Earthquake accounting issues paper

Introduction

The purpose of this document is to provide a summary of Audit New Zealand's views reached on earthquake accounting issues. The guidance in this paper may also be relevant when accounting for other natural disasters, such as storms and floods.

This document was originally prepared following the Canterbury earthquakes. At that time, public benefit entities (PBE) prepared their financial statements in accordance NZ IFRS. This document has been updated to reflect the PBE IPSAS based accounting standards that now apply to PBEs.

The matters in this paper are generally targeted at PBE reporting issues. However, at the start of each answer we note whether the answer to the question relates to a public benefit entity (PBE) or both PBEs and for-profit entities. In addition, the paper is for Tier 1 and 2 PBEs and for-profit entities only. Under the Tier 3 accounting standard, an entity is required to consider whether assets have been impaired, and auditors may find the guidance in this document helpful for determining whether assets of Tier 3 entities have been impaired by earthquakes.

More views will be added to this document as further accounting issues arise and are addressed. An appendix to this paper provides a high level decision tree on accounting for earthquake damage to PBE property, plant, and equipment.

Caution should be used when applying the response to these issues as there may be different circumstances that may not be readily apparent from the discussion.

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Issue	Summary of view
Accounting for insurance claims and receivables	
When should earthquake-related insurance recoveries be recognised?	**Relevant for PBEs and for-profit entities** PBE IPSAS 17/NZ IAS 16 *Property, Plant and Equipment* paragraph 80/65 and PBE IPSAS 16/NZ IAS 40 *Investment Property* paragraph 83/72 require compensation from third parties for assets that were impaired, lost, or given up to be recognised when the compensation becomes **receivable**. The standards do not discuss when compensation becomes receivable. Our view is that an insurance recovery becomes receivable when its receipt is considered **virtually certain**. This recognition threshold is the same as that applied when recognising compensation assets related to provisions under PBE IPSAS 19/NZ IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. An insurance recovery would be considered receivable when the insurer has confirmed acceptance of the claim. If the **amount** of the claim has not yet been agreed, the insurance receivable is measured at the best estimate of what is expected to be received provided it can be measured reliably. If an insurance receivable cannot be reliably measured, an asset is not recognised.

Issue	**Summary of view**
When should earthquake-related insurance recoveries be recognised? (continued)	There may be circumstances where an insurance recovery qualifies for recognition as an asset prior to the insurer accepting a claim. For example, entities making multiple claims will be working closely with their insurers. Entities' experience in dealing with their insurers may mean they have sufficient knowledge to judge whether a claim will be covered by their insurance policy and that its receipt is considered virtually certain. Due to the complexity and size of some insurance claims, significant judgement will need to be exercised in deciding whether it is appropriate to recognise an insurance receivable before an insurer accepts a claim. An insurance receivable and revenue is recognised regardless of whether the insured party or the insurer makes the payment for the replacement or repairs of an asset. Where the insurer pays directly for the replacement or repair of assets, the amount of the insurance recovery is based on an estimate of the fair value of the asset replacement or repairs. Our view is the same principles above apply to the recognition of **business interruption** (BI) insurance recoveries. The insurance recoveries are recognised in accordance with the substance of the policy. For example, if BI insurance covers additional operational costs incurred due to the earthquakes and the recovery of those additional costs by insurance is considered virtually certain, the recoveries are recognised as those costs are incurred. If there is doubt about whether a BI insurance claim will be accepted then the recoveries are recognised when the receipt is considered virtually certain, which may be when the insurer confirms acceptance of the claim. The accounting for government assistance is explained in the "Accounting for Government grants received that relate to the earthquake" section below.

Issue	Summary of view
How insurance claims accepted after balance date should be accounted for?	**Relevant for PBEs and for-profit entities** PBE IPSAS 19/NZ IAS 37 paragraph 43/35 states that if it has become virtually certain that an inflow of economic benefits will arise and the asset value can be measured reliably, the asset and related revenue are recognised in the financial statements of the period in which the change occurs. There are two alternative views on the accounting for an insurance claim accepted after the balance date (and prior to authorisation of the financial statements) that was not recognised at balance date: - View 1 – The confirmation of the claim after balance date is viewed as resolution of a measurement issue of the insurance proceeds an entity is due under its insurance policy. Therefore, the acceptance of an insurance claim after balance date shall be accounted for as an adjustable post balance date event. - View 2 – The reason the proceeds were not recognised at balance date was because their receipt was not virtually certain. Acceptance of the claim after balance date means the claim is now virtually certain but as that occurred after balance date there is not an adjustable post balance date event as supported by PBE IPSAS 19/NZ IAS 37. We consider either of these 2 views are acceptable. Where material, an entity shall disclose information about their accounting policy judgement where material insurance claims are accepted post balance date. If an entity recognised a receivable at balance date prior to the claim being accepted, the entity shall consider post balance date information that affects the measurement of the receivable and amend the amount of the asset to reflect that information.

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<tr><th>Issue</th><th>Summary of view</th></tr>
<tr><td>Should insurance claims not recognised as an asset be disclosed as a contingent asset?</td><td>Relevant for PBEs and for-profit entities

PBE IPSAS 19/NZ IAS 37 paragraph 105/89 requires a contingent asset to be disclosed if an inflow of future economic benefits of a possible asset is probable.

