

Christchurch earthquake: Financial reporting considerations



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Our thoughts are with those friends, family, staff and clients impacted by the recent Christchurch earthquake. Many Deloitte clients and their staff have been affected, with personal loss, damage to homes, premises, loss of stock and so on. Our Christchurch office has relocated to 60 Grove Road, at the intersection of Moorhouse Avenue and Lincoln Road, and is now fully operational.

Our people in Christchurch have been operational since 7th March and are ready to help clients and other local businesses recover from the impact of the February 22 earthquake, and assist them with the multitude of business challenges they will face over the next few months. Some clients have already asked us for assistance in certain areas, and we would like to share with you our thoughts on some of the commonly raised issues.

No doubt more pressing things are on your mind in the immediate aftermath; however when the time comes you may find this Alert helpful to consider in the process of preparing your own financial reports¹ including considering how these issues may affect the annual audit. We have put together a high level summary of areas you may need to consider in more detail.

Potential impairment of assets

Entities may need to consider impairing damaged property, plant and equipment or other assets. They will also need to account for related compensation as a separate economic transaction. Treatment of compensation (e.g. insurance proceeds, grants or donations) is discussed below.

Asset	Key considerations
Inventory	Inventory is carried at the lower of cost and net realisable value in accordance with NZ IAS 2: <i>Inventories</i>. Entities will need to consider whether net realisable value has now fallen below cost, especially if the inventory is damaged or selling prices have declined. Net realisable value is the estimated selling price, less estimated costs of completion and estimated costs to make the sale.

¹We have prepared this advice under NZ IFRS. Similar considerations exist under old NZ GAAP.

Asset	Key considerations
Investment property	Investment property will need to continue to be measured at fair value, reflecting market conditions at the end of the reporting period (NZ IAS 40: <i>Investment Property</i>). Some entities may be considering whether it is possible to determine fair value reliably during this difficult period. In periods where there is an absence of current prices in an active market, entities (and the appointed independent valuers) will need to consider information about fair value from other sources, including: • Current prices in an active market for properties of different nature, condition or location; • Recent prices of similar properties on less active markets, with adjustments; and • Discounted cash flow projections. Entities which <i>already</i> use the fair value model under NZ IAS 40 must continue to do so. They cannot revert to the cost basis, which is only available on <i>initial</i> recognition to entities which qualify for differential reporting or other entities where there is evidence that fair value cannot be reliably determined on a continuing basis.
Property, plant & equipment	Assets that are unable to be repaired will need to be derecognised in their entirety. Assets that are damaged (but will be repaired) may be impaired. They will need to be assessed in accordance with NZ IAS 36: <i>Impairment of Assets</i>. Entities will need to consider the recoverable amount of assets individually, unless the asset does not generate cash inflows that are largely independent of other assets in which case it will be considered as part of the cash generating unit ("CGU") to which it belongs. Impairment and CGU's is a complex area, requiring careful consideration. While damage may be obvious, entities with significant headroom in their CGU impairment testing may not need to provide for any impairment, and in fact won't be permitted to. This may be more prevalent where entities include operations in Christchurch and other locations in the same CGU.
Goodwill and intangible assets	Goodwill and indefinite life intangibles are tested for impairment annually, and finite life intangibles are tested whenever there is an indication of impairment. Changes in expected profitability and cash flows will impact on the determination of recoverable amount, and entities will need to carefully consider the application of NZ IAS 36 in this area. Recoverable amount is the higher of fair value less costs to sell and value in use. Entities may need to make substantial changes to their previous value in use model, to reflect the disruptions to the Christchurch economy and revised expectations of profitability and cash flows. In the event that a goodwill impairment is recognised, it cannot be subsequently reversed.
Investments in other entities	Investments in other entities may be impaired if those entities are also affected by the earthquake. The measurement and treatment of any impairment is dependent on the type of investment and the policy adopted for that investment. As with goodwill and intangible assets above, entities may find that the models used to determine fair value (for investments carried at fair value) or recoverable amount (e.g. for equity accounted investments or investments carried at cost) need to be updated for significant changes.
Debtors and receivables	While we hope your cash flows and profitability are not negatively impacted, some of your customers may be facing the issues in this Alert. Even if your customers are not based in Christchurch, they might have Christchurch customers or business operations, and be facing difficulties as a result of the earthquake. This could have a flow-on effect in relation to your doubtful debt provisions. Entities will need to consider appropriate doubtful debt provisions, in accordance with NZ IAS 39: <i>Financial Instruments</i>. This requires entities to estimate future cash flows, discount that cash flow (at the original effective interest rate), and then compare that to the current receivable balance in order to determine if the provision level is adequate. Changes in the fair value of any collateral that is expected to be called on should also be considered, particularly if it is physical property and based in the affected area.

