Grant Thornton

Technical Accounting Alert

Natural Disasters – What are the Implications to Consider?

Introduction

The purpose of this alert is to provide an overview of the possible implications that businesses may need to considered in light of the recent natural disasters within Australia.

In the wake of the recent and devastating flood events in Queensland and Victoria, the destruction caused by Cyclone Yasi in Far North Queensland and the fires that have raged in Western Australia, attention for business has now turned from crisis management and clean up to addressing the longer term financial and business implications.

Business Issues

Business Continuity and Crisis Management

In the immediate aftermath of a disaster, the focus should be on stabilising your business.

Factors to consider include:

- Cash flow – consider your short term cash flow requirements and evaluate how these needs might be met. This could include sourcing government grant assistance, taking advantage of concessions offered by government agencies to disaster affected business (eg ATO lodgement and payment deferrals), discussing short term financing needs with your bankers, discussions with stakeholders such as shareholders, deferring or re-prioritising (where possible) major items of expenditure and reviewing your commitments to your customers and suppliers.
- People – employees may have been directly or indirectly impacted by the disasters, and support for staff at this time can be critical to the recovery of your business. Consideration should be given to ensuring staff are able to take an appropriate time off work (both when directly affected and also to participate in voluntary clean-up activities where appropriate), providing support services such as Employee Assistance Programs, and ensuring premises and work sites are safe. Other factors to consider include actively managing your workforce to preserve working capital, ensuring employees are focused on tasks that provide the biggest benefit to your business, and being mindful of potential legal obligations and responsibilities to employees. Above all, it is extremely important to communicate effectively with employees at times of crisis, to ensure that they remain focused on the things that matter to your business, and to ensure that a lack of information is not filled by counter-productive speculation and rumour.

- Customers and suppliers – businesses should focus on discussing how the disasters have impacted key customers and suppliers, as disruptions to the supply-chain or sales pipeline may have significant adverse impacts on cash flow. Consideration should not just be given to those suppliers and customers directly impacted, but also to the indirect impacts (e.g. suppliers to your supplier / customers of your customer etc).

In the longer term, many businesses will need to consider and perhaps recreate their business continuity plans/crisis management strategies moving forward. Despite many businesses having these plans in place, the "acid test" of true crisis has highlighted that many businesses were not as well prepared as they thought. Many plans had never been properly tested in the past.

Some aspects businesses should consider when evaluating crisis management strategies include:

- Access to business premises and critical business equipment / machinery – recent events have shown that the disruption caused by disasters can be severe, even when a business's premises are not directly impacted, and that corporate head offices can equally be impacted as operational locations. For example, many businesses (and many corporate head offices) in Brisbane's CBD lost power, and hence were closed, even though in many cases the flooding did not directly impact them. The inability to access business premises and / or critical business equipment can cause major difficulties and be harmful to the bottom line. Many businesses will now be evaluating how to overcome these difficulties by establishing disaster recovery / back up sites and offices, and establishing better infrastructure for staff to work remotely.
- Access to, and effective start up of, IT, telecommunications and back-ups – whilst many businesses have historically felt that they had adequate back-up of their IT data and telecommunications systems, the recent disaster events have found many of these processes wanting. The complexity of some IT systems was such that, despite there being a disaster plan in place, systems still failed, as they were reliant on other systems or processes that were either impacted by the disasters or the associated loss of power. We are also aware of some instances where data was available via back-ups, however businesses did not have access to, or back-ups of, the applications used to access this data.
- Effectiveness of emergency communication channels with staff, customers and suppliers - these communications take on increased importance in times of crisis. Ensuring that you have access to the contact information for staff, customers and suppliers is something that can be easily overlooked. The recent crises highlighted the importance of being able to communicate via several different channels, as the disruption caused by disasters often mean staff, customers and suppliers may not have access to the usual communication channels. Communication channels used by many businesses in the recent disasters include, emails, websites, text messages and social media.