For insurance claims not yet accepted by the insurer or claims not yet provided to an insurer, a contingent asset shall be disclosed if the insurance claim is not recognised as an asset and the entity expects it is probable the claim will be accepted by their insurer. If it is virtually certain the claim will be accepted, then the insurance recovery is recognised as an asset.

We also consider it appropriate to disclose a contingent asset for an insurance claim not recognised as an asset because the amount of the claim cannot be reliably measured.</td></tr>
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Issue	Summary of view
Should insurance recoveries be presented net of relevant expenses (such as impairment or business interruption costs) or gross as revenue in the statement of comprehensive revenue and expense/income? Can insurance recovery assets be presented net of related liabilities in the statement of financial position?	**Relevant for PBEs and for-profit entities** Arguments for gross presentation of insurance receipt revenue and assets is supported by: - PBE IPSAS 1/NZ IAS 1 paragraph 48/32 prohibit the offsetting of assets and liabilities or revenue and expenses unless required or permitted by a PBE/NZ IFRS Standard. There is no standard that explicitly permits the offsetting of **all** insurance proceeds against related expenses; and - PBE IPSAS 17/NZ IAS 16 paragraph 81/66 and PBE IPSAS 16/NZ IAS 40 paragraph 84/73, which requires impairments, disposals, compensation and subsequent purchase or replacement of assets to be accounted for as separate economic events. Therefore, the compensation should be presented separately. - PBE IPSAS 19/NZ IAS 37 paragraph 63/53 requires reimbursements in relation to a provision to be recognised as a separate asset. There is an argument, by analogy, for net presentation of insurance revenue based on the reimbursements guidance for provisions recognised under PBE IPSAS 19/NZ IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* paragraph 64/54 being permitted to be presented net. Our view is that only a gross presentation of insurance assets and liabilities or revenue and expenses (including business interruption insurance) is acceptable, which is consistent with the general principle of PBE IPSAS 1/NZ IAS 1 that assets and liabilities and revenues and expenses are not offset unless expressly permitted by an accounting standard. The only exception to this view is that we could accept offsetting of an insurance reimbursement and related expense from a directly related provision, such as business interruption insurance received in relation to a lease that is onerous because an entity cannot use the leased premises. We can accept offsetting of the revenue and expense in this case as it is explicitly permitted as an option by PBE IPSAS 19/NZ IAS 37. The asset and liability in this case however must be presented gross. Offsetting business interruption insurance revenue against lease costs for temporary accommodation would not be acceptable as a provision would not be recognised for the temporary accommodation (unless that arrangement is onerous). Further detail about onerous leases is provided on page 23 of this document.

Issue	Summary of view
How should an insurer's ability to pay a claim be taken into account when recognising insurance recoveries?	**Relevant for PBEs and for-profit entities** The Canterbury earthquakes put the spotlight on the ability of some insurers to meet their insurance obligations arising from earthquakes. This included the liquidation of Western Pacific Insurance, the government agreeing to a rescue package for AMI Insurance, and the Local Authority Protection Programme signalling difficulties. For insurance claims recognised as a receivable asset, the collectability of the insurance claim must be considered to determine whether there is any objective evidence of impairment of the receivable (see paragraph 68/59 of PBE IPSAS 29/NZ IAS 39 *Financial Instruments: Recognition and Measurement*). If there is objective evidence that the full amount of the accepted claim will not be paid, the receivable should be recognised at the present value of the estimated future cash flows to be collected (which could be nil). The "virtually certain" test explained above is unlikely to be met when there is uncertainty over an insurer's ability to pay out the claim.

