

Local Government - Accounting for Natural Disasters

2016-17



Local Government Victoria, FG 5 - 2017

Acknowledgements

Local Government Victoria acknowledge the contribution of RSM Bird Cameron to the development of the original version of this publication.

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ISBN 978-1-76047-431-7 (pdf/online)

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Foreword

In recognition of the impact of recent years' natural disasters in Victoria, including flood events, the Department of Environment, Land, Water and Planning (DELWP) is reissuing "*Accounting for Natural Disasters*". The guide was originally issued by Local Government Victoria in 2011 to assist councils with the required accounting recognition, measurement and disclosure requirements that may arise as a result of a natural disaster.

Since then, the Victorian Government has sought to better coordinate responses to emergencies and natural disasters. The *Emergency Management Act 2013* enables organisations with an emergency management role to come together to help prevent, prepare for, respond to and recover from emergencies and natural disasters. Victorian emergency managers work together to support safer and more resilient communities. For local governments, often at the front line of emergencies arising from natural disasters, the work of recovery can be long and arduous. Accurate accounting of the costs of recovery are an important part of an effective response and Local Government Victoria (LGV) is committed to providing targeted support to enhance natural disaster management capability and capacity within local government.

This re-issued LGV financial guidance has been updated to include current references to accounting standards and other authoritative guidance material however the substance of the document remains consistent with the previous edition. This financial guidance forms part of the suite of guidelines developed by LGV to provide accounting support to councils.

Key areas of focus are:

- items of property, plant, equipment or infrastructure damaged or destroyed;
- costs of restoring, replacing or reconstructing damaged or destroyed property, plant, equipment or infrastructure;
- damaged or destroyed inventory;
- insurance recoveries;
- future expected costs or claims against councils;
- funding provided as a result of a natural disaster;
- impact on creditors and borrowings;
- debt collectability;
- going concern implications; and
- the consideration of subsequent events.

While every attempt has been made to ensure this guide is accurate councils are encouraged to seek professional advice, if necessary, on application to their individual circumstances.

I trust you find the 2017 edition of "*Accounting for Natural Disasters*" a useful reference in determining the accounting treatment required in the event of a natural disaster.

Dr Graeme Emonson

Executive Director

Local Government Victoria

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1 How items of property, plant, equipment or infrastructure damaged or destroyed, are accounted for in the financial statements

Councils that have been directly affected by a natural disaster, such as flooding or bushfire, may have damaged or destroyed physical assets. These events can affect a Council's ability to service the community. Management need to assess the impact of a natural disaster, including accurate accounting of the damage in order to support recovery and future planning.

Impairment testing is an important first step to identifying correct carrying values at balance date. Some assets following natural disasters may be completely destroyed or lost, while other assets may be subject to restoration and reinstatement.

This section covers the application of relevant accounting standards related to natural disasters, specifically paragraph 12(e) of AASB 136 *Impairment of Assets* ("AASB 136") that identifies physical damage as one of a number of internal sources of information available to management as an indicator of impairment. Where this has occurred, the following guidance can assist in the recognition and measurement of asset impairment in the financial statements.

1.1 What accounting standards need to be considered in regards to impairment?

AASB 136 *Impairment of Assets* provides guidance on how to recognise and measure the impairment of assets in the financial statements. AASB 136 prescribes the approach of assessing the carrying amount of non-financial assets, including physical assets, and intangibles. Some physical assets that have been damaged or destroyed may need to be written-off immediately, while other assets, including intangible assets, may need to be tested for impairment to determine the impact of natural disasters on their recoverable amount.

AASB 116 *Property, Plant and Equipment* provides key recognition and measurement requirements in respect to non-current physical assets.

1.2 Whether impairment is required to be recognised in the financial statements?

Some key rules need to be identified upfront in considering when an impairment test is required, and when an impairment loss is to be recognised in the financial statements:

1. **Assets damaged, where there is intention to repair, but not conducted prior to 30 June** – these assets will still have their carrying values recorded at pre-natural disaster stage (prior to the damage occurring), therefore an impairment assessment will need to be conducted by management at 30 June, and any actual impairment will need to be accounted for in accordance with AASB 136 at this date.
2. **Repairs or replacements made to assets before 30 June** – if assets have been damaged or partially replaced as a result of a natural disaster and are in use at normal capacity before 30 June, then an impairment test will not be required as the asset's carrying value and its use has returned back to its condition pre-natural disaster.
3. **Assets completely destroyed, or where no repairs are intended** – if the carrying value of assets have been written down during the period, or if the assets have been completely written-off (derecognised) prior to 30 June, further impairment tests at balance date are not required in respect of these assets.

This guidance will assist Councils in accounting for an impairment loss, as well as the accounting treatment for fully written-off assets.

1.3 What is an impairment loss?

Paragraph 6 of AASB 136 defines an impairment loss as:

The amount by which the carrying amount of an asset (or cash-generating unit), exceeds its recoverable amount.

Where there is an **indication** that an asset may be impaired, the Council needs to estimate the recoverable amount of the asset. An impairment loss is required to be recognised in respect of an asset when its recoverable amount is less than its carrying amount.

Some key definitions need to be noted to assist in comprehending these guidance steps. Paragraph Aus 32.2 and paragraph 6 of AASB 136 define the following:

Table 1A: Impairment of assets – key definitions

Term	Definition
Carrying amount	is the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.
Current replacement cost	is an asset's cost measured by reference to the lowest cost at which the gross future economic benefits of that asset could currently be obtained in the normal course of business.
Depreciated replacement cost	is the current replacement cost of an asset, less, where applicable, accumulated depreciation calculated on the basis of such cost to reflect the already consumed or expired future economic benefits of the asset.
Depreciation (and amortisation)	is the systematic allocation of the depreciable amount of an asset over its useful life.
Fair value less costs of disposal	is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, less the costs of disposal.
Recoverable amount	is the higher of the fair value less costs of disposal and value in use.
Useful life	is the period of time over which an asset is expected to be used by the entity (council).
Value in use	is the present value of the future cash flows expected to be derived from an asset or cash generating unit.

1.4 What types of asset classes need to be considered?

Property, plant, equipment and infrastructure assets are tangible assets that are expected to be used in more than one period of operations by a Council. These include the following:

Table 1B: Asset classes common to Local Councils

Asset classes	Includes	Examples
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Property	Land	<ul style="list-style-type: none"> land and land improvements land under roads
	Buildings	<ul style="list-style-type: none"> buildings (including heritage buildings) building improvements fit-outs, air-conditioning and lifts leasehold improvements
Plant and equipment	Plant, machinery and equipment	<ul style="list-style-type: none"> graders tractors and front end loaders lathes welders motor vehicles other
	Computers and telecommunications	<ul style="list-style-type: none"> hardware integral operating system software cabling phones faxes microwave links
	Fixtures, fittings and furniture	
	Leased plant and equipment Heritage assets Library books	
Infrastructure	Roads sealed and unsealed	<ul style="list-style-type: none"> pavements and seals substructure formation and earthworks kerb, channel and minor culverts other- traffic islands, signage and traffic management devices
	Bridges- including major culverts	<ul style="list-style-type: none"> deck substructure guardrails
	Footpaths and cycle ways Drainage Recreational, leisure and community facilities Waste management- landfill and weighbridges Parks, open space and streetscapes Aerodromes Off street car parks Other infrastructure (i.e. piers, jetties, caravan parks)	

1.5 How is impairment recognised in the financial statements?

Items of property, plant, equipment and infrastructure damaged or destroyed by the floods will need to undergo an impairment assessment or be written-off immediately. Impairment of assets needs to be recognised in accordance with AASB 136.

AASB 136 requires an impairment test to be conducted when there is an indicator of impairment; this being the recent floods (physical damage as an indicator).

Certain assets may have been damaged to such a degree that they will no longer be in use and there are no proceeds expected from their disposal. If a natural disaster has damaged an asset to the extent that a repair is not possible and the asset is deemed to have no further use, then the asset needs to be derecognised.

If only part of an asset is damaged, and that part will be replaced, then the damaged portion of the asset is required to be derecognised, even if it was not being separately depreciated (or amortised). Subsequently, the replacement cost of the segment of the asset can then be recognised as part of the carrying amount of that asset.

This section has been split into two specific areas:

- Immediate write-off of an asset lost or completely destroyed (section 1.6.1)
- Impairment loss of an asset damaged (section 1.6.2)

1.5.1 Immediate write-off of an asset lost or completely destroyed (derecognition)

Paragraph 67 of AASB 116 states that:

The carrying amount of an item of property, plant and equipment is derecognised:

- (a) on disposal; or
- (b) when no future economic benefits are expected from its use or disposal.

The gain or loss arising from the derecognition of an item of property, plant, equipment or infrastructure is required to be recognised as either a gain or loss in the Comprehensive Income Statement on the date of derecognition. Essentially, this will be, at a basic level:

- Dr Written down value of assets disposed
- Cr Property, plant, equipment or infrastructure required to be immediately written-off

Corresponding disclosure is required.

What if compensation is received in respect of the written-off asset?

