related damage and may need help to keep up with their tax obligations, including filing and paying on time. The IRD have a range of relief available to those affected by adverse events – refer to the recent **Recent weather events - Cyclone Gabrielle update.**

The Chartered Accountants Australia and New Zealand's article additionally provides a range of resources and useful links to help you respond to and recover from natural disasters in New Zealand.

Whether there is a loss, for tax purposes, if a business asset (including a building) is scrapped or demolished? Any insurance proceeds received will need to be taken into account when calculating any loss. This could have the effect of clawing back any tax depreciation previously claimed. Unlike at the time of the Christchurch earthquakes, there are currently no specific rules to defer depreciation recovery (although we understand the Government may introduce measures as part of a 2023 Tax Bill).

07 Disclosure impacts

Entities need to provide disclosures necessary for users to understand and evaluate the information presented in the financial statements. Although not exhaustive, the following are examples you should consider for your entity.

Even if the natural disaster occurred after the year end and is therefore a non-adjusting event, a description of the nature and financial effects of the event will need to be disclosed if the financial statements for the current reporting period if these have not yet been authorised for issue.

Information on how recoverable value has been determined for an asset or cash generating unit (CGU) that has been impaired.

The nature and amounts of significant losses recognised as a result of the natural disaster and the amounts of any related insurance recoveries.

Contingencies which have not yet been recognised but may have a significant impact on the business (e.g. potential compensation for which the entity does not have contractual rights to pursue, akin to a subsidy).

Accounting policies for items which may not have been material in the past e.g. compensation from third parties.

Provide clear and meaningful disclosures about judgements and estimates made e.g. in recognising and measuring provisions, the recoverability of receivables from debtors who are suffering financial difficulties.

Have a look at **KPMG's financial reporting resource centre on uncertain times** for more information.

08 What are your next steps?

01

Understand the impact

Understand the impact of any natural disasters on your the entity.

02

Assess the impact

Engage with the business and then the accounting and/or valuation, assess the impacts and monitor the progress.

03

Conclude on accounting

Discuss and agree on proposed accounting treatments.

04

Propose disclosures

Ensure that you collect sufficiently detailed information to provide disclosure about the accounting for and impact of natural disasters in the financial statements.

Keeping in touch

Whether you are new to IFRS Standards or are a current user, you can find digestible summaries of recent developments, detailed guidance on complex requirements, and practical tools such as illustrative disclosure and checklists.

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