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<tr><th>Issue</th><th>Summary of view</th></tr>
<tr><td>How should insurance recoveries be presented in the statement of cash flows?</td><td>Relevant for PBEs and for-profit entities
Our view is the presentation of insurance recoveries in the statement of cash flows shall be driven from the nature of the insurance claim and not how the insurance recovery is expected to be expended
Insurance recoveries received for damaged PPE shall be classified as an investing cash flow in the statement of cash flows. The logic of this is it reflects that an entity is being reimbursed for the loss of property value (for example, impairment) or property loss (for example, asset write-off). This is akin to the explicit requirement to present cash flows from disposed PPE as an investing activity, which is requiring cash flows received in relation to the loss of value of the PPE being classified as an investing activity.
This view also means there is some symmetry in the presentation of cash flows as investing activities for cash expended on PPE that is capitalised (for example, for assets replaced or restoration of impaired assets). That is, cash flows outflows that increase PPE value and cash inflows in relation to reduction in PPE values are presented in the same section of the statement of cash flows as an investing cash flow.
We believe it is appropriate to classify insurance proceeds as an operating cash flow if those proceeds relate to damaged PPE whose service potential is largely unaffected (that is, the damage has not triggered an impairment test and repair costs would be expensed). This means there would be consistency with the presentation of repairs and maintenance cash outflows as an operating cash flow if incurred within the same accounting period.
Business interruption insurance would be classified as an operating cash flow.
Judgement may need to be exercised in determining the portion of an insurance claim that should be classified as operating cash flow or an investing cash flow.</td></tr>
<tr><td colspan="2">Accounting for damage to PPE</td></tr>
<tr><td>For revalued assets, should damage to PPE be accounted for as impairment or dealt with as part of periodic revaluations?</td><td>Relevant for PBEs and for-profit entities
Our view is that the most appropriate accounting treatment for earthquake damage to a revalued asset is to first consider the application of the impairment standards (PBE IPSAS 21 Impairment of Non-Cash-Generating Assets/PBE IPSAS 26 Impairment of Cash-Generating Assets/NZ IAS 36 Impairment of Assets) prior to the revaluation requirements of PBE IPSAS 17/NZ IAS 16.</td></tr>
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Issue	Summary of view
	For for-profit entities: The main matters that we have considered in forming this view are: • Paragraph 5 of NZ IAS 36 clearly states that revalued assets under NZ IAS 16 are within the scope of NZ IAS 36. • Paragraph 12(e) of NZ IAS 36 lists physical damage of an asset as an indicator of impairment. • Paragraph 66(a) of NZ IAS 16 requires any impairment of items of property, plant, and equipment to be recognised in accordance with NZ IAS 36. • Accounting for earthquake damage as an impairment event means that a full revaluation under NZ IAS 16 would not be required for all assets within the same asset class. That is, undamaged assets will not be required to be revalued. We acknowledge the scope wording of paragraph 5 of NZ IAS 36 could be interpreted differently, particularly given the interaction between NZ IAS 16 and NZ IAS 36. Nevertheless, we believe the intention of the standard setter in paragraph 5 was to make it clear that after the revaluation requirements of NZ IAS 16 have been applied, an entity still needs to consider whether a revalued asset is impaired. Paragraphs 5(a) and 5(c) of NZ IAS 36 provide two examples that may give rise to such impairment after a revaluation. We do not interpret paragraph 5 to mean that the revaluation requirements of NZ IAS 16 need to be considered first before impairing under NZ IAS 36 when there is an impairment indicator. ***PBEs:*** For PBEs, paragraph 2(e) of PBE IPSAS 21 and PBE IPSAS 26 specifically exclude PPE that are measured at revalued amounts from the scope of those standards. The rationale is that PPE will be revalued with sufficient regularity to ensure that they are carried at an amount that is not materially different from their fair value, which would take into account impairment. As paragraph 51 of PBE IPSAS 17 requires all assets within an asset class to be revalued if an item of PPE is revalued, impairment of an asset could require a revaluation of the entire asset class. However, in practice we have approached this requirement with some pragmatism. Where a specific event (such as an earthquake) can be determined to have impaired the carrying value of revalued assets, our view is that it is reasonable to impair the affected asset(s) without

Issue	Summary of view
	consequently forcing a revaluation of the entire class of assets. Note that the entity still needs to demonstrate that at the reporting date the carrying value of the remaining assets in the asset class are not materially different to fair value. The IPSASB has issued amendments that scope revalued assets back into the impairment standards. The NZASB has issued an exposure draft proposing to adopt these amendments. This will align the accounting standards with our current interpretation (above) and the requirements of NZ IFRS.
How do you determine whether a damaged asset should be impaired or derecognised?	**Relevant for PBEs and for-profit entities** An item (also called the "unit of account") of PPE is derecognised if it will provide no future economic benefits or service potential (for example, can't be repaired). It is impaired if it will be repairable and will provide economic benefits or service potential in the future. For non-network assets (for example, buildings and plant and equipment) and distinguishable network assets (for example, pump stations and wastewater treatment plants), the assessment of whether an item should be derecognised or impaired should generally be straight-forward. For example: 1 A building will need to be derecognised and its carrying amount recognised in the surplus/deficit if the building has been found to be structurally unsafe and will need to be demolished. If there are revaluation reserves allocated to the building, these will need to be transferred to general funds/retained earnings **within equity** and are not included as part of the asset write-off/disposal accounting. 2 A building will need to be impaired with the impairment recognised in other comprehensive revenue and expense/income (if revalued and sufficient reserves are allocated to the building) if it has sustained repairable structural damage and the asset will be useable again once repaired. For network assets (for example, roads, water and waste piping, and flood protection banks), whether an item of PPE should be derecognised or impaired will depend on what is regarded as the unit of account. The level of detail that an entity accounts for its network assets would typically reflect the unit of account that should be used in determining whether the damaged part of the network should be impaired or derecognised. This means for a 1.0km stretch of water piping damaged in an earthquake that is recorded as a separate asset in the fixed asset register of a Council, the assessment of impairment vs. derecognition is performed at this level of detail (that is,

Issue	Summary of view
	the assessment is not done treating the entire water pipe network as the unit of account). For example: 1 If the 1.0km of piping will predominantly require replacement, this should be accounted for as derecognition and an expense will arise. 2 If the section of the piping will predominantly be repaired (rather than replaced), this would be accounted for as an impairment. The experience from the Canterbury earthquakes was that distinguishing between impairments and assets that shall be derecognised can be challenging. For example, challenges can arise due to the extensive damage to network assets or because of uncertainties of whether an asset is repairable (e.g. where decisions may be influenced by expert opinions and insurer decisions). Judgements will need to be made using the evidence available at the time the financial statements are prepared.