AASB 116 requires the impairment and derecognition of assets and any potential compensation claims relating thereto, to be treated as separate economic events and accounted for separately in the period in which each separate transaction occurs.

It is not appropriate to net these events off by not recording an impairment loss; separate recording of these events may result in a loss relating from the impairment to occur in one reporting period, with the receipt of compensation occurring in a subsequent reporting period.

Paragraph 65 and 66 of AASB 116 requires compensation received and receivable by entities in respect of damage to property, plant, equipment or infrastructure to be included in the Comprehensive Income Statement as a profit or loss.

Compensation for Impairment

65. Compensation from third parties for items of property, plant and equipment that were impaired, lost or given up shall be included in profit or loss when the compensation becomes receivable.

66. Impairments or losses of items of property, plant and equipment, related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets are separate economic events and are accounted

for separately as follows:

- (a) impairments of items of property, plant and equipment are recognised in accordance with AASB 136;
- (b) the derecognition of items of property, plant and equipment retired or disposed of is determined in accordance with this Standard;
- (c) compensation from third parties for items of property, plant and equipment that were impaired, lost or given up is included in determining profit or loss when it becomes receivable; and
- (d) the cost of items of property, plant and equipment restored, purchased or constructed as replacements is determined in accordance with this Standard.

Compensation for damages experienced by Councils is likely to come in the form of government funding or insurance recoveries. Councils can only recognise compensation as a receivable if management are 'virtually certain' that the compensation will be received. Management will need to seek confirmation from their insurance provider or grantor, by way of written consent, that an unconditional contractual right exists for receipt of compensation under the insurance policy (successful claim assessment) or other agreement, for it to be deemed a 'receivable' prior to it being recognised in the financial statements.

Please refer to *Section 4 How are actual or anticipated insurance recoveries accounted for as a result of a natural disaster?* for further detail on how to assess when compensation for damage or loss to property, plant, equipment or infrastructure is receivable.

If a Council receives funds from a government department for damaged assets, then they will also need to consider how to account for such contributions. This is discussed in *Section 6 How should funding provided as a result of a natural disaster be recognised in the financial statements?*

Let's look at an example that incorporates the derecognition of a destroyed asset and the recognition of subsequent compensation for the destroyed asset.

Example 1 – Derecognition of a destroyed asset and subsequent receipt of compensation

Example

On 31 January 2011, the flood disaster destroyed a pedestrian bridge owned by the Australian City Council ("City Council"). The carrying amount (at depreciated replacement cost) of the bridge was \$500,000 (current replacement cost of \$700,000 less \$200,000 accumulated depreciation).

The City Council immediately registered a claim of \$700,000 for the replacement costs of the pedestrian bridge with their insurance company.

On 15 March 2011, the insurance company confirmed, via formal correspondence, to the City Council that its claim would be settled in full. The insurance company paid the Council the \$700,000 on 31 March 2011.

On 15 April 2011, the City Council utilised the \$700,000 to rebuild the pedestrian bridge, which was ready for use on 15 June 2011.

What is the impact on the City Council's financial statements for the year ended 30 June 2011?

31 January 2011

Dr Accumulated depreciation (contra-asset)	\$ 200,000	
Dr Impairment expense— infrastructure assets (expense)	\$ 500,000	
Cr Infrastructure— bridge gross carrying amount (asset)		\$ 700,000

To record the impairment and derecognition of the pedestrian bridge destroyed by the floods

15 March 2011

Dr Receivable (asset)	\$ 700,000	
Cr Insurance compensation income (income)		\$ 700,000

To record the compensation to be received from the insurance company in respect of the approved claim

31 March 2011

Dr Cash (asset)	\$ 700,000	
Cr Receivable (asset)		\$ 700,000

To record the cash receipt of the compensation from the insurance company in respect of the approved claim

15 April 2011

Dr Infrastructure— bridge (asset)	\$ 700,000	
Cr Cash (asset)		\$ 700,000

To recognise the rebuilding of the new pedestrian bridge (when available for use)

** For detail on costs allowable to be capitalised, please refer to Section 2 How are costs of restoring, replacing or reconstructing damaged or destroyed property, plant, equipment or infrastructure assets to be recognised in the financial statements?*

1.5.2 Impairment loss of damaged assets

Finite-lived assets (those that are depreciated or amortised over their useful life) are required to be tested for impairment when there is an indicator of impairment. The impact of the recent floods is an impairment indicator which will trigger the requirement for an impairment test to be performed in accordance with AASB 136.

In situations where property, plant, equipment or infrastructure is damaged, but can be repaired or a segment of the asset replaced and/or will be used in the future, it is likely that the recoverable amount of that asset is less than its carrying amount. As a result, the carrying amount of the asset is to be reduced to its recoverable amount. That reduction is known as an **impairment loss**.

Impairment loss = recoverable amount less than carrying amount

The recoverable amount is defined as the higher of an asset's:

- fair value less costs of disposal or;
- its value in use.

It is not always necessary to determine both an asset's fair value less costs of disposal and its value in use; if either of these amounts exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount.

Fair value less costs of disposal (FVLCD)

FVLCD is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, less the costs of disposal.

In measuring fair value less costs of disposal, it is not always possible to determine fair value less costs of disposal of some assets. The reason is that there may not be any basis available for making a reliable estimate of the amount obtainable from the sale of the asset in an orderly transaction between market participants. In this case, the Council may use the asset's value in use as its recoverable amount.

If FVLCD is **less than** the carrying amount of an asset, then the Council needs to assess the asset's Value in Use.

Value in use (VIU)

The value in use of an asset is the present value of the future cash flows expected to be derived from an asset or cash generating unit.

For most assets, the future economic benefits are not primarily dependent on the asset's ability to generate net cash flows. These assets are held primarily for social or strategic purposes and not for the generation of net cash inflows. Under AASB 136, value in use for these assets is deemed to be the depreciated replacement cost of the asset if the Council would (if deprived by the asset) replace its remaining future economic benefits.

Depreciated replacement cost is the current replacement cost of an asset less accumulated depreciation calculated on the basis of such cost to reflect the already consumed or expired future economic benefits of the asset.

The current replacement cost is the lowest cost at which the gross future economic benefits of that asset could currently be obtained in the normal course of the business. As per the Local Government Guidance: Accounting for non-current physical assets under AASB 116, released in 2006, this is the minimum that it would cost, in the normal course of business, to replace the existing asset with a technologically modern equivalent new asset (as opposed to a second hand asset) with the same economic benefits [gross service potential], allowing for any differences in the quantity and quality of output and in operating costs.

Infrastructure assets are typical examples of such assets. If these assets are already measured at their depreciated replacement cost, the impairment standard does not usually have any practical application. However, a natural disaster will result in damage to these assets and costs will be incurred to repair the damage. As a result, impairment will need to be booked to the estimated value of those repairs.

For other assets that are used primarily to generate revenue, value in use is the present value of the future cash flows expected to be derived from the asset. Cash flows are required to be estimated that represent management's best estimate of economic conditions that exist over the remaining life of the asset. As a result of the natural disaster, councils could be faced with such impacts as clean-up costs and reduced revenues due to operational closures. All such cash flow impacts should be taken into account.

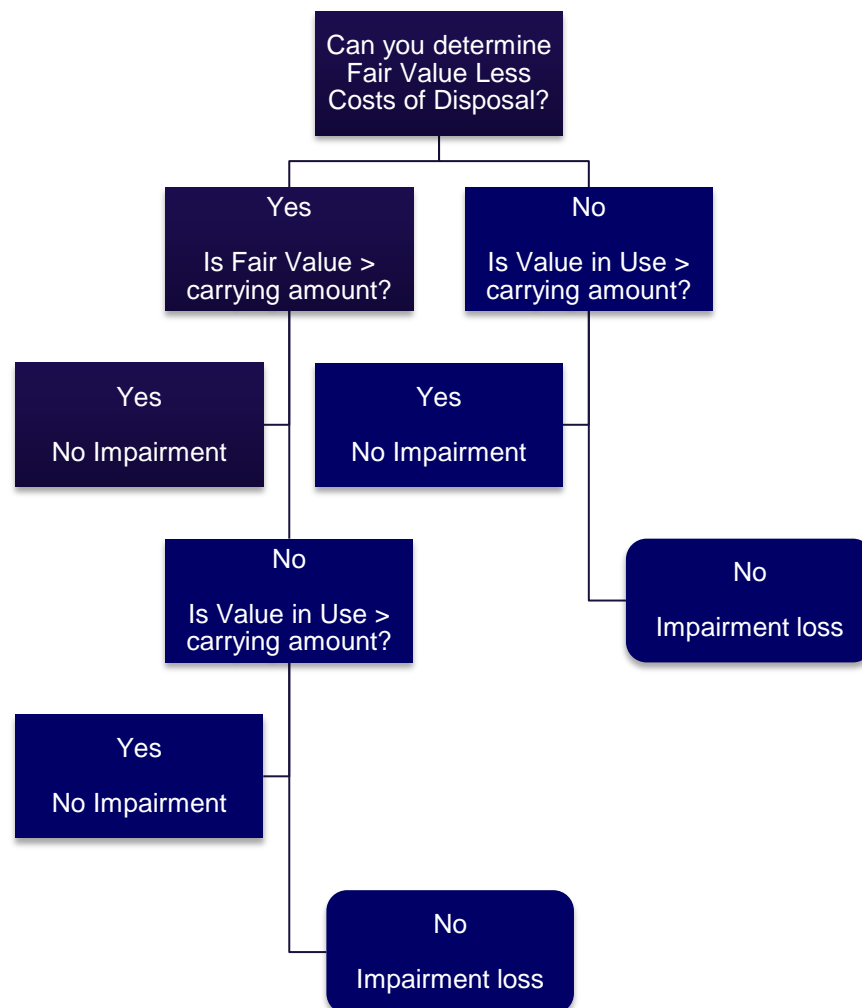
Paragraph 30 of AASB 136 states the elements that should be reflected in the calculation of the asset's value in use:

- (a) an estimate of the future cash flows the entity expects to derive from the asset;

- (b) expectations about possible variations in the amount or timing of those future cash flows;
- (c) the time value of money, represented by the current market risk-free rate of interest;
- (d) the price for bearing the uncertainty inherent in the asset; and
- (e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

Below is a diagram that depicts FVLCO and VIU to assist in determining when an impairment loss is required to be recognised.

