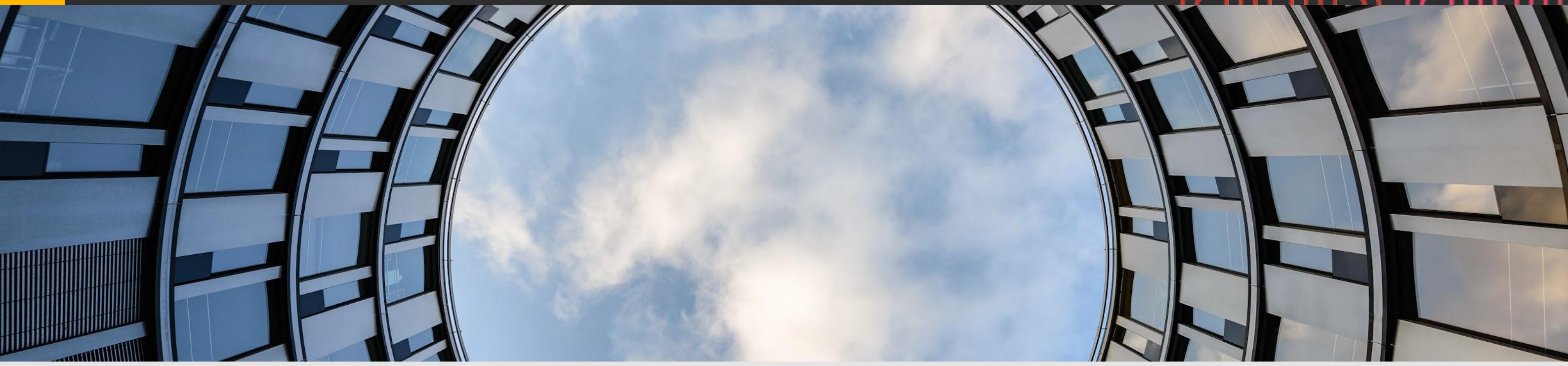
Update: February 2023

In Brief:
Extreme weather events: the impact on financial statements



At a glance

Aotearoa New Zealand has recently experienced the most significant weather events in this century, including Cyclone Gabrielle and widespread flooding, and our thoughts are with those that have been impacted. In this publication we consider the impact of extreme weather events on financial statements, as well as the impact of climate change.

Issue

There will be widespread impacts to the financial statements of entities affected directly or indirectly by Cyclone Gabrielle and flooding. Further impacts on financial statements may also need to be considered where New Zealand entities have related entities or investments in other global jurisdictions impacted by extreme weather events, or other natural disasters.

The frequency and intensity of extreme weather events may increase as a consequence of climate change. Entities need to consider the importance of climate-related risks to their strategic decision making and how these risks are disclosed to stakeholders and regulators.

Accounting issues

In the tables below we look at the impact of natural disasters on significant accounting issues.

Accounting issue	
Damage to buildings and other physical assets	Buildings, or other physical assets, which have been directly impacted should be assessed for damage when safe to do so. When assessing for impairment: • write off any assets that are destroyed; and • consider if the assumptions for useful life or residual value of damaged assets should be revised. A reduction in asset value to below the carrying value, where assets are held at depreciated cost, should be written off immediately to profit or loss. For assets held at a revalued amount, the write off is recognised as a revaluation decrease. The loss is recognised in other comprehensive income to the extent that it does not exceed the amount in the revaluation surplus for that same asset (or for public benefit entities, that same class of asset). Any excess loss is recognised immediately in profit or loss.