Issue	Summary of view
When is a non-cash-generating asset considered impaired?	**Relevant for PBEs** If the earthquake has affected the service potential of an asset (for example, a building is not able to be fully used), this would trigger an impairment test under PBE IPSAS 21 *Impairment of Non-Cash-Generating Assets*. Examples where the service potential of a building is likely to have been affected include: • Where a building is unable to be used to deliver educational services due to earthquake damage and the damage is repairable. For example, a building is unable to be occupied until the damaged stairwells have been replaced. • Where part of a building is unable to be used to deliver educational services due to earthquake damage and the damage is repairable. For example, the top three floors of a building cannot be used until all broken windows and fittings have been replaced. • Where the useful life of a building has been notably affected by the earthquake. For example, a building that will require structural strengthening to ensure the continued delivery of educational services. We consider that where the service potential of an asset has not been affected (for example, the building is able to be fully used), it would be reasonable to not perform an impairment test and to expense all repair costs. For example, the cost of repairing cracks in a building that is able to be used to provide educational services before being repaired should be expensed as incurred.

Issue	Summary of view
How is impairment calculated for non-cash-generating assets?	**Relevant for PBEs** Where there is indication of impairment of a non-cash-generating asset, PBE IPSAS 21 requires the recoverable service amount of the impaired asset to be calculated. The recoverable service amount is the higher of a non-cash-generating asset's fair value less costs to sell and value in use. An impairment loss is recognised if the asset's carrying amount is greater than the recoverable service amount of the asset. PBE IPSAS 21 defines value in use of a non-cash-generating asset as the present value of the asset's remaining service potential. Three impairment approaches are outlined in PBE IPSAS 21 for calculating this – depreciated replacement cost (DRC), restoration cost approach, and the service units approach. Of the three impairment approaches discussed in PBE IPSAS 21, the restoration approach would usually be considered the most appropriate to apply to assets that have sustained damage. The restoration cost approach considers the cost of restoring the remaining service potential of an asset to its pre-impaired level. The remaining service potential of the asset is determined by subtracting the estimated cost to restore the asset from the DRC of the asset before impairment. The impairment loss recognised will be the difference between a) the carrying amount before impairment and; b) the DRC (pre-impairment) less the estimated cost to restore. Note that if the DRC (pre-impairment) less the estimated cost to restore is greater than the asset's carrying amount, no impairment would be recognised. The estimated repair costs are based on those costs to restore the service potential of the existing asset to it pre-impaired level. Therefore, betterment costs are not included in the estimated costs to repair. For example, if a Council will replace part of a damaged water piping network with pipes of a larger diameter, the replacement cost of the pipes shall be based on the existing pipe diameter and material. Excluding expected betterment costs in the impairment test will ensure the asset impairment is not overstated. **The impairment loss cannot exceed the pre-damaged carrying amount of the asset.**

Issue	Summary of view
	Application to assets measured at fair value For PPE measured using the fair value model and that are carried at a **recent** DRC (for example, infrastructural assets and specialised buildings), a reasonable proxy of the impairment charge would be the amount of the estimated earthquake damage repair costs. In this situation, it would be reasonable to assume that the pre-impaired carrying value of DRC assets immediately prior to the earthquake materially approximates their DRC. If actual repair costs are greater or less than estimated, we consider the difference to be an adjustment to the initial estimate that is accounted for in the same manner as the initial impairment. An appropriate threshold may need to be applied to this to avoid complexity. The outstanding estimated repair costs for impaired assets at each year end will need to be re-assessed and the adjustment accounted for in the same manner as the initial impairment. ***Application to assets measured at cost*** The DRC less the cost of earthquake repairs would first need to calculated and then compared to the carrying amount of the asset. For older assets, this may result in no impairment charge being recognised as the cost of replacement may have increased significantly since the asset was acquired.
Where asset write-off and impairment events occur at the same time within the same asset class, what event is accounted for first when determining the revaluation reserves of a revalued asset class?	**Relevant for PBEs** Our view is that the revaluation reserves allocated to assets that must be derecognised/disposed of are first transferred from asset revaluation reserves to general funds/retained earnings within equity before accounting for impairments. This accounting is the most logical as it ensures impairments are not utilising revaluation reserves that no longer exist.

Issue	Summary of view
What if there is uncertainty about whether assets are impaired or uncertainty about the amount of impairment?	**Relevant for PBEs and for-profit entities** When impairing an asset, entities will need to make a best estimate of the impairment. Our experience from the Canterbury earthquakes was that, in some circumstances, entities may be unable to fully determine the extent of damage and/or the impairment to its damaged assets to reliably recognise an impairment charge by the time the financial statements are to be authorised for issue – for example, a stretch of underground piping may not be working due to damage but it is uncertain whether all or part of the piping requires repair/replacement. These issues create uncertainty about asset carrying amounts, impairment charges, and related insurance recoveries. A balance sheet materiality alone is unlikely to be appropriate in deciding on the materiality of these issues as related insurance recoveries are recognised in the surplus/deficit and/or there may not be sufficient reserves in equity to absorb the total potential impairment charge.