Figure 1A Decision tree– Assessment of an impairment loss



How are impairment losses recognised?

Paragraph 60 of AASB 136 states that an impairment loss is recognised immediately as an expense in the Comprehensive Income Statement.

However, for assets carried at revalued amounts, an impairment loss is treated 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 class of asset. Any excess loss is recognised immediately as an expense.

After the recognition of an impairment loss, the depreciation (amortisation) charge for the asset is to be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value, on a systematic basis over its remaining useful life.

Let's look at an example here identifying the recognition of an impairment to an asset that has been damaged.

Example 1 – Recognition of impairment when an asset is damaged

Example

On 31 January 2011, the floods damaged a pedestrian bridge owned by the Australian City Council ("City Council") when the carrying amount of the bridge, measured at depreciated replacement cost, was \$500,000. The asset revaluation reserve in respect of this class of assets at 31 January 2011 was \$100,000.

An engineer has estimated that the cost of repairing the damage to the pedestrian bridge will be \$300,000. This expenditure will return the pedestrian bridge to its condition prior to the floods. The repairs to the bridge were carried out in July 2011.

What is the impact to City Council's financial statements for the year ended 30 June 2011?

31 January 2011

Dr Revaluation Reserve– Bridges (equity)	\$ 100,000
Dr Impairment expense– infrastructure assets (expense)	\$ 200,000
Cr Accumulated impairment–against assets carrying value (contra asset)	\$ 300,000

To record the impairment of the pedestrian bridge damaged by the floods (repairs cannot be considered in the current financial year as they occurred in July 2011)

Please note: The treatment of the cost of the repairs and their impact on the carrying value of the asset, subsequent to 30 June, is discussed in *Section 2 How are costs associated with restoring, replacing, or reconstructing damaged or destroyed property, plant, equipment or infrastructure recognised in the financial statements?*

The damage caused by the floods may also result in the need to reassess the residual values and useful lives of items of property, plant, equipment and infrastructure. As stated in paragraph 17 of AASB 136 *"if there is an indication that an asset may be impaired, this may indicate that the remaining useful life, the depreciation (amortisation) method or the residual value for the asset needs to be reviewed and adjusted in accordance with the Standard applicable to the asset, even if no impairment loss is recognised for the asset"*.

Management should consider the effect of the disaster on the expected remaining useful life of the assets on the estimated cash flows over this period to determine the recoverable amount of the physical assets.

1.6 What are the disclosure requirements?

Councils are required to disclose the following for each material impairment loss recognised during the period in accordance with paragraph 130 of AASB 136:

- (a) the events and circumstances that led to the recognition or reversal of the impairment loss.
- (b) the amount of the impairment loss recognised or reversed.
- (c) for an individual asset:
 - (i) the nature of the asset; and
 - (ii) if the entity reports segment information in accordance with AASB 8, the reportable segment to which the asset belongs.
- (d) for a cash-generating unit:
 - (i) a description of the cash-generating unit (such as whether it is a product line, a plant, a business operation, a geographical area, or a reportable segment as defined in AASB 8);
 - (ii) the amount of the impairment loss recognised or reversed by class of assets and, if the entity reports segment information in accordance with AASB 8, by reportable segment; and
 - (iii) if the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash-generating unit's recoverable amount (if any), a description of the current and former way of aggregating assets and the reasons for changing the way the cash-generating unit is identified.
- (e) the recoverable amount of the asset (cash-generating unit) and whether the recoverable amount of the asset (cash-generating unit) is its fair value less costs of disposal or its value in use.
- (f) if the recoverable amount is fair value less costs of disposal, the entity shall disclose the following information:
 - (i) the level of the fair value hierarchy (see AASB 13) within which the fair value measurement of the asset (cash-generating unit) is categorised in its entirety (without taking into account whether the 'costs of disposal' are observable);
 - (ii) for fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, a description of the valuation technique(s) used to measure fair value less costs of disposal. If there has been a change in valuation technique, the entity shall disclose that change and the reason(s) for making it; and
 - (iii) for fair value measurements categorised within Level 2 and Level 3 of the fair value hierarchy, each key assumption on which management has based its determination of fair value less costs of disposal. Key assumptions are those to which the asset's (cash-generating unit's) recoverable amount is most sensitive. The entity shall also disclose the discount rate(s) used in the current measurement and previous measurement if fair value less costs of disposal is measured using a present value technique.
- (g) if recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use.

The impairment loss should be disclosed as a separate line item in the notes to the accounts with the corresponding impact to the property, plant, equipment and infrastructure asset in the P,P and E movement reconciliation note.

1.7 Do we need to consider the effect that a natural disaster will have on intangible assets?

The following intangible assets may be held by Councils:

- software developed in-house
- landfill airspace assets
- aged care bed licenses
- parking infringement systems developed in-house.

While intangible assets cannot be physically damaged, their fair value may have been affected by a natural disaster if either they are used in conjunction with physical assets that have been damaged or their value will not be recovered in instances where they result in the earning of revenue and the services which are provided by using those assets, will no longer be provided.

In these cases, a flood may be an indicator of impairment, and this would result in impairment testing being required to determine if the intangible asset's carrying value exceeds its recoverable value.

1.8 What happens where the Council cannot gain access to conduct an impairment assessment?

If infrastructure assets, such as roads, are not accessible for the purpose of performing an assessment on the damage to the asset (i.e. road inundated with water), then the following need to be considered by management:

- Where impairment assessments have been conducted on similar infrastructure assets (such as similar roads), then this experience can be used as a guide for an estimated impairment loss to be applied to the inaccessible asset.
- Management should base their assessment on the best available knowledge and experience. Disclosure may be required in the financial statements on the basis of the estimate and any uncertainty surrounding that estimate.
- Where no past experience is available to make a reliable estimate on the damage of infrastructure because it cannot be accessed, the financial statements (in the property, plant and equipment note), must disclose the following:
 - i. class of assets where the impairment assessment cannot be conducted;
 - ii. carrying value of assets where the impairment assessment cannot be conducted;
 - iii. detail on the reasons why the assessments cannot be conducted;
 - iv. the level of significant uncertainty that exists in relation to the carrying value of these assets; and
 - v. a timeframe for when management believe the impairment assessment can be conducted, or where an exact timeframe cannot be determined, what conditions are required to occur before the assessment can be conducted (i.e. flood waters subsiding to a certain level, prior to physical access of a site).
 - vi. AASB 101 *Presentation of Financial Statements* states in paragraph 125, that a Council must disclose information about the future, and other major sources of estimation uncertainty at the end of a reporting period, that have significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year (such as assets that are unable to be accessed for adequate impairment assessments to be conducted).

2 How costs associated with restoring, replacing or reconstructing damaged or destroyed property, plant, equipment or infrastructure recognised in the financial statements

Councils would have incurred expenditure as a result of the recent floods to restore, replace or reconstruct non-current physical assets, where they will need to consider whether these costs can be capitalised against the asset's carrying value or expensed directly to the Comprehensive Income Statement.

Local government non-current physical assets can be split into two main areas:

- Property, plant and equipment— assets required for normal operations; and
- Infrastructure assets— required to meet the public need for access to major economic and social facilities and services.

At a high level, Councils may have incurred costs associated with replacing a segment or an entire portion of an asset, where the costs can generally be capitalised. However, Councils may also have incurred costs to merely repair assets to bring them back to their original use, where these costs are generally not allowed to be capitalised.

This section deals with the appropriate accounting treatment for restoring, replacing or reconstructing damaged or destroyed property, plant, equipment or infrastructure.

2.1 What accounting standards need to be considered when looking at capitalisation?

AASB 116 *Property, Plant and Equipment* ("AASB 116") prescribes the requirements for accounting for the cost of restoring, replacing or constructing replacement items of property, plant, equipment or infrastructure.

