Natural disasters and their accounting implications

In the months following a disaster, businesses that prepare financial statements in accordance with accounting standards will need to turn their attention to the preparation of financial statements and to consider the associated accounting implications arising from the disaster.

So, what should I be thinking about in the preparation of financial statements?

Typically, there is a time delay between the end of the reporting period and the authorisation of the financial statements. When the natural disaster event occurs after the end of the reporting period and prior to authorisation, Accounting Standard AASB 110 *Events After The Reporting Period* requires that the event be identified as non-adjusting and the business disclose for each material category of non-adjusting event, the nature of the event and an estimate of its financial effect, or a statement that such an estimate cannot be made. In contrast, when the natural disaster event provides evidence of conditions that existed at the end of the reporting period (an adjusting event), AASB 110 requires that the amount recognised in the financial statements reflect the adjusting event. Determining whether the natural disaster event is an adjusting or non-adjusting event will often be straightforward. However, in other situations it might be less clear. When the natural disaster event occurs before the end of the reporting period or is a AASB 110 adjusting event, you will need to consider the accounting required of, for example, items of inventory, financial assets, intangible assets and goodwill, onerous contracts, property, plant and equipment damaged or destroyed, costs of restoring, purchasing or constructing replacement items of property, plant and equipment, and compensation from government and/or under insurance policies. You also must keep in mind that if after the end of the reporting period the affect of the natural disaster is such that you have no realistic alternative than to liquidate the business or cease trading (or that is what you intend to do), AASB 110 requires a fundamental change in the basis of accounting from the going concern basis, rather than an adjustment to the amounts recognised within the original basis of accounting. For further information on departing from the going concern basis, speak to your accountant.

Items of inventory destroyed or damaged

AASB 102 *Inventories* requires the measurement of inventories at the lower of cost and net realisable value. Inventories that have been affected by a natural disaster event must be assessed and valued. The practice of writing down inventories to their net realisable value is consistent with the view that assets not be carried in excess of amounts expected to be realised from their sale or use. The amount of any write-down of inventories to net realisable value and all losses of inventories are recognised as an expense in the period the write-down or loss occurs.

Financial assets

At the end of the reporting period, AASB 139 *Financial Instruments: Recognition and Measurement* requires you to assess whether the collectability of receivables has been affected by the natural disaster event and sets out various requirements to determine the amount of any impairment loss.

Intangible assets and goodwill

AASB 136 *Impairment of Assets* requires indefinite useful life intangible assets and goodwill to be tested for impairment annually in addition to whenever there is an indication of impairment by comparing the carrying amount with the recoverable amount. Natural disaster events can give rise to an indicator that can affect the future profitability of the business. The presence of AASB 136 impairment indicators may require a finite life intangible asset that is available for use to be written down.

Onerous contracts

The AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* definition of an onerous contract is a contract in which the unavoidable costs of meeting the obligation under the contract exceed the economic benefits expected to be received under it. Lease contracts and supply contracts typically establish both rights and obligations for each of the contracting parties. While the natural disaster event may require the business to recognise a liability measured at the lower of the cost of fulfilling it and compensation or penalties arising from failure to fulfil it, the affect of any *force majeure* clauses needs to be assessed. According to The Australian Financial Review, a number of mining companies with activities in Queensland have all declared *force majeure* to break supply contracts in the wake of the floods. You may need to consult your lawyer for further advice and your accountant for the financial reporting implications.

Items of property, plant and equipment destroyed or damaged

AASB 116 *Property, Plant and Equipment* requires derecognition of items that are destroyed or damaged to such an extent that no future economic benefits are expected from use or sale. Otherwise, AASB 136 is applied to determine the amount of the write down to recoverable amount. Further, the presence of AASB 136 impairment indicators such as a significant change in business activity, might require the write down of Items that are damaged but can be repaired or will be utilised in the future.

Costs of restoring, purchasing or constructing replacement items of property, plant and equipment

AASB 116 states that any costs directly attributable to bringing the item to the location and condition necessary for it to be capable of operating in the manner intended by management are part of the item's cost. The costs of relocating or reorganising part or all of a business' operations are ordinarily not included in the carrying amount of the item. However, you should seek advice from your accountant as to whether you can capitalise these costs when, because of the natural disaster event, management is not able to operate the items of property, plant and equipment in the manner intended.

Compensation from government and/or under insurance policies

AASB 116 requires that compensation from third parties (i.e., from government or an insurer under the terms of an insurance policy) for items of property, plant and equipment that were impaired lost or given up be included in profit or loss when the compensation becomes receivable. However, the standards applying to other assets and revenue are silent on this matter. AASB 120 *Accounting for Government Grants and Disclosure of Government Assistance*, requires that government assistance to businesses affected by a disaster event not be recognised until there is reasonable assurance that the business will comply with any conditions attaching to it and the grant will be received. AASB 137 notes that compensation from third parties will be receivable only when the realisation of income is virtually certain.

Therefore, it is possible that the recognition of the compensation from third parties will occur in a later reporting period than the recognition of the loss or impairment.

Other considerations

The affect of the global financial crisis on debt covenants gave rise to challenges around the classification of liabilities as current and non-current. Natural disaster events may give rise to similar challenges. Some businesses expect to incur costs of cleaning up following the natural disaster event. AASB 137 requires that in the absence of a present obligation the business does not recognise a provision. Therefore, the future expected costs of clean up would not meet the definition of a provision until the clean up is performed and the costs incurred. in addition to its half-yearly reporting obligations, an Australian Securities Exchange (ASX) listed business will need to be cognisant of the obligation to immediately report to the ASX any information of which it is aware concerning it, that a reasonable person would expect to have a material effect on the price of its securities.

All of the above areas involve significant judgement and where applicable are likely to feature highly on your auditor's agenda. As with all such matters, early communication is key. Involving your auditor in early discussions on these areas will allow you to align your expectations and benefit from their experience with other businesses that are facing the same challenges.

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