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<tr><td>How should earthquake damage repair costs be accounted for?</td><td>Relevant for PBEs and for-profit entities
If the earthquake has affected the future economic benefits or service potential of an asset (for example, the building is not able to be fully used), the repair costs to reinstate the future economic benefits or service potential should be considered for capitalisation. Examples where the future economic benefits or service potential of a building is likely to have been affected include:
Where a building is unable to be used to deliver educational services due to earthquake damage and the damage is repairable. For example, a building is unable to be occupied until the damaged stairwells have been replaced.
Where part of a building is unable to be used to deliverer educational services due to earthquake damage and the damage is repairable. For example, the top three floors of a building cannot be used until all broken windows and fittings have been replaced.
Where the useful life of a building has been notably affected by the earthquake. For example, a building that will require structural strengthening to ensure the continued delivery of educational services.
We consider that where the future economic benefits or service potential of an asset has not been affected (for example, a building is able to be fully used), it would be reasonable to expense all repair costs. For example, the cost of repairing cracks in a building that is able to be used to provide educational services before being repaired should be expensed as incurred.
The extent of damage and the impact of the damage on the use of the building are likely to influence the assessment of whether repair costs are considered minor and therefore expensed.
Judgement will need to be exercised in deciding whether the earthquake damage to an asset would trigger an impairment test and whether repair costs should be capitalised. Entities with significant asset damage may need to develop appropriate guidelines to ensure a consistent approach is taken in making this assessment.</td></tr>
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Issue	Summary of view
How should earthquake repair work that is temporary in nature be accounted for?	**Relevant for PBEs and for-profit entities** Some earthquake repair work may only be temporary in nature, with longer lasting repairs to be carried out in the near term. The accounting treatment for temporary repairs will depend on the length of time the temporary repair work is expected to last for. Temporary earthquake repair works that are expected to last for less than 12 months would typically be expensed. Temporary earthquake repair works that are expected to last for greater than 12 months would typically be capitalised and depreciated over their useful life.
What if three-yearly revaluations are due for the upcoming year end?	**Relevant for PBEs and for-profit entities** If an entity is due for a revaluation per their accounting policy, the non-performance of a revaluation would be acceptable only if the entity can demonstrate it is compliant with PBE IPSAS 17/NZ IAS 16 paragraph 44/31. The requirement of paragraph 44/31 is that valuations are to be made with sufficient regularity to ensure that the carrying amount of revalued assets do not differ materially from that which would be determined using fair value (taking into account impairment) at the end of the reporting period. For entities that do not plan on revaluing at year end, they will need to assess whether the carrying value of revalued assets approximates their fair value (factoring in impairment). This should be completed as per the normal non-revaluation year assessment of the likelihood of a change in fair value with reference to either valuers, or the applicable indices. If there is sufficient evidence that the current carrying value of assets is not materially different from fair value, then no valuation is required.

Issue	Summary of view
How should spikes in contract prices be dealt with for asset capitalisation and revaluations?	**Relevant for PBEs and for-profit entities** Following a major disaster there could be higher tendered prices from contractors for repair and construction work due to the demand for construction work. The price paid for expenditures that satisfy the asset recognition criteria is the amount that should be capitalised. If price spikes are short-term in nature, then the excess price will be washed out in the next revaluation for revalued assets. The replacement costs that are used in DRC calculations should reflect typical and sustainable market conditions. Short-term market fluctuations should be corrected by asset valuers, and the method of adjustment (such as the average of the last three years) should be stated in their valuation report. Entities will need to work with their valuers to ensure that any temporary price spikes are excluded from DRC valuations. However, given the lengthy time period that can be necessary to rebuild after earthquakes (as is still experienced in Christchurch), valuers and auditors will need to give careful consideration to whether any contract price increases can reasonably be considered temporary. Auditors will need to carefully assess the reasonableness of any valuation assumptions in relation to price spikes made by valuers.
Do useful lives need to be re-assessed?	**Relevant for PBEs and for-profit entities** PBE IPSAS 17/NZ IAS 16 paragraph 67/51 requires the useful life of an asset to be reviewed at least at each year end, and requires any changes to the useful life to be accounted for as a change in accounting estimate. The useful life assessment of an asset will need to take into account any earthquake damaged sustained to assets and any repairs and replacements to assets.

Issue	**Summary of view**
Accounting for government assistance, such as grants	
What principles shall be applied to the recognition of government grants that are in substance similar in nature to insurance recoveries?	**Relevant for PBEs** The Crown provides a funding mechanism to local authorities for repairing infrastructure (excluding roads) damaged by a natural disaster under the National Civil Defence Emergency Management Plan (CDEM). Broadly, the Crown will reimburse 60% of the eligible repair costs above specified thresholds. The CDEM is complimented by the Local Authority Protection Programme (LAAP), which is a mutual fund where Councils can purchase insurance to insure the remaining 40% of infrastructure damage. We consider there are 2 alternative views in accounting for the government's obligations under the CDEM, as follows: - View 1 – The CDEM policy has features of an insurance arrangement (i.e. compensates the holder for damage arising from a natural disaster above pre-specified amounts) but without an insurance premium. Insurance type accounting therefore applies. - View 2 – The CDEM policy is a grant scheme for damaged Council infrastructure. Grant accounting therefore applies. Grant accounting with conditions arguably would apply as the funds are only paid when eligible repair costs are incurred by the Council. ***Crown expense and liability*** Under the insurance approach, the Crown would recognise an expense and liability up front (i.e. once the event that causes damage occurs) based on the best estimate of the expected expenditure required to settle its obligations under the CDEM. In this case, it is the disaster event that creates the past event that gives rise to a present obligation. Under the grant approach, the Crown would recognise a liability and expense as eligible costs are incurred by the Council in repairing damaged infrastructure as there is a condition attached for the payment of monies to the Council. In this case, it is the incurrence of eligible costs that is the past event that gives rise to a present obligation.