2.2 What common terms need to be considered?

Table 2A - Capitalisation versus expenditure— key definitions

Term	Definition
Cost	the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other Australian Accounting Standards.
Depreciable amount	is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.
Fair value	is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
Residual value	is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

2.3 What types of asset classes need to be considered?

Property, plant, equipment and infrastructure are tangible assets that are expected to be used in more than one period of operations by a Council. These include assets disclosed in *Section 1 How are items of property, plant, equipment or infrastructure damaged or destroyed, accounted for in the financial statements?* in Table 1B.

2.4 How are costs associated with restoring, replacing or reconstructing replacement items recognised, measured and disclosed?

AASB 116 requires an item of property, plant and equipment that qualifies for recognition as an asset, to initially be recognised at cost.

Paragraph 7 specially states that the cost of an asset can be recognised as an asset if, and only if:

- (a) it is **probable** that future economic benefits associated with the item will flow to the entity; and
- (b) the cost of the item can be **measured reliably**.

Councils will need to evaluate, under this recognition principle, all property, plant and equipment or infrastructure costs at the time they are incurred. These costs include costs incurred initially to acquire or construct an item of property, plant and equipment or infrastructure and costs incurred subsequently to add to, replace part of, or service it.

In the context of assets damaged as a result of a natural disaster, this section has been split into two specific areas:

- Elements of Cost – Replacement of Assets
- Subsequent Costs – Repairs to Existing Assets

2.4.1 Elements of Cost – Replacement of Assets

This area will apply when completely new assets are constructed to replace damaged assets as a result of the floods. For example, when a bridge has been washed away in the floods and is therefore replaced.

Paragraph 16 of AASB 116 states the elements of costs as:

- (a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates;
- (b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management; and
- (c) the initial estimate of the costs of dismantling and removing the asset and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

Under this definition of cost, it can be seen that any costs directly attributable to bringing an asset to the location and condition necessary for it to be capable of operating in the manner intended by the Council, can form part of the item's cost.

However, the costs of relocation or reorganising part or all of Councils' operations are ordinarily not included in the carrying amount of the item.

It is important to note that costs of the day-to-day servicing of an asset are also not included in the carrying amount. Rather, these costs are recognised in the Comprehensive Income Statement as incurred. Costs of day-to-day servicing are primarily the costs of labour and consumables which are often described as 'repairs and maintenance' of the item of property, plant and equipment or infrastructure.

Examples of the elements of cost

In the table below, examples of costs that are allowed to be capitalised upon initial purchase of an asset have been disclosed:

Table 2B – Examples of elements of cost

Element	Examples
Purchase price	<ul style="list-style-type: none"> Acquisition cost Costs incurred for internally developing asset
Directly attributable costs	<p>Costs incurred in bringing an asset to the location and condition necessary for it to be capable of operating in the manner intended by the Council, such as:</p> <ul style="list-style-type: none"> professional fees initial delivery and handling costs costs incurred as a result of site preparation costs incurred with testing asset functionality any labour costs associated with acquisition or construction of an asset installation and assembly costs
Restoration costs	<ul style="list-style-type: none"> Costs incurred to dismantle an asset Costs incurred to remove or restore an asset at the end of the asset's life.

2.4.2 Subsequent Costs – Repairs to Existing Assets

This section will apply to assets that are damaged as a result of the recent floods, which require repairs.

Items that can be capitalised

Subsequent expenditure on an asset, such as restoring and repairing damaged property, plant and equipment or infrastructure, can only be capitalised (i.e. added to the carrying amount of the asset) when it improves the condition of the asset beyond its originally assessed standard of performance or capacity. Essentially, costs associated with repairing an asset to enhance its useful life to be greater than what it was pre-natural disaster.

Where subsequent expenditure is incurred that enhances the asset's service capacity or improves the quality or standard of a service provided to the community, this can be accounted for as an asset enhancement, hence capitalised.

Items that must be expensed

Costs of maintenance and repairs are generally expensed (therefore cannot be added to the carrying amount of the asset) as they maintain the asset in its original condition rather than increase its service potential.

Maintenance is an action taken to ensure that the asset or component of an asset achieves its original intended useful life at its desired service level standards. Examples of maintenance as a result of the floods would be costs incurred for cleaning carpets, painting buildings and bridges and clearing debris.

Key rules to remember

When considering whether subsequent costs can be capitalised against an asset, management needs to consider firstly, whether the costs meet the cost recognition criteria as discussed above and whether the costs enhance the asset (specifically in regards to service capacity, service quality and useful life).

Table 2C Key rules for subsequent costs– capitalise verses expenditure

Subsequent	Rule
Capitalisation	Costs incurred can only be capitalised if they relate to enhancing the asset to increase its service capacity or service quality.
Expenditure	Costs incurred with repairing an asset to its original intended useful life at its desired service levels must be expensed.

These requirements will translate to the specific circumstances as a result of the floods, for Councils, as follows:

Where the damage is repaired before 30 June

If the damage is repaired to the asset before 30 June, then there will be no impairment of the asset at balance date. The cost of these repairs will therefore be expensed during the period.

Example 1 – Damage repaired prior to 30 June

Example

A bridge was damaged by the floods in January 2011. Immediately before the floods, the carrying amount of the bridge was \$100,000, being its depreciated replacement cost.

An estimate for the repairs was made in February 2011 to be \$30,000. The damage was repaired in April 2011 at a cost of \$40,000. The functionality of the bridge after the repairs is exactly the same level as it was immediately prior to the floods.

How will this be accounted for?

This would be accounted for as follows:

February 2011

Dr Impairment expense– infrastructure assets (expense)	\$30,000	
Cr Infrastructure– bridge (asset)		\$ 30,000

To record the impairment on the initial identification of the damage

February 2011

Dr Repairs expense (expense)	\$ 30,000	
Cr Provision for repairs (liability)		\$ 30,000

To record the provision for the repair of the bridge as the costs do not increase the functionality of the assets; they have to be expensed

Dr Infrastructure – bridge (asset)	\$ 30,000	
Cr Impairment expense – infrastructure assets (expense)		\$ 30,000

To record the reversal of the impairment to the bridge

April 2011

Dr Provision for repairs* (liability)	\$ 30,000	
Dr Repairs expense (expense)	\$ 10,000	
Cr Cash (asset)		\$ 40,000

To recognise the repair expense of the bridge

**For guidance on when a provision can be recognised, please refer to Section 5 How are future expected costs or claims lodged against the CCouncil by ratepayers recognised in the financial statements?*

The net effect of these entries for the year ended 30 June 2011 is:

Year ended 30 June 2011

Dr Repairs expense (expense)	\$ 40,000	
Cr Cash (asset)		\$ 40,000

To recognise the cost of repairs to the bridge which do not increase its useful life or functionality.

Where the damage is repaired after 30 June

In this example, there will be a requirement for the bridge to be impaired at 30 June (please refer to *Section 1 How are items of property, plant, equipment or infrastructure damaged or destroyed, accounted for in the financial statements?* for further details on impairment).

As a result, the cost of the repairs will essentially be shown as impairment at 30 June which will be reversed when the actual cost of repairs is expensed in the actual period it occurs (in this example, the subsequent reporting period).

Example 2 – Damage repaired post 30 June

Example

Assume the same facts as Example 1, except that the bridge was not repaired until September 2011.

How will this be accounted for?

This would be accounted for as follows:

February 2011

Dr Repairs expense (expense)	\$ 30,000	
Cr Provision for repairs* (liability)		\$ 30,000

To record the provision for the repair of the bridge

30 June 2011

Dr Impairment expense*– infrastructure assets (expense)	\$ 30,000	
Dr Provision for repairs (liability)	\$ 30,000	
Cr Repairs expense (expense)		\$ 30,000
Cr Infrastructure asset– bridge (asset)		\$ 30,000

To record impairment and reversal of provision for the repair of the bridge

September 2011

Dr Infrastructure asset– bridge (asset)	\$ 30,000	
Cr Impairment expense– infrastructure assets (expense)		\$ 30,000

To record the reversal of the impairment of the bridge

Dr Repairs expense (expense)	\$ 40,000	
Cr Cash (asset)		\$ 40,000

To recognise the repair expense of the bridge

* For guidance on when a provision can be recognised, please refer to *Section 5 How are future expected costs or claims lodged against the Council by ratepayers recognised in the financial statements?* For guidance on impairment of assets, please refer to *Section 1 How are items of property, plant, equipment or infrastructure damaged or destroyed, accounted for in the financial statements?*

What if the repairs increase functionality?

An example of costs that may be capitalised due to the flooding would be the replacement of the seal on a sealed road segment which was not due for replacement prior to the flooding. As the seal is designed to keep water out of the sub-grade and pavement, if the seal is not replaced it will become brittle and crack allowing water to flow through. If the seal is replaced earlier than anticipated, it will increase the useful life of the seal to a greater number of years than it would previously have had remaining.

Example 3 – Repairs increasing functionality

Example

The Australian City Council (“City Council”) owns a road and the seal was completely damaged due to the floods in January 2011 and is required to be replaced immediately.

Experience has shown that the seal requires replacement, on average, every four years. City Council depreciates the road seal on the straight line basis over its estimated four-year useful life to a nil residual value.