Accounting issue	
Impact on operations	Normal business operations can be impacted by a natural disaster in many ways. Clean-up activities could suspend operations for a period of time; the damage to assets might substantially reduce future production and/or the ability to fulfil customer contracts; and there may be an indirect effect if the flooding also impacts the operations of a significant supplier or customer. Where operations are impacted, performing an impairment test will determine the effect on the carrying value of goodwill and intangible assets (at the cash generating unit level and below), valuations of investments and investment in subsidiaries. Impacts on the future financial performance of the business, including the impact on future revenue and any limitation on production due to damaged assets and supply chain disruptions, should be considered and included in management's future estimates of cash flow or service potential, as appropriate.
Financial assets carried at amortised cost or fair value through other comprehensive income	Financial assets carried at amortised cost or fair value through other comprehensive income, including loans and receivables, held with customers based in the affected area should be assessed for recoverability. Consider whether the credit risk has significantly increased, which could impact the recoverability of mortgages, personal or business loans and any outstanding receivables and payments due from impacted customers.
Inventory valuation	If inventory has been destroyed or is no longer in a saleable condition it should be written off to profit or loss. Assess damaged inventory to ensure it remains valued at the lower of cost or net realisable value.
Biological assets	Where agricultural assets are impacted, for example the area has been flooded, or the access route for harvesting has been significantly damaged, it is likely that the assets will be written off, or there will be a reduction in the fair value less costs to sell, with the loss recognised in profit or loss. The nature and amount of a material loss should be disclosed in the financial statements.
Provisions	It is unlikely that a present obligation for clean up costs exists until costs are incurred, and therefore such costs are recognised immediately as expenses as they are incurred. A best estimate of future costs to be incurred can be disclosed. An example of where a present obligation for clean up costs might exist and the provision definition met, is where damage is caused to property leased by the entity where there is a contractual requirement for the entity to restore the leased items to their original condition. This creates a present obligation as a result of a past event, and, in these circumstances, a provision should be recognised for the associated costs.
Onerous contracts	Reviews of existing contracts should be completed to see if they have become onerous. An onerous contract may occur where a customer contract cannot be fulfilled, however the contract is non-cancellable and contains penalties for non-delivery. Force majeure clauses might alleviate the accounting implications associated with onerous contracts.

Accounting issue	
Hedge accounting	There may be unexpected delays for designated forecast transactions in cash flow hedging relationships such as raw materials purchases, sales or revenues. Depending on the severity of such delays, existing hedging arrangements may no longer be effective. If the forecast transactions cease to be highly probable or are no longer expected to occur, some hedge accounting relationships will need to be discontinued. The appropriate treatment of accumulated other comprehensive income related to such discontinued hedges will depend on whether the transaction is still expected to occur. Where the hedged item is still expected to occur, the entity should retain the amounts accumulated in other comprehensive income until the forecast transaction occurs. Where the hedged item is no longer expected to occur, the amounts accumulated in other comprehensive income should be reclassified into profit or loss.
Insurance	A timing difference between a loss being incurred and any insurance reimbursement being received is likely. This difference might span one or more financial years and may impact on recognition at the reporting date. Any business interruption insurance policies in place should be reviewed carefully as they can cover numerous aspects of operations. Insurance proceeds should only be recognised when recovery is virtually certain. It is likely that this would be when the claim has been accepted by the insurance company and communication of reimbursement value has been received. The proceeds will be recognised separately in the income statement, and not as a reduction of the cost to rebuild or replace the insured asset. Likewise, they will be classified within the statement of cash flows based on the nature of the insured item.
Lost or damaged financial records	The increased use of technology in recent years is likely to minimise the impact of weather events on financial records. However, any effect on the internal control environment in place should be reviewed to ensure that effective controls remain in place. The FMA has recently published *Guidance and expectations for keeping proper accounting records* to support FMC reporting entities to meet their statutory requirements relating to financial records. This is also helpful for non-FMC reporting entities to meet the requirements of Section 194 of the Companies Act 1993.
Going concern assumption	Where an entity has been significantly impacted by the weather events, the going concern assumption should be robustly reviewed. Considerations include the: • ability to meet ongoing debt obligations and covenants; • ability to secure additional financing to re-establish the business or continue operations; • impact of any delays to production on existing customer contracts and orders, including penalties; and • overall impact on the entity's operating cash flows and forecast financial performance. Financing arrangements may be amended to increase borrowing capacity on a temporary or permanent basis, extend repayment terms or introduce interest rate holidays. These amendments should be reviewed to determine whether to account for them as a modification of the existing borrowing arrangement, or an extinguishment of debt using the provisions of NZ IFRS 9 *Financial Instruments*. If there is significant uncertainty over the ability to continue as a going concern, this must be disclosed, along with how management plans to mitigate that uncertainty. Consider if the financial statements should be prepared on a non-going concern basis.