Issue	Summary of view
	Recognition of revenue from the CDEM Under the insurance approach, the Council would recognise revenue when the receipt of the funding is considered "virtually certain", consistent with other insurance guidance as discussed above. This could result in revenue recognition prior to a Council incurring eligible costs under the CDEM policy. Due to the challenges in reliably estimating the costs expected to be incurred that would be covered by the CDEM framework, it could be possible during the early stages of a disaster that the future funding to be received under the CDEM guidelines is only reliably measurable by the Council when the costs are incurred under the insurance approach. Under the grant approach, PBE IPSAS 23 *Revenue from Non-exchange Transactions* would apply. As the grant includes conditions to receive funding (incurring eligible expenditure), the revenue would be recognised as eligible costs are incurred by the Council in repairing damaged infrastructure. While our preferred treatment is the insurance accounting approach explained above, we acknowledge that it is reasonably arguable that the CDEM is characteristic of a grant scheme with conditions and therefore could accept a Council accounting for revenue under the CDEM when eligible costs are incurred. ***CDEM payments in advance*** Under the CDEM guidelines, the government can provide advance payments. This is subject to Cabinet approval. Accounting for the payment in advance will depend on the terms and conditions attached to it. If there are no terms or conditions attached to the advanced funding, the funding will clearly be revenue at the earlier of approval or receipt. If there are terms and conditions attached to the advanced funding, the terms will need to be considered as to whether there is any basis for deferral of revenue recognition.

Issue	Summary of view
Other recognition and measurement matters	
How should potentially onerous contracts (including leases) be accounted for?	**Relevant for PBEs and for-profit entities** An onerous contract is a contract where the unavoidable costs of meeting the obligations of the contract exceed the economic benefits or service potential expected to be received under it. The unavoidable costs under a contract reflects the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. Entities are required by PBE IPSAS 19/NZ IAS 37 paragraph 76/66 to recognise onerous contracts as a provision. Entities will need to consider whether any purchase and supply contracts have become onerous and therefore a provision is required to be recognised. For example, if an entity has leased premises in a structurally unsafe building and is unable to use the premises, and is obliged to continue making lease payments, an onerous contract provision would need to be recognised for the required lease payments for which no benefit will be received. Insurance recoveries related to provisions are recognised as an asset if it is virtually certain the recovery will be received. PBE IPSAS 19/NZ IAS 37 paragraph 63/53 requires the insurance recovery asset to be presented separately from the related provision. PBE IPSAS 19/NZ IAS 37 paragraph 64/54 provides an option to present insurance recovery revenue and associated provision expense net or gross in the statement of comprehensive revenue and expense/income. Our preferred view is the amounts should be presented gross to be consistent with the presentation of other insurance recoveries. In order to offset a provision expense and insurance revenue, our view is the insurance recovery needs to be directly related to the provision expense (e.g. the insurance recovery is for the cost of the onerous lease contract, not for reimbursement of additional lease costs incurred by the entity because they have had to lease new premises). A force majeure clause in a contract may relieve an entity from a potential onerous contract. Entities may need to seek legal advice on whether such clauses can be applied in the circumstances.

Issue	Summary of view
When should lease make-good provisions be derecognised?	**Relevant for PBEs and for-profit entities** There may be circumstances where an obligation related to an asset has been extinguished due to an earthquake. For example, an entity that has recognised a lease make-good provision for a leased building that has since been demolished following the earthquake. The lease make-good obligation is derecognised because the entity no longer has a legal obligation to make-good the leased premises as they no longer exist. Entities will need to provide support that evidences the derecognition of an asset-related obligation. For a leased building, this could be confirmed in writing by the landlord, evidence confirming the building will be (or has been) demolished, or confirmation from the landlord that the lease contract has been cancelled.

What is the treatment of leasehold improvements and/or fixtures and fittings where an entity does not have access to its premises?	**Relevant for PBEs and for-profit entities** Entities may not have access to leased buildings for a significant amount of time after an earthquake. Therefore, uncertainties may arise around whether leasehold improvements and/or fixtures and fittings should be impaired (and if so, by what amount) or derecognised, and the treatment of depreciation. *Impairment vs. derecognition* The first step an entity needs to take is to determine whether it will be able to occupy the building in the future to utilise the service potential of the assets inside the building. This may require judgement based on the information provided by the landlord and/or other information such as the entity's own engineering assessments. If it is more likely than not that an entity won't be able to occupy the building again because of the damage sustained to the building, the leasehold improvements and fixtures and fittings should be derecognised, with the carrying value of those assets recognised in the surplus or deficit. If it is more likely than not that the building will not be demolished, and it is expected that the entity will be able to occupy the building at some point in the future to access the service potential of the assets inside, impairment needs to be considered. Assets becoming idle is an indicator of impairment, which would require an entity to test those assets for impairment. Therefore, entities in this situation will be required to calculate the recoverable amount of the asset for comparison to its carrying amount, with any excess of the carrying amount over the recoverable amount recognised as an expense. *Impairment* One approach to determining value in use under PBE IPSAS 21 is to apply the service units approach whereby an entity determines the current value of the asset by determining the depreciated replacement cost of the asset and then reducing that for the time the asset is not expected to be in use (the service units in this case would be reflective of time). This may or may not result in an impairment adjustment as it would be dependent on how replacement costs have changed since initial recognition of the asset. As a practical expedient, a reasonable approach to determining the impairment of the asset would be to reduce the net book value by the amount of the depreciation charge for the period that the asset is not expected to be in use. This approach may not be appropriate if replacement costs have changed significantly since acquisition of the asset.