The seal on the road had been in place for three years prior to the flooding and had a carrying amount of \$70,000, (cost \$100,000 less \$30,000 accumulated depreciation). It was replaced at a cost of \$420,000 on 30 June 2011.

What is the accounting entry to record this?

30 June 2011

Dr Repairs expense- infrastructure assets (expense)	\$ 70,000
Dr Accumulated depreciation (contra asset)	\$ 30,000
Dr Infrastructure Assets– road gross carrying amount (asset)	\$ 320,000
Cr Cash (asset)	\$ 420,000

To recognise the replacement of the seal. (In substance the cost is split between ‘repairing’ the seal to its pre-flood condition then capitalising the remainder as it represents enhancement to the useful life.

The carrying value of the seal will then be depreciated over 4 years at \$105,000 per annum.

** For guidance on impairment of assets, please refer to Section 1 How are items of property, plant, equipment or infrastructure damaged or destroyed, accounted for in the financial statements?*

2.5 Other considerations

2.5.1 Land under Roads

In accordance with AASB 1051 *Land under Roads* (“AASB 1051”), land under roads is a property and therefore falls within the scope of AASB 116.

In measuring the value of land under roads, AASB 116 applies. Therefore, in determining whether the costs associated with restoring, replacing or constructing damaged or destroyed land

under roads, the same recognition criteria will need to apply as stated in paragraph 16 of AASB 116 (consistent with section 2.5.1 above).

2.5.2 Frequency of Revaluation

Paragraph 34 of AASB 116 provides consideration on the frequency of the revaluation required by the local government in terms of whether items of property, plant and equipment experience significant and volatile changes in fair value.

The local government will need to consider the changes to the use of the assets that may have affected their useful life due to the recent flood disaster. It is important for the councils to assess the remaining useful life of an asset based on the physical wear and tear and legal or other limits on the use of the assets.

Paragraph 36 of AASB 116 states that if an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs is to be revalued.

It is important to note that in paragraph 39 of AASB 116, if an asset's carrying amount is increased as a result of revaluation, the increase is to be recognised in other comprehensive income and accumulated in equity under the heading of asset revaluation surplus. However, the increase is to be recognised in the Comprehensive Income Statement to the extent that it reverses a revaluation decrease of the same asset class previously recognised as a profit or loss in the Comprehensive Income Statement.

3 How inventory damaged or destroyed as a result of a natural disaster is accounted for

Councils' inventory may be damaged or destroyed in the event of a natural disaster, such as the recent floods. As such, management will need to consider how to recognise the appropriate value of inventory in their financial statements.

This section deals with the accounting treatment for the appropriate valuation of inventory when it is damaged or destroyed.

The vast majority of inventory held by the councils are inventories held for distribution, including materials and supplies, which are held for distribution to other parties (such as internal council divisions) for no charge or for a nominal charge; for example, gravel for use in the maintenance of roads.

Councils also hold inventory that relate to the provision of services to the community rather than goods purchased and held for resale or goods manufactured for sale.

In the event of a flood, inventories such as these may be damaged, therefore management are required to assess what costs are required to be incurred to bring the inventory back into a usable condition and/or the impact on the inventory value as at the reporting date.

This section provides guidance on how to account for damaged or destroyed inventories.

3.1 What accounting standards need to be considered when looking at inventory?

AASB 102 *Inventories* ("AASB 102") prescribes the requirements for accounting for inventories.

Inventories that have been affected by the natural disaster must be assessed and valued accurately at balance date. AASB 102 provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down by the amount of any loss of service potential.

3.2 What key terms need to be considered?

Table 3A Inventory – key definitions

Term	Definition
Current replacement cost	is the cost the entity would incur to acquire the asset at the end of the reporting period.
Fair value	is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
Inventories	are assets: (a) held for sale in the ordinary course of business; (b) in the process of production for such sale; or (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Inventories held for distribution

are assets:

- (a) held for distribution at no or nominal consideration in the ordinary course of operations;
 - (b) in the process of production for distribution at no or nominal consideration in the ordinary course of operations; or
 - (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services at no or nominal consideration.
-

3.3 How is inventory required to be recognised, measured and disclosed?

In accordance with paragraph AUS 9.1 of AASB 102, inventories held for distribution at no charge or for a nominal charge must be measured at cost, adjusted when applicable for any loss of service potential.

For these inventories held for distribution, the loss of service potential would be identified and measured based on the existence of a current replacement cost that is lower than the original acquisition cost or other subsequent carrying amount.

Measurement of cost

In accordance with paragraph AUS10.1 of AASB 102, the cost of the inventories acquired for no cost or for nominal consideration is the current replacement cost as at the date of acquisition.

Loss of Service Potential

As noted above, the measurement of inventories held for distribution is required to be at cost, adjusted when applicable for any loss of service potential.

Councils will need to use judgment in determining the factors relevant to the circumstances in assessing whether there is a loss of service potential for inventories held. In most cases, damage to inventory will result in a loss of service potential for councils, where that inventory is no longer usable in its current form. As a result, the value of the inventory will have to be reduced by that loss of service potential.

The service potential of inventories held by councils is not directly related to their ability to generate net cash inflows. Rather, service potential of the inventory will be reflected by the amount the council would need to pay to acquire or reinstate that service potential. This will usually be measured as the current replacement cost or other costs that will need to be incurred to restore the service potential.

Recognition as an Expense

In accordance with paragraph AUS 34.1 of AASB 102, the amount of any write-down of inventories for loss of service potential and all losses of inventories is recognised as an expense in the period in which the write-down or loss occurs.

Any reversal of a write-down of inventories arising from a reversal of the circumstances that gave rise to the loss of service potential need to be reversed against the inventories carrying value.

Disclosure

Councils are required to disclose the following for inventories in accordance with paragraph AUS36.1 of AASB 102:

- a) the accounting policies adopted in measuring inventories held for distribution, including the cost formula used;
- b) the total carrying amount of inventories held for distribution and the carrying amount in classifications appropriate to the entity;

- c) the amount of inventories held for distribution recognised as an expense during the period;
- d) the amount of any write-down of inventories held for distribution recognised as an expense in the period;
- e) the amount of any reversal of any write-down that is recognised as a reduction in the amount of inventories held for distribution recognised as expense in the period;
- f) the circumstances or events that led to the reversal of a write-down of inventories held for distribution;
- g) the carrying amount of inventories held for distribution pledged as security for liabilities; and
- h) the basis on which any loss of service potential of inventories held for distribution is assessed, or the bases when more than one basis is used.

Let's look at an example here to assess the accounting treatment for damaged inventory.

Example 1 – Damaged Inventory

Scenario 1

The Australian City Council ("City Council") has \$400,000 worth of gravel on hand on 1 January 2011. On 15 January 2011, the City Council purchased an additional \$200,000 of gravel. On 31 January 2011, the City Council's warehouse was flooded and all but \$15,000 worth of gravel was ruined and will no longer be able to be used in road construction or maintenance. The damaged inventory will be disposed of for no consideration.

What is the impact on the City Council's financial statements for the year ended 30 June 2011?

15 January 2011

Dr Inventories– gravel (asset)	\$ 200,000	
Cr Cash (asset)		\$ 200,000

To recognise the purchase of additional gravel

31 January 2011

Dr Expense– loss of inventories (expense)	\$ 585,000	
Cr Inventories– gravel (asset)		\$ 585,000

To record the loss of inventory destroyed by the floods

Scenario 2

The Australian City Council ("City Council") has \$600,000 worth of gravel on hand at 31 January 2011. On 31 January 2011, the City Council's warehouse was flooded and the gravel suffered water damage. It was not usable in its current form and would have to be cleaned before being used in road construction or maintenance. At 30 June City Council had accepted a quote for cleaning of the gravel which would cost \$50,000, but this would not be performed until July (subsequent reporting period).

What is the impact on the City Council's financial statements for the year ended 30 June 2011?

31 January 2011

Dr Expense– loss of service potential (expense)	\$ 50,000	
Cr Inventories– gravel (asset)		\$ 50,000

To record the loss of service potential destroyed by flood

July 2011 (assume in July)

Dr Inventories– gravel (asset)	\$ 50,000	
Cr Cash (asset)		\$50,000

To recognise the clean-up for the inventory destroyed by the flood and the reversal of the loss

4 How actual or anticipated insurance recoveries are accounted for as a result of a natural disaster

This section provides guidance on the accounting treatment for insurance recoveries as a result of actual or anticipated compensation payable under an insurance contract due to damage, loss or costs incurred to assets and other items in the event of a natural disaster.

Councils may have entered into insurance contracts where they have the possibility of being compensated for any damage or loss to their assets or for costs incurred as a result of the recent floods. The best way to determine if your council is eligible for compensation under an insurance contract such as this, would be to contact your insurance agency and discuss the specific terms of your policy.

Compensation under an insurance contract needs to be considered as a **separate transaction (separate asset)** from the event resulting in the damage, loss or costs incurred. For example, compensation for asset impairment due to it being destroyed or damaged needs to be treated in two separate steps:

- First, the recognition of the write-off or impairment provision; and
- Second, the receipt of the compensation.