- Emergency delegations – when disaster strikes, it is important that each business has an emergency response group to whom important responsibilities are delegated during the crisis and immediate aftermath. This group should be familiar with the disaster recovery plan and the plan to return the business to "stability". Members of this group should comprise representative from across the operations of the business, as well as IT. Consideration should also be given to how this group would operate if one of its members were themselves impacted by the disaster and were not able to perform their role for the group.
- Assessing insurance coverage - many businesses are still in the process of determining their insurance coverage in relation to the floods, cyclone damage and fires, and preparations for insurance claims are now under way. Our initial observations show that many businesses believed that their policies provided flood cover, when in fact this was not the case. Additionally, many businesses have insurance coverage to protect certain assets, however they are not covered for the business interruption expenses that the flooding, cyclone and fires have caused. The combined effect of these issues will likely result in many businesses re-evaluating their insurance arrangements.
- Document storage and recovery– the recent disaster events have demonstrated the importance of having access to key business documents, customer lists, insurance policies and contracts by ensuring that copies are retained in a secure off-site location. For those businesses that have lost these important documents, it is important to try to salvage as much information as possible. In addition to trying to recover documents from business premises impacted by the disaster, other places where important documents are often stored include customers, suppliers, employees, banks, regulators (ATO, ASIC etc), emails and digital devices.

How well does your business adapt to changes in the weather?

Many experts suggest that the arrival of the flood events in Queensland indicate an end to the El Niño weather conditions that resulted in severe drought through much of Australia during the decade from 2000 to 2010. Whilst these drought conditions were devastating to many industries, and particularly for agriculture, for many businesses these periods of extended dry weather resulted in high levels of productivity. With the onset of wetter weather, many businesses may need to adapt the way they do business to account for extra delays and costs associated with the disruption caused by wet weather. Factors to consider include:

- Increasing working capital to allow for delays in deliveries and sales or lack of delivery from suppliers
- Impact of penalty clauses in contracts arising from delays

Force majeure

Most businesses have important long term contracts that impact their relationships with suppliers and customers. Many of these contracts contain "force majeure" clauses that protect the parties in the event that a significant part of the contract cannot be performed due to factors, like a natural disaster, that are outside of the control of the parties.

Businesses need to carefully consider how force majeure provisions may impact upon their key contracts. Aspects to consider include whether the force majeure provisions excuse contracted obligations, or merely postpone the contracted commitments. Working proactively with your customers and suppliers can help to alleviate the practical and potential legal issues.

Businesses will also need to consider the impact of contracts that do not contain force majeure clauses, as these contracts may present even more pressing obligations. Consideration should also be given to the appropriateness of current contract wording for all future business.

Environmental issues

Natural disasters do not automatically alleviate businesses of their environmental responsibilities. Rain and cyclones may cause flooding which can result in the release of contaminated water,, sewerage, or damage / destruction to protective infrastructure (e.g. tailings dams). Whilst the Department of Environment and Resource Management (DERM) in Queensland has issued some relief via Transitional Environmental Programmes to certain affected mines, wide ranging relief from environmental protection obligations has not been granted. DERM has indicated that it will continue to consider applications for relief on a case by case basis. Businesses are encouraged to consider the extent to which additional water testing and preventative measures might be required.

Consideration should also be given to the adequacy of rehabilitation and restoration provisions required.

Corporate social responsibility

Many businesses are helping to contribute to disaster relief efforts through donations (both financial and in-kind) and allowing staff to take paid (or unpaid) leave to assist with the clean-up effort. These initiatives not only assist those impacted by the floods,cyclones and fires, but allow employees to be a part of the community's healing process. Many businesses are also helping staff to deal with the emotional trauma that these events can cause via initiatives such as employee assistance programs.

Financial issues

It is critical to consider now how the flood and cyclone events and subsequent financial reporting will have on the businesses profit and loss and balance sheet. Adjustments could be detrimental and result in going concern issues, breaching banking covenants or possible qualification of audited accounts. Some adjustments to consider:

Subsequent Event?

Businesses need to consider the implications of natural disasters on their reporting requirements. The way in which the impact physical damage is reported will likely depend on each individual business's reporting date, and the date on which the damage occurred.

For businesses with a reporting date of 31 December 2010, where damage occurred prior to 31 December 2010, the financial impact of the damage will need to be recorded in the accounts at 31 December 2010.
For businesses that incurred damage after 31 December, disclosure of the estimated impact of the flood or cyclone damage will typically be disclosed by way of note disclosure to the financial statements, and will not result in the adjustment reported values until subsequent reporting periods (e.g. 30 June 2011 or 31 December 2011).