Issue	Summary of view
	Depreciation PBE IPSAS 17/NZ IAS 16 requires assets to be depreciated over their useful life, which is the period over which an asset is expected to be available for use by an entity. PBE IPSAS 17 paragraph 71 also states depreciation starts when an asset is available for use. In the context of assets whose service potential cannot be utilised because of lack of building access due to damage, it could be interpreted from these requirements that the asset would only be depreciated while the building is in a condition that it can be occupied in the future. This would mean no depreciation during the period the building is not available for use. However, PBE IPSAS 17/NZ IAS 16 paragraph 71/55 states that depreciation does not cease when an asset becomes idle unless it is fully depreciated. It is unclear whether paragraph 71/55 means that an asset must still be depreciated because it is idle due to it not being in a condition to be able to be used. Our preferred view is the asset would not be depreciated while it is unable to be used to be consistent with the basis of the impairment calculation discussed above. PBE IPSAS 17/NZ IAS 16 paragraph 94(a)/79(a) encourages disclosure of the carrying amount of temporarily idle property, plant and equipment if this is relevant to the needs of users. *Judgements* Decisions around derecognition and impairment will require the use of professional judgement by entities and auditors. Where the entity or auditor is unable to make judgements because information is not available (e.g because the condition of assets is not known due to lack of building access), and this could result in a material limitation in scope, the auditor will need to consider the impact this might have on the audit report.

Issue	Summary of view
How should Council-generated obligations to strengthen earthquake prone buildings be accounted for?	**Relevant for PBEs and for-profit entities** Under the Building Act 2004, Councils are required to have a policy for earthquake prone buildings which may include the requirement for building owners to strengthen earthquake prone buildings within a certain timeframe. Some Councils have a policy that earthquake strengthening needs to be above the legislative minimum of 33%. Our view is that if an entity owns an earthquake prone building there is no present obligation to strengthen under these policies, and therefore no provision is recognised. This is because the entity has the ability to avoid future expenditure by its future actions (refer to paragraph 27/19 of PBE IPSAS 19/NZ IAS 37) as they have the choice of either: 1) Strengthening the earthquake prone building; 2) Demolishing the earthquake prone building to build a new one; 3) Continuing to use the building until the Council blocks access to it due to it being unsafe; or 4) Selling or abandoning the building. However, the earthquake prone status of a building does become an asset measurement (or revaluation) issue. In particular, we would expect valuers to make any required adjustments to fair value calculations for earthquake prone buildings – for example: • For a commercial-based fair value of an earthquake prone building, valuers will need to consider the negative effects this has on the fair value of the building – for example, reduced rent or cash outflow for the estimated strengthening costs. • For a depreciated replacement cost (DRC) valuation, we would expect a negative effect to the valuation of an earthquake prone building to be reflected by including a negative adjustment to the DRC for the estimated replacement cost if the replacement costs are based on code compliant building. Estimates of strengthening costs should be on the basis of strengthening the building to the required standard for its future use. This standard might be higher than that required by the Council.

Issue	Summary of view
Do the impairment standards (PBE IPSAS 21, PBE IPSAS 26, and NZ IAS 36) apply to investment property?	**Relevant for PBEs and for-profit entities** Our interpretation of PBE IPSAS 16/NZ IAS 40 paragraph 84(a)/73(a) and the scoping of the impairment standards is that only investment properties measured at cost are required to be considered for impairment under the impairment standards. This is because the impairment standards (refer paragraph 2(d) of PBE IPSAS 21/PBE IPSAS 26 and paragraph 2(f) of NZ IAS 36) are clear that revalued investment property is outside their scope, therefore only investment property at cost is within its scope. For revalued investment property that is damaged by an earthquake, the normal capitalisation and derecognition rules would apply (paras 20 to 25 of PBE IPSAS 16/16 to 19 of NZ IAS 40) when accounting for earthquake damage repairs. The fair value of the investment property at balance date will need to reflect the condition of the asset at balance date (which may be in an unrepaired or partially repaired state) and consider other assumptions (for example, capitalisation rates, levels of rent, and occupancy rates) that affect the fair value of the property.
Should PPE that has an unknown future use following the earthquake be reclassified as investment property?	**Relevant for PBEs and for-profit entities** There may be situations where the future use of PPE is considered uncertain following the earthquake and a decision on its future use has not yet been made by balance date. For example, an entity may be uncertain as to whether they will re-occupy their premises in an area affected by a significant earthquake. PBE IPSAS 16/NZ IAS 40 *Investment Property* suggests land and buildings with an uncertain future use may need to be reclassified as investment property. Our view is PPE with an uncertain future use due to earthquake issues shall not be reclassified unless a formal decision has been made by an entity to change its future use.

Issue	Summary of view
When should a provision be recognised for earthquake clean-up/damage obligations?	**Relevant for PBEs and for-profit entities** A clean-up/damage provision is recognised only when an entity has either a legal or constructive obligation to clean up/repair. When there is no legal or constructive obligation, clean up/repair costs are a future operating cost that must be expensed as incurred The following are examples where an obligation may require recognition: • Where the lessee has a contractual obligation to make-good an earthquake damaged leased asset. • Where a building owner is legally required to demolish a building. • Where a Council has created a constructive obligation through past practice or clear and specific public statements of cleaning up earthquake damage, such as land slips over roads. The accounting for constructive obligations can require significant judgement.
How should the costs of engineering assessments be accounted for?	**Relevant for PBEs and for-profit entities** A cost incurred by some entities after the earthquakes has been obtaining engineering assessments of buildings to determine the extent of any damage and whether the buildings are structurally sound to enable them to be reoccupied. **These costs should be expensed as they are incurred.** They do not meet the recognition criteria for capitalisation nor should they be recognised as a provision in advance of the work being performed. If the engineering assessments require invasive investigation (e.g. carpet is required to be pulled up or walls removed) the entity will also need to consider whether there is damage to assets that would result in an impairment expense.