The reason for this is generally a result of timing. The impairment or write-off of an asset will need to be booked once the indicator, in this case, the natural disaster, is apparent to management.

The notification of compensation payable to a council from an insurance entity may then not occur for some time after the event (likely to be in a subsequent reporting period). Therefore, the receivable from the insurance company cannot be booked until this notification is received (refer 4.5 below for further discussion).

4.1 What is an insurance recovery?

An insurance recovery is compensation received or receivable for damage, loss or costs incurred to property, plant, equipment, infrastructure or other items, under an insurance contract.

4.2 What accounting standards need to be considered when assessing the treatment of insurance recoveries?

There is no specific applicable pronouncement providing guidance on how to account for insurance recoveries anticipated or provided as a result of loss or expenditure incurred on items other than property, plant, equipment or infrastructure.

AASB 116 *Property, Plant and Equipment* ("AASB 116") provides guidance on compensation from insurance contracts for the impairment of property, plant, equipment and infrastructure.

AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* ("AASB 137") provides guidance on the recognition of a reimbursement from insurance entities for costs incurred, other than property, plant, equipment or infrastructure and for the potential recognition of contingent assets.

4.3 When can an insurance recovery be recognised in the financial statements?

Compensation under insurance contracts for damage or loss caused by a natural disaster, such as the floods, needs to be considered separately for items of property, plant, equipment or infrastructure **and** for other items. As a result, this section has been split into the following:

- Compensation for items of property, plant, equipment or infrastructure; and
- Compensation for items other than property, plant, equipment or infrastructure.

4.3.1 Compensation for items of property, plant, equipment or infrastructure

Paragraph 65 and 66 of AASB 116 requires compensation received and receivable by entities in respect of loss or damage to property, plant, equipment or infrastructure to be included in the Comprehensive Income Statement as income.

Compensation for Impairment

65 Compensation from third parties for items of property, plant and equipment that were impaired, lost or given up shall be included in profit or loss when the compensation becomes receivable.

66. Impairments or losses of items of property, plant and equipment, related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets are separate economic events and are accounted for separately as follows:

- impairments of items of property, plant and equipment are recognised in accordance with AASB 136;
- the derecognition of items of property, plant and equipment retired or disposed of is determined in accordance with this Standard;
- compensation from third parties for items of property, plant and equipment that were impaired, lost or given up is included in determining profit or loss when it becomes receivable; and
- the cost of items of property, plant and equipment restored, purchased or constructed as replacements is determined in accordance with this Standard.

Compensation for damages experienced by councils from insurance entities can **only** be recognised when the reimbursement is 'receivable'. Management will need to seek confirmation from their insurance provider, by way of written consent, that an unconditional contractual right exists for receipt of compensation under the insurance policy (for example, notification of a successful lodged claim) prior to it being recognised in the financial statements.

Please refer to *Section 1 How are items of property, plant, equipment or infrastructure damaged or destroyed, accounted for in the financial statements?* for further detail on how to account for compensation for damage or loss to property, plant, equipment or infrastructure where the council has received confirmation from their insurance agency that compensation will be received.

4.3.2 Compensation for items other than property, plant, equipment or infrastructure

Reimbursements provided under an insurance contract for costs associated with other items (excluding property, plant, equipment or infrastructure) are to be recognised in accordance with paragraph 53 of AASB 137:

Reimbursements

53 Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement shall be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The reimbursement shall be treated as a separate asset. The amount recognised for the reimbursement shall not exceed the amount of the provision.

54 In the statement of comprehensive income, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.

55 Sometimes, an entity is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the entity or pay the amounts directly.

56 In most cases the entity will remain liable for the whole of the amount in question so that the entity would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the entity settles the liability.

Rules on reimbursements

AASB 137 provides *Guidance on Implementing AASB 137*, which covers (in part A, on page 20), clear rules on when a reimbursement can and cannot be recognised. These rules have been adapted in the table below:

Table 4A – Examples of whether a reimbursement can be recognised

Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party (i.e. insurance company or government):

Situation	Council holds the obligation for expenditure and they expect to be reimbursed. The receipt of reimbursements has been assessed as 'virtually certain' by the Council.	Council holds the obligation for expenditure; however receipt of reimbursements is <u>not</u> 'virtually certain'.
Recognition requirements	<p>✓ The reimbursement is recognised as a separate asset (receivable) in the Balance Sheet and may be offset against the expense in the Comprehensive Income Statement.</p> <p>The amount recognised for the expected reimbursement must not exceed the liability (paragraph 53 and 54).</p>	<p>✗ The expected reimbursement is not recognised as an asset (receivable) in the financial statements (paragraph 53).</p>

Disclosure requirements	✓ The reimbursement is disclosed together with the amount recognised for the reimbursement in the notes to the financial statements (paragraph 85(c))*.	✓ The expected reimbursement is disclosed in the notes to the financial statements (paragraph 85(c))*.
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* Disclosure requirements as per paragraph 85 (c): the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Accounting for reimbursements

Reimbursements in respect of losses experienced from a natural disaster that are covered by an insurance contract, can be recognised as a receivable only when management have determined that the receipt of the reimbursement is ‘virtually certain’. Management are firstly required to recognise a provision for the costs associated with the loss incurred as a result of the natural disaster, and then, upon confirmation that the reimbursement will occur, are to recognise the receivable. The most important factor to note here is that a receivable cannot be recognised in the financial statements of a council unless management are ‘virtually certain’ that the compensation or reimbursement is receivable (and can be measured reliably).

In determining whether a reimbursement is ‘virtually certain’, management need to carefully analyse their insurance contracts to determine if they will be covered. Management may need to seek confirmation from their insurance provider, by way of written consent, that an unconditional contractual right exists for receipt of compensation under the insurance policy (successful claim assessment) prior to it being recognised in the financial statements.

Let’s look at applying the concepts of AASB 137 for reimbursements, to a practical example:

Example 1 – Recognition of a reimbursement

Example

Australian City Council (“City Council”) has confirmed that a loss of \$100,000 has resulted in regards to repairs and maintenance for cleanup of a local library. These costs have been deemed recoverable under their insurance contract with Insurance Entity Pty Ltd as evidenced by a letter from the insurers detailing approval of their claim.

The insurance recovery is to be recognised as a receivable, with the corresponding provision for costs incurred:

Dr Repairs and maintenance expense (expense)	\$ 100,000
Cr Provision for costs of repairs and maintenance* (liability)	\$ 100,000

To provide for the recognised loss associated with the clean up repairs and maintenance of the local library

* Please refer to Section 5 How are future expected costs or claims lodged against the Council by ratepayers, recognised in the financial statements? for guidance on when a provision can be recognised in the financial statements

Dr Insurance recoveries receivable (asset)	\$ 100,000
Cr Insurance recoveries (income)	\$ 100,000

To recognise the receivable in respect of the insurance recoveries from Insurance Entity Pty Ltd, as the receipt of reimbursement is 'virtually certain' due to the approval of the claim from the insurer, evidenced by confirmation in a formal letter

Dr Cash (asset)	\$ 100,000	
Cr Insurance recoveries receivable (asset)		\$ 100,000

To recognised the actual receipt of funds provided by Insurance Entity Pty Ltd

Dr Provision for costs of repairs and maintenance (liability)	\$ 100,000	
Cr Cash (asset)		\$ 100,000

To reverse the provision for repairs and maintenance once funds are spent

4.4 How are anticipated insurance recoveries (compensation) recognised and measured in the financial statements?

When management are not 'virtually certain' of the recoverability for compensation under an insurance contract for the damage or loss of property, plant, equipment or infrastructure, or are unsure of whether a reimbursement will occur for losses' associated with other items under insurance policies, due to:

- not having received confirmation from their insurers of previously lodged claims, or
- not having lodged a claim, however have knowledge that they will be able to seek compensation, then consideration is required against AASB 137 in respect to contingent asset disclosures.

AASB 137 defines a contingent asset as:

A possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non- occurrence of one or more uncertain future events not wholly within the control of the entity.

It then goes on to impose disclosure as per below:

89 Where an inflow of economic benefits is probable, an entity shall disclose a brief description of the nature of the contingent assets at the end of the reporting period, and, where practicable, an estimate of their financial effect, measured using the principles set out for provisions in paragraphs 36-52.

Rules on contingent assets

AASB 137 also has *Guidance on Implementing AASB 137*, which covers (in part A, on page 19), clear rules on when a contingent asset should be recognised. These rules have been adapted in the table below:

Table 4B – Rules on contingent assets

Where, as a result of past events, there is a possible asset whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity:

Situation	The inflow of economic benefits is 'virtually certain'	The inflow of economic benefits is probable, but not 'virtually certain'	The inflow is not probable
	<p>✗ The asset is not contingent (paragraph 33).</p> <p>Recognition will result as disclosed in 4.4.2 above.</p>	<p>✓ Contingent asset disclosure is required in the notes to the financial statements (paragraph 89).</p> <p>No asset is recognised (paragraph 31).</p>	<p>✗ Not a contingent asset, therefore no disclosure is required in the notes to the financial statements (paragraph 89).</p> <p>No asset is recognised (paragraph 31).</p>

A number of situations where 'anticipated' compensation or reimbursement from a loss incurred as a result of a natural disaster, could result in the definition of a contingent asset as defined above. Where management deem a contingent asset to exist, disclosure is required in the notes to the financial statements in accordance with paragraph 89.