Accounting issue	
Subsequent events	An extreme weather event occurring subsequent to balance date is likely to be a non-adjusting subsequent event as the impacts of the event did not exist at the reporting date. However, where the impacts are material, the nature of the event and an estimate of its financial impact on the entity (where possible) must be disclosed in the financial statements. For some estimates, such as expected credit losses or value-in-use, determining whether, and to what extent, information and events after the reporting date reflect information available and circumstances that existed at the reporting date and/or information about expected future scenarios at the reporting date may be judgmental. Entities should take into account whether changes to inputs might have a material impact on these estimates and whether a particular outcome was contemplated within the original assessment.
NZX reporting obligations	Information that a person would reasonably expect to receive about a material impact on security prices must be disclosed to the market immediately under the NZX's continuous disclosure reporting obligations. If the event has had a impact on the operations of the entity, disclosure may be required in accordance with the NZX Listing Rules.
Future climate scenarios and climate related risks	Recent extreme weather events highlight the need for entities to actively revisit their existing climate change strategy. How climate related risks could impact the entity should be considered by using future climate risk scenarios to develop assumptions about the likelihood, frequency and severity of these events occurring and assess the impact this could have on operations and cash flows, both in the short and longer term. An entity's assessment of climate related risks and impacts, and the strategies developed to respond to these, will have an impact on the assumptions used in the measurement of a number of assets and liabilities presented in the financial statements. Stakeholders, including investors and regulators, expect clear disclosure of these impacts in financial statements, aligned to the required NZ IAS 1 *Presentation of Financial Statements* disclosure of: • significant judgements made in applying the accounting policies; • the estimates that are most likely to result in an adjustment to profits in future periods; and • sources of estimation uncertainty. The nature of climate change statements made by an entity outside of the financial statements might raise an expectation by stakeholders to understand the related impact on the financial statements or the reasons for there being no impact. Entities need to consider whether specific financial statements disclosure is required to meet stakeholder expectations, keeping in mind that information is material if omitting, misstating, or obscuring it, could reasonably be expected to influence decisions made by primary users of financial statements. For more information refer to our webpage, which is designed to help you navigate financial reporting challenges arising from climate change.

Accounting issue

Regulatory focus on the impact of climate change in the financial statements

The FMA has set clear expectations for management and Directors of regulated entities when preparing financial statements (view their publication here), to:

- consider climate risks throughout their risk assessment process and look at how this impacts the preparation of financial statements;
- prepare high-quality technical papers for all material areas impacted by climate risk, including materiality assessments and accounting considerations of decisions made to support financial statement disclosures; and
- have adequate documentation in minutes of board and audit committee meetings that includes discussions, analysis and conclusions for accounting areas impacted by climate change.

The FMA also expects entities to not only consider climate change when applying accounting standards, but also its likely effect in the context of the financial statements (taken as a whole) including the level of disclosures relevant for investors to understand the impact of climate-related matters on the reporting entity, if that impact is assessed to be material. When considering materiality, entities should consider quantitative disclosures such as the impact of climate change on the impairment of assets, as well as disclosures that could reasonably be expected to influence the economic decisions of users, based on the financial statements as a whole. Where decisions are made that items are deemed immaterial, these decisions should also be included in the documentation.

The FMA's upcoming financial reporting reviews will consequently be focused on

- entities' assessment of climate change and its effect on their financial statements; and, where relevant, entities' consideration of climate-related matters when applying accounting standards including level of disclosures; and
- consistency between the information presented outside of the financial statements relating to climate change and the financial statements.

Need more information?

If you wish to discuss this or any other financial reporting related matter, please contact your usual PwC contact or one of the following financial reporting specialists:

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