Impact on reported values

Accounting standards generally require assets to be carried at the lower of either amortised cost or net realisable value, or at market value. The flood and cyclone events may have impacted the value of assets via impairment or market value movements, as follows:

- Financial assets (e.g. Accounts receivable) – Businesses should consider their debtors book as customers may be directly affected by the disaster resulting in delays to or non-payment of accounts. Consideration should also be given to potential cash flow disruptions to your business as a result of debtor default further up the payment chain (for example, your customer's customers may have cash flow difficulties).
- Inventories – These need to be written down to their net realisable value, or written off if they are not in a saleable condition. If inventories are written off, businesses should consider the associated documentation that they may need for insurance or taxation purposes (for example, stock takes)
- Property, plant & equipment – This needs to be written down to its recoverable amount or written off and derecognised if it cannot be repaired. Impairment analyses using discounted cash flow techniques may be needed to account for potential reduced or deferred future cash flows arising from suspension of trading or production activities during or after the disaster or from the unavailability of infrastructure. Depreciation rates may also need to be adjusted.
- Goodwill and intangible assets – Business interruption from a disaster is, in many cases, considered to be an indicator of impairment, as future cash flows are disrupted or changed. As a consequence, impairment reviews are likely to be required, whereby the carrying value of goodwill or intangible assets is compared with the recoverable amount. The likely reduction in future cash flows arising from suspension of trading or production activities or disruption to infrastructure needs to be taken into account when determining the recoverable amount.
- Agricultural inventory assets – The agriculture accounting standard requires agricultural inventory to be recognised at either fair value, less costs to sell, or at cost. Where the fair value or net realisable amount of the inventory has decreased as a result of damage, this decrease in value needs to be recognised in the carrying value of agricultural assets.
- Investments (e.g. joint ventures, associates, financial instruments) – Accounting standards require investments to be recorded either at fair value or amortised costs. Businesses will need to consider whether the value of investments has changed as a consequence of a disaster, and record impairment charges where required.

- Investment properties – The investment property accounting standard allows businesses to choose the accounting treatment for investment properties – either fair value or amortised cost. A natural disaster may impact the value of investment properties resulting in charges to the profit and loss account.
- Deferred Tax Assets (DTA) – The impact of a natural disaster may result in future profitability and taxable profits being severely impacted. Consideration should be given to the impact any reductions in taxable income have on the recovery, and therefore the recognition of DTAs.

Hedge effectiveness

The ability to apply hedge accounting, and hence record movements in the fair value of derivative instruments through Other Comprehensive Income (OCI) to equity, as opposed to the profit and loss account to retained earnings, depends on the effectiveness of the derivative instrument in covering risk. Hedge effectiveness may be negatively impacted by production, shipping or sales delays as a result of the disruption caused by a natural disaster. Any hedge ineffectiveness results in the cumulative gain or loss recognised previously through OCI being immediately recognised through the Profit and Loss (P&L). This will directly impact the reported profit before tax. Businesses should also consider their obligations under hedge contracts, as the disaster events may have changed the timing of cash flows that were forecast to satisfy obligations under hedge contracts.

Onerous contracts

Accounting standards define an onerous contract as one where the unavoidable costs of meeting obligations exceed the economic benefits expected to be received under the contract. Examples of contracts that may become onerous as a consequence of a natural disaster include lease agreements, take or pay contracts and demurrage. The accounting requirements to be applied to onerous contracts are that the future obligations under these contacts need to be recognised as a provision. As discussed previously, force majeure contract provisions also need to be considered in the context of onerous contracts.

Provisions

Under IFRS, it is not possible to make provisions for future losses unless those provisions relate to an obligation to pay another party that was incurred prior to balance date. As a consequence, it is not possible to provide for the cost of clean-up, restoration or disruption in advance of the relevant expenses actually being incurred. In other words, although a business might be able to estimate its exposure to clean-up costs, it cannot recognise those costs as a provision until such time as there is an obligation to pay another party.

Insurance claims

Recoveries made via insurance claims can only be recognised in the accounts when there is an unconditional right to receive payment. In practice, this will likely result in disaster related losses being recognised in a different accounting period to the benefits derived from insurance claims, due to the length of time insurance companies often take to process claims.