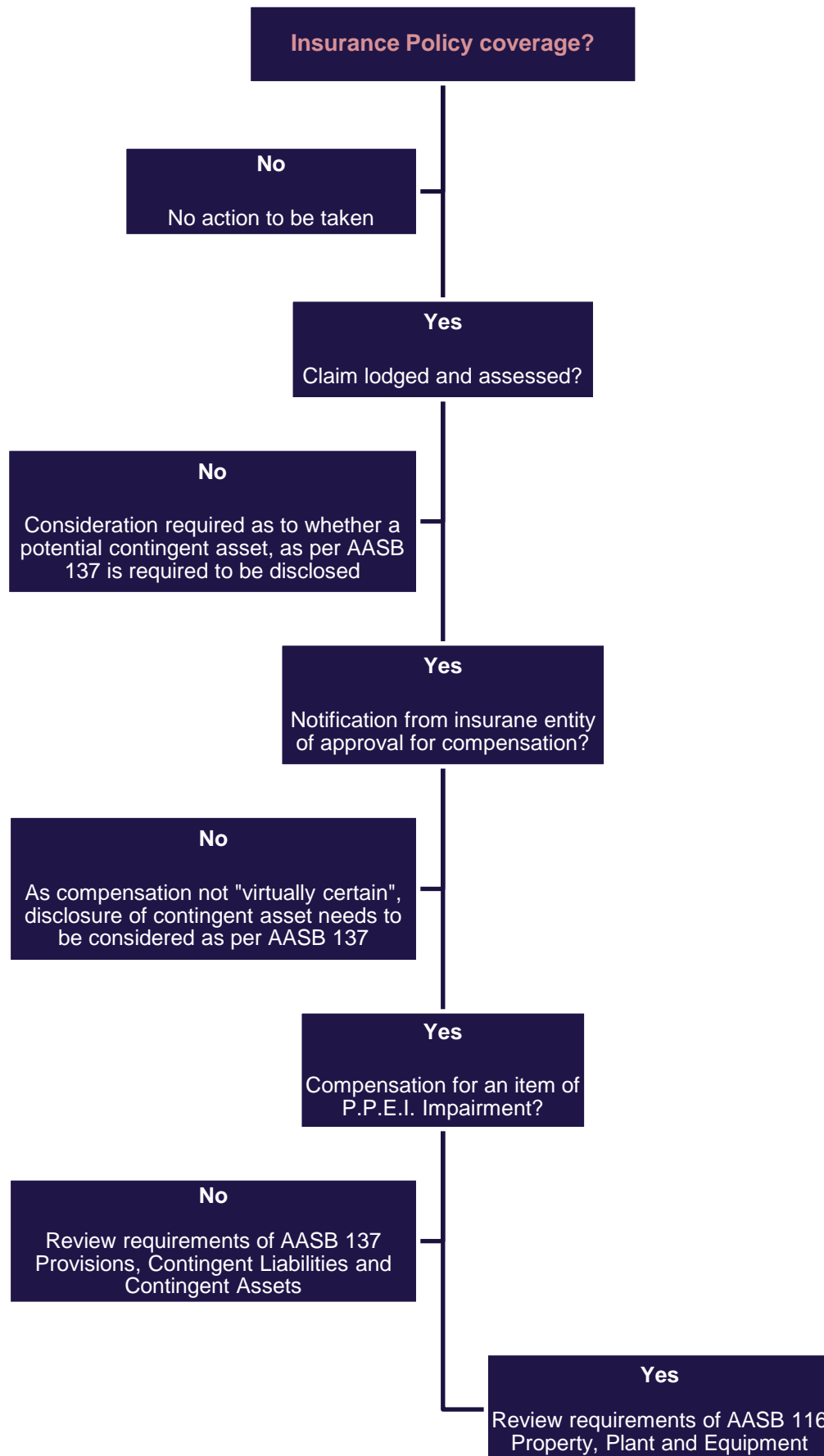
Key points to be disclosed are:

- what the reimbursement or compensation relates to;
- what third party is liable to pay for the reimbursement or compensation amount;
- expected timing for receipt of the reimbursement or compensation amount; and
- if possible, a quantification of the estimated figure of the reimbursement or compensation.

Where quantification of a contingent asset is determined by the council, consideration must be given to how the amount is described in the note to avoid misleading indications on the likelihood of the income arising. Management should carefully research the specific conditions of their insurance contract to ensure any estimated figures are derived from a reasonable basis (i.e. ensuring nature of item or asset where reimbursement or compensation is sought is actually fully covered under the contract and nature of loss or damage to item or asset is an allowable event to seek reimbursement or compensation under the contract).

Below is a decision tree to help you identify in what circumstances an insurance recovery will impact upon potential recognition, measurement and/or disclosure in your notes to the financial statements.

Figure 4A - Decision tree – Circumstances warranting recognition, measurement and or disclosure of insurance recoveries



5 How future expected costs or claims lodged against the Council by ratepayers are recognised in the financial statements

The council may have expected future costs as a result of the floods that they will be considering when preparing their financial statements. The council may also have claims that have been lodged against them by ratepayers, for situations where the ratepayer believes the council was negligent in delivering service to them as a community member throughout the flood period.

This section deals with the appropriate accounting treatment for future expected costs and potential claims against a council.

5.1 What accounting standards apply to assessing future expected costs? And claims lodged against the Council?

AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* ("AASB 137") provides guidance on when a provision can be recognised in the financial statements and when certain circumstances warrant the disclosure of a contingent liability.

AASB 101 *Presentation of Financial Statements* ("AASB 101") provides guidance on the recognition of committed expenditure, where a legal or constructive obligation exists to pay future costs at balance date.

5.2 How do I account for future expected costs?

5.2.1 Accounting for future expected costs

Cleanup and other similar costs may occur due to natural disasters, such as the floods. Examples may be cleanup costs associated with gathering debris once flood waters have subsided in a specific area or may relate to expected costs associated with claims lodged against a council for loss of business.

AASB 137 does not permit a provision for future expected costs to be recognised when there is no present obligation for these activities to occur. A council can only recognise a provision for expenditure, such as cleanup costs, where activities have taken place to incur that expenditure. AASB 137 clearly states (as per paragraph 14 (a)) that a provision can only be recognised when:

- (a) an entity has a **present obligation** (legal or constructive) as a result of a past event;
- (b) it is probable that an **outflow of resources embodying economic benefits will be required to settle the obligation**; and
- (c) a **reliable estimate** can be made of the amount of the obligation.

If these conditions are not met, no provision shall be recognised.

A present obligation is a legal or constructive obligation that a council must settle, such as specific community obligations under legislation. An outflow of resources embodying economic benefits essentially is an outflow of an asset to settle the obligation, generally being cash.

A reliable estimate must be the best estimate that management can determine, for the expenditure required to settle the obligation at balance date. In considering the most appropriate estimates, Councils should consider:

- what the most likely amount to settle the obligation will be (i.e. derived from historical experience, quotations, market rates);
- the risks and any uncertainty surrounding the provision itself; and
- whether the costs associated with settling the obligation will be reimbursed.

If the provision raised is to be reimbursed by an insurance recovery or specific government funding, this is required to be recognised as a separate asset (receivable) when it is virtually certain that the reimbursement will be received, however must not exceed the amount of the provision, otherwise, the estimate is incorrect.

There are some specific rules to note upfront in regards to future expected costs:

- Where damage or destruction has occurred within an accounting period, such as the recent floods, then consideration must be given to whether a present obligation exists as a result of a past event;
- Councils who merely know that they “need” to incur expenditure to repair or cleanup an area, cannot assume that a present obligation exists because the actual carrying out of the act of this expenditure is a decision that they can control therefore cannot book a provision. Disclosure of a contingent liability is required; and
- If, however, a present obligation exists (i.e. time limit under legislation) for damage or repair expenditure, as a result of a past event, and it can be reliably estimated, then a provision can be recognised.

Where damage or destruction has occurred post 30 June, therefore outside the reporting period, no provision can be recognised. However, where the council has knowledge of the damage or destruction, disclosure of the impact on the events would be required (i.e. in the subsequent events note to the financial statements).

Please refer to Section 4 *How are actual or anticipated insurance recoveries accounted for as a result of a natural disaster?* for guidance on how to recognise insurance recoveries, and Section 6 *How should funding provided as a result of a natural disaster be recognised in the financial statements?* for appropriate grant recognition in respect of compensation payments.

The difference between provisions and other liabilities

As there is uncertainty involved with provisions due to the timing or expected cost, they are clearly different to that of trade payables or accruals. Trade payables are liabilities booked for goods or services that have been received and expenditure incurred within the reporting period, where an invoice exists to substantiate the liability. Accruals are liabilities booked for goods and services received in a financial year, where no invoice exists to substantiate the balance, where an estimate is derived to calculate the accrual, however the certainty for this expenditure is far greater than for a provision.