Understandably, it may be difficult to determine fair value less costs to sell, value in use, or net realisable value (as appropriate). Careful consideration will need to be given to arriving at appropriate carrying amounts for assets, and entities will need to clearly disclose the judgements, estimates and assumptions made.

Treatment of compensation

Compensation (e.g. insurance proceeds, grants or donations) should be treated as a separate economic transaction from the impairment event. Entities will need to consider when to recognise compensation, and also what amount to recognise.

Insurance cover

Insurance cover may be a contingent asset, rather than a receivable, until the point at which cover is confirmed, e.g. by an insurer.

We appreciate that insurers will be meeting some costs directly and entities in effect receive a “make-good” service from the insurer. In such a scenario it may be difficult for entities to determine the cost actually incurred by the insurer in restoring damaged assets. In any event, the compensation received or receivable should be recognised at an estimate of its fair value.

The facts and circumstances of the insurance arrangement will also influence the timing of recognition of any insurance revenue. If, for example an entity is entitled to reimbursement of costs actually incurred by the entity in repairing a building, then that insurance revenue would be recognised as repair costs are incurred. If however, an agreement obligates an insurer to repair or replace a building, the facts and circumstances may suggest that the insured entity could recognise the insurance revenue/receivable immediately.

Once the repair of impaired property, plant and equipment carried at cost has been completed, an entity may be able to reverse its impairment provision. However, this should not result in the asset value being greater than the carrying value before impairment unless the “repair” has resulted in additional economic benefits (such as an extended useful life). Any excess of the fair value of the insurance proceeds over the amount which can be capitalised is likely to represent compensation for repairs and maintenance expenses.

The costs incurred by the entity or the insurer to replace property, plant and equipment which was unable to be salvaged (and accordingly was written off) can be fully capitalised, provided it meets the criteria for capitalisation in NZ IAS 16.

In the case of business interruption insurance or loss of profits insurance, it is important that entities carefully document their losses to increase the chance of a successful insurance claim. When to recognise compensation will depend on the facts and circumstances of your insurance arrangement, but must not be before losses have actually been incurred. Entities will need to consider the likelihood of the claim being accepted by the insurer, and the amount to recognise may require some degree of estimation.



Government assistance

If a government grant is received then profit oriented entities will need to consider NZ IAS 20: *Accounting for Government Grants and Disclosure of Government Assistance*. The accounting treatment is dependent on the terms of the grant, so careful consideration will need to be given to the facts and circumstances of each grant.

Government grants are recognised as a receivable when there is reasonable assurance that the entity will comply with the conditions of the grant, and the grant will be received. They are then recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate. Grants related to assets may be treated as deferred income, or deducted against the carrying amount of the asset.

Grants that are receivable as compensation for expenses or losses already incurred, or for the purpose of giving immediate financial support with no future related costs, shall be recognised in profit or loss in the period they become receivable.

Public benefit entities are prohibited from applying the recognition and measurement requirements of NZ IAS 20 and should look to the requirements of NZ IAS 41: *Agriculture* as guidance instead, which allows recognition of revenue only when unconditional grants become receivable, or when the conditions attaching to conditional grants are met.