Government Grants

Various government grants can be made available to businesses to assist with the recovery from a disaster. It is important to remember that recognition of government grant revenue can only occur when there is a reasonable expectation that the grants will be received and that the business has satisfied any conditions attaching to the grant.

Contingent liabilities and assets

We consider that there is the potential for broad ranging business issues and disputes to arise following a natural disaster, and that some of these matters will unfortunately precipitate legal activity and claims/counter claims. When businesses are party to such actions, consideration must be given to disclosure of associated contingent liabilities or assets.

Judgments and estimates

Businesses will need to make judgments and their best estimates in relation to many of the matters identified above. Care should be taken to ensure that judgments and estimates are made using appropriate assumptions and that the business retains appropriate documentation of the judgments and estimates.

Reclassification of debt

If businesses breach their lending agreements (i.e. fail to make scheduled debt repayments), facilities may be able to be called by financiers, which in turn may result in the debt facilities being reclassified from non-current to current. Going concern considerations could then arise.

Disclosure and reporting issues

The impact on profit and loss

Unlike previous Australian Accounting Standards, IFRS does not permit the reporting of "abnormal" or "extraordinary" items on the face of the Profit & Loss Account. Whilst it may be possible to highlight expenses relating to recovery from a natural disaster in the statutory P&L, it is more likely that the impact of these events will be detailed in a note to the accounts and in the Directors' Report and review of operations.

One of the reporting trends that emerged during the GFC was the reporting of "underlying profit" – a non-statutory disclosure that many companies used to convey normalised profitability to shareholders, financiers and the financial markets. We believe that the impacts of a natural disaster may see this trend perpetuated, despite some indications from ASIC that it may seek to regulate this type of reporting.

ASIC and ASX reporting obligations
ASIC has indicated that it would consider extending company reporting deadlines on a case by case basis. If an extension of time is required, companies are encouraged to apply to ASIC directly.
The reporting deadlines for listed company half and full year reporting are currently unchanged, and companies need to be mindful that failure to lodge accounts on time will result in a market suspension.

Companies also need to be mindful of the ASX's continuous disclosure obligations, particularly if the impact of the natural disaster is likely to strongly impact the company's current year earnings forecast and share price.

Where to from here?

- Quantification of losses and navigating the insurance claim process – for those businesses with appropriate insurance cover, the current focus is on producing the necessary documentation to support their claims. Any evidence that shows the impact of the disaster on your business will be helpful to the insurers e.g. photographs etc. Generally, quick lodgement of valid claims results in faster payments from insurers, which assists in minimising the cash flow impact, and you should consider the potential benefits of seeking expert assistance to help speed things up. It is likely that there will be significant litigation in this area, both in terms of the cover afforded by policies, and the quantification of loss. Businesses and insurers/brokers will be preparing, reviewing and challenging insurance assessments made as a consequence of claims, and businesses may need assistance in verifying losses incurred (both direct loss and business interruption).
- Loan covenants – Businesses will need to monitor their compliance with lending covenants in both the short and medium term. It is likely that the impact a natural disaster will have on liquidity will extend for several months, and consideration will need to be given not only to clients and customers directly affected, but also to those customers who themselves have customers who have been adversely affected.
- Going concern and insolvent trading – There is no doubt that the financial pressures caused by a natural disaster will exacerbate difficult trading and financial positions experienced by some businesses. Directors will need to be mindful of the risk that a company may no longer be a going concern, so as to manage potential exposure to perils such as trading whilst insolvent.
- Reforecasting and refinancing – Many businesses will find it necessary to reforecast their results, cash flows and financial positions to enable decisions about future actions to be made with clarity. This may lead many businesses to the conclusion that the need to refinance their arrangements.
- Stakeholder management – The above factors may lead many businesses to foresee troubled times ahead. During such periods, proactive stakeholder management becomes extremely important, particular with parties such as financiers, shareholders, customers and employees. Communicate with these groups early and often!

- Managing the emotional impacts – Psychological research has show that the effects of traumatic events can be severe and long-lasting. Businesses will need to consider the impact that a natural disaster may have on their people, and work with them to overcome these issues in a supportive manner.
- Fostering a resilient business culture – Whilst the recent floods, cyclone and fires have been difficult for many businesses and individuals, those that are able to foster a resilient business culture will not only survive, but will be well placed to prosper from future opportunities.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au