<table>
<tr><th>Issue</th><th>Summary of view</th></tr>
<tr><td>Can salary costs associated with the secondment of staff be offset by a reimbursement of those costs?</td><td>Relevant for PBEs and for-profit entities
The rebuttable presumption in PBE IPSAS 1/NZ IAS 1 is that revenue and expenditure should not be offset, except when offsetting reflects the substance of the transaction. Typically, offsetting would occur where there is a debtor/creditor transaction with the same counter-party or where an entity is acting as an agent for the other entity.
Therefore, our general view is that reimbursement of salary costs should not be offset against the cost of seconded staff because this would not reflect the substance of the transaction.
It may be appropriate to offset secondment costs where the substance of the arrangement is that the employee has permanently changed employer but is still being paid by the entity that has provided the employee as a secondee. In this situation, the entity is acting, in substance, as an agent for the entity reimbursing the costs.</td></tr>
<tr><td colspan="2">Disclosures</td></tr>
<tr><td>What disclosures are required as a result of the earthquakes?</td><td>Relevant for PBEs and for-profit entities
For those entities significantly affected by an earthquake, we encourage entities to include a single note about the event dealing with all the required disclosures rather than having disclosures about the event scattered throughout the financial statements. The detail and extent of disclosure will depend on the effects of the disaster to the entity.
The following disclosure requirements may be relevant for entities affected by the an earthquake:
PBE IPSAS 1/NZ IAS 1 Presentation of Financial Statements:
Paragraph 137/122 – Disclose significant judgements made in applying accounting policies. For example, if significant judgement has been exercised in determining whether earthquake damage should be treated as impairment, derecognition, or repairs and maintenance.
Paragraph 140/125 – Disclose the significant assumptions and estimates applied in accounting for the effects of an earthquake. For example, disclose information about the uncertainties surrounding the estimate of asset impairments or measurement of insurance receivables.</td></tr>
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Issue	Summary of view
	• PBE IPSAS 1.148.1/FRS-44 – When budget figures are presented, disclose major variances against budget due to the disaster. PBE IPSAS 17/NZ IAS 16 *Property, Plant and Equipment:* Paragraph 89(d)*/74(d)* – If not disclosed separately in the statement of comprehensive revenue and expense/income, disclose the amount of compensation from third parties for items of PPE that were impaired, lost or given up. Note that this disclosure requirement is not required if the entity is applying the reduced disclosure regime. We would encourage separate disclosure of earthquake recoveries on the face of the statement of comprehensive revenue and expense/income or in the notes when the amounts are material. PBE IPSAS 21 *Impairment of Non-Cash-Generating Assets*/PBE IPSAS 26 *Impairment of Cash-Generating Assets*/NZ IAS 36 *Impairment of Assets* • Paragraph 73/115/126 – Disclose the amount of impairment losses (and any reversals of impairment losses) recognised in the surplus/deficit (and which line items). • Paragraph 77*/120*/130* – For material impairments of individual assets, disclose: o The events and circumstances that led to the impairment. o The amount of the impairment loss and nature of assets. o Whether the recoverable amount was fair value less costs to sell or value in use. • Paragraph 78*/121*/131* – For immaterial impairments, disclose: o The main classes of assets affected by impairment losses. o The main events and circumstances that led to the impairment. (Note, an aggregated disclosure on impairment is probably useful for entities significantly affected by the earthquake.) PBE IPSAS 19/NZ IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* • Paragraph 98/85 – For provisions created as a result of earthquakes:

* Not required if the entity is applying the Reduced Disclosure Regime

Issue	Summary of view
	o Provide a description of the nature of any obligation and expected timing of any resulting outflows, including an indication of uncertainties about the amount or timing of these outflows. o The amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement (not required if the entity is applying the Reduced Disclosure Regime). • Paragraph 100/86 – Certain information may need to be disclosed for contingent liabilities related to the disaster. • Paragraph 105/89 – Disclose information about contingent assets in relation to insurance recoveries not recognised. ***For PBEs only:*** • PBE IPSAS 17, paragraph 92(c) – For PPE at revalued amounts, disclose the significant methods and assumptions applied in estimating fair values. • For cost of service statements, earthquake related costs and revenue could be disclosed as separate line items or included in the relevant activity line items. ***For for-profit entities only:*** • NZ IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance,* paragraph 39 – Disclose the nature and extent of government grants and assistance recognised in the financial statements and unfulfilled conditions or other contingencies attached to these. If an entity's revenue accounting policies do not adequately deal with the government grants received, disclose the accounting policy for such government grants. • NZ IAS 36, paragraph 126(c),(d) – Disclose the amount of impairment losses (and reversals of impairment losses) recognised in other comprehensive income (for revalued assets).

Appendix 1: Decision tree – Accounting for earthquake damage to public benefit entity PPE