Onerous lease provisions

Entities will need to consider whether any lease (or other) contracts at balance date are onerous contracts under NZ IAS 37: *Provisions, Contingent Liabilities and Contingent Assets*. An onerous contract arises when the unavoidable costs of meeting the obligations under the contract exceed the benefits expected to be received under it.

It may be an indication that a lease contract is onerous where an entity is required to continue to pay lease costs for premises that it does not intend to, or is unable to occupy for a period of time. This may include where:

- for the period of repair an entity has leased, and is using, alternative premises; or
- an entity has entered into an agreement for a long term lease of alternative premises, whilst still continuing to lease the damaged or unusable premises; or
- an entity does not intend to re-open for business from the current lease premises.

It is important that entities consider the expected benefits over the lease term as a whole, rather than just the near future.

Loan covenants

Entities will need to consider whether their loan covenants are breached as a result of the earthquake, for example asset write downs may impact balance sheet ratios prescribed in the loan agreement.

We encourage entities to fully understand the terms of their financing agreements and to discuss any issues that arise with their lenders as soon as possible, to ensure any necessary covenant waivers are in place by balance date.

Guarantees

Has your entity guaranteed the obligations of another party, for example a subsidiary or joint venture partner's bank loans? Is that guarantee now more likely to be called upon?

Entities will need to consider whether any additional liabilities need to be recognised in relation to guarantees given. The accounting for guarantees is complex, and the accounting policy adopted will determine any amount that needs to be recognised, which is likely to be either:

- fair value, or
- the higher of:
 - the amount determined under NZ IAS 37 (when it is probable that the guarantee will be called on, the entity recognises a provision for the present value of the best estimate of the amount required to be paid); and
 - the amount initially recognised less, when appropriate, cumulative amortisation in accordance with NZ IAS 18: *Revenue*.

Is the earthquake an adjustable event?

For entities with balance dates before the earthquake

The earthquake is a non-adjusting event where the financial reporting period ended before the earthquake, but audited financial statements were not produced before the earthquake.

NZ IAS 10: *Events after the Reporting Period* requires note disclosure for all material non-adjusting events, including:

- the nature of the event; and
- an estimate of its financial effect or, where the effect is not known, a statement that an estimate cannot be made.

However, where an entity is determined to be not a going concern after balance date, but before signing the financial statements, the financial statements will need to be adjusted to a basis other than going concern. In such a scenario, a realisation or settlement basis may be more appropriate.

For entities with balance dates after the earthquake:

The financial impact of the earthquake should be included in the financial statements where the financial reporting period ends after the earthquake, including any potential going concern issues, as discussed below.

Going concern

Entities worst affected, even if the earthquake occurred after balance date, may also need to consider the appropriateness of preparing financial statements on the basis of the going concern assumption, although we certainly hope this is not the case.

When management is aware of material uncertainties that cast significant doubt upon the entity's ability to continue as a going concern, the entity is required to disclose those material uncertainties in the financial statements, and the auditor is also required to refer to those material uncertainties in their audit report.

Loss of accounting records

Some entities may also have lost all or a significant portion of their accounting records, and could face considerable difficulty in preparing their financial statements.

Likewise, auditors of these entities may face significant obstacles in obtaining evidence to support the amounts recognised in those financial statements. Please bear in mind that your auditors may need to consider whether their audit opinion needs to be modified to reflect the loss of accounting records.

Taxation

Entities may also be facing a number of tax issues, and you may find some helpful information in our October 2010 Tax Alert useful – "[Canterbury earthquake – the tax issues emerging](#)".

Closing word – transparency

Consideration of the issues discussed above will involve a significant amount of judgement, and significant estimates and assumptions. We encourage entities to ensure that there is transparency for users of financial statements, and to disclose those significant judgements, estimates and assumptions, as appropriate.

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