Let's look at an example here for recognising a provision:

Example 1 – Recognition of a provision

Example

In June 2011, Australian City Council (“City Council”) management are aware that they have to collect debris from a recent site where water has recently subsided. City Council has only discussed this at a recent operational meeting, where \$15,000 has been budgeted for this activity based on general cash available. No further decisions have been made.

Can a provision be recognised in the financial statements at 30 June 2011?

Present Obligation? No, activity for cleanup has not commenced– no obligation exists.

Economic Flow? Yes, payment for services is assumed to occur once cleanup commences.

Reliable Estimate? No, financial estimates for the specific activity have not been determined, only a high-level budget figure.

No provision can be recognised in the financial statements as the situation does not meet the recognition criteria of a provision; that being, the activity for costs has not occurred, nor can a reliable estimate be derived. Management are only “aware” of the cleanup required, no specific obligation exists to warrant a provision to be recognised.

AASB 137 (paragraphs 84 and 85) also details specific disclosure requirements for provisions. The key items that must be disclosed in respect of each provision are:

- the carrying amount at the beginning and end of the period;
- additional provisions made in the period, including increases to existing provisions;
- amounts used (that is, incurred and charged against the provision) during the period;
- unused amounts reversed during the period; and
- the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

In addition, the following commentary is required to supplement the provisions:

- a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
- an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide
- adequate information, an entity shall disclose the major assumptions made concerning future events, as addressed in paragraph 48; and
- the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that
- expected reimbursement.

5.2.2 Accounting for contingent liabilities

AASB 137 does not allow for the recognition of a liability for future expected costs that **may** be incurred.

Costs expected to be incurred in the future, such as cleanup costs or repairs and maintenance costs, where **no activity** has taken place, including no engagement of a service provider to carry the work out, cannot be recognised as a provision in the financial statements, as they do not meet the definition of a provision.

AASB 137 defines a contingent liability to be:

- (a) a **possible obligation that arises from past events** and whose **existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events** not wholly within the control of the entity; or
- (b) a **present obligation that arises from past events but is not**

recognised because:

- (i) it is **not probable that an outflow of resources embodying economic benefits will be required** to settle the obligation; or
- (ii) **the amount of the obligation cannot be measured** with sufficient reliability.

Essentially, a contingent liability is a potential obligation that may arise due to something occurring in the past, where a significant amount of uncertainty exists around the outcome of the liability and the cost of the liability.

Councils should not recognise a contingent liability in their balance sheets. Contingent liabilities are required to be disclosed in the notes to the financial statements.

Let's have a look at a few specific events to assess whether they warrant the disclosure of a contingent liability in the financial statements.

Table 5A – Examples of contingencies

Situation	Present obligation as a result of a past obligating	Conclusion
On 14 May 2011, the council decided to cease operations of a local entertainment centre. Before 30 June 2011 the decision was not communicated to any staff of the facility and no other actions were taken to implement the decision.	No obligating event has occurred; therefore there is no present obligation.	No provision can be recognised. The council may consider disclosure of a contingent liability in the notes to the financial statements, detailing their intention to close the local entertainment centre.
Close to balance date, Australian City Council received notification that a ratepayer has lodged a claim against the council due to loss of business, as a council owned road leading off their farm is still inundated with water and they cannot transport their produce. Management have sought legal advice and have been informed that the case is plausible, yet the estimated potential loss cannot be determined.	This lawsuit is considered a contingent liability, which should be only described in the notes to the financial statements. This is due to the fact that a reasonable estimate of the expected loss could not be determined and the existence of this claim can only be confirmed by the occurrence or non-occurrence of further legal pursuit (possible obligation).	Disclose a contingent liability in the notes to the financial statements.

AASB 137 has a table highlighting the rules of a contingent liability in Guidance on implementing AASB 137, on page 19, which we have adapted below:

Table 5B – Contingent liability rules

Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of: (a) a present obligation; or (b) a possible obligation whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity:

Situation	Provision	Contingency	No action
There is a present obligation that probably requires an outflow of resources.	A provision is recognised, with the required provision disclosure.		
There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.		No provision is to be recognised. A contingent liability shall be disclosed in the notes to the financial statements.	
There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.			No provision is to be recognised. No contingent liability disclosure is required.

5.3 Accounting for commitments

The following are the disclosure requirements for commitments:

An entity **shall disclose the nature and amount of each individual and each class of capital commitments and of other expenditure commitments contracted** for as at the reporting date, other than commitments for the supply of inventories, which have not been recognised as liabilities.

The disclosures shall be made in the following time bands, according to the time that is expected to elapse from the reporting date to their expected date of settlement:

- (a) within twelve months;
- (b) twelve months or longer and not longer than five years; and
- (c) longer than five years.

Councils need to be mindful, that where contracts have been entered into for capital works or operating arrangements, such as repairs and maintenance as a result of the recent floods, that span greater than the current reporting period that they include these in their commitment note disclosure.

Disclosure of commitments allows the readers of the financial statements to assess the quantum of cash outflow expected in the short and long term for capital and operating purposes.

Please remember that when disclosing commitments, they are required to be **inclusive of GST**.

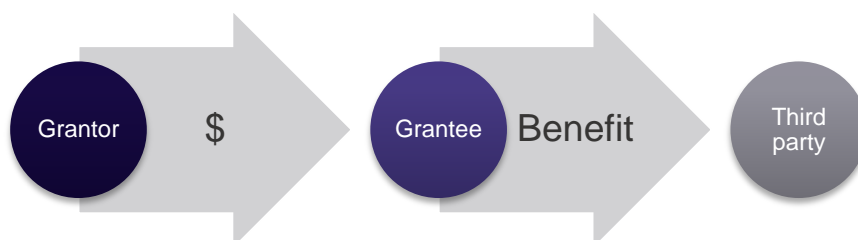
6 How funding provided as a result of a natural disaster should be recognised in the financial statements

As a result of the recent floods, councils would have received funding from various government departments to assist in the cleanup. For example, in 2011 grants could have been received under the 'Local Government Clean Up Fund', which was a \$5.0 million program made available to the 28 Councils affected by the floods to assist them as they undertook the long and costly clean up and rebuilding process. Funds from the program were to be used for a variety of purposes as a direct result of the floods, with no specific conditions attached.

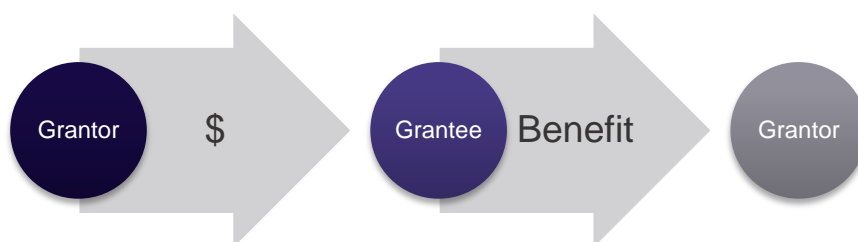
This section provides guidance on how such funding should be recognised in the financial statements at balance date.

6.1 What types of grants are there?

Initially, councils need to consider whether grant funding received is deemed a reciprocal transfer or a non-reciprocal transfer between the council and the grantor (i.e. Department of Environment, Land, Water and Planning).



A **non-reciprocal transfer** involves a transfer where the council receives assets (such as cash) without directly giving approximately equal value in exchange to the other party or parties to the transfer. An example of this would be grant funding provided with no specific conditions attached, such as recurrent funding.



A **reciprocal transfer** is one in which an equal value is exchanged for an asset (such as cash). An example of this would be where grant funding has been provided to a council that has specific conditions attached which are in the nature of providing services directly back to the grantor, and if these conditions have not been met, the funds must be returned to the grantor.

If the transfer is considered to be **non-reciprocal**, then councils can apply AASB 1004 *Contributions*, however if the transfer is considered **reciprocal**, councils must recognise the grant in accordance with AASB 118 *Revenue*.

6.2 What accounting standards need to be considered when assessing revenue recognition for grants?

AASB 1004 *Contributions* ("AASB 1004") provides guidance on how to recognise grant funding for non-reciprocal transfers. The standard stipulates, in paragraph 6, the specific sections that are applicable to local governments, these being:

Paragraph	Topic
11	Measurement of contributions
12-15	Recognition of contributions of assets
16-17	Liabilities forgiven
18	Disclosures
19-30	Recognition of contributions other than contributions by owners
44-47	Contributions of services
48-53	Contributions by owners and distributions to owners
60-62	Disclosure of contributions

AASB 118 *Revenue* ("AASB 118") provides guidance on how to recognise grant funding in respect to reciprocal transfers.

Please note that:

- AASB 120 *Accounting for Government Grants and Disclosure of Government Assistance* is **not applicable** to councils. This standard only relates to 'for-profit' entities.
- AAS 27 *Financial Reporting by Local Government* ceased to exist as the Australian Accounting Standards Board relocated the requirements of this standard across relevant existing standards as part of their 'topic- based, transaction-neutral' standards project.

6.3 What is a contribution?

AASB 1004 defines a contribution in paragraph 19 to be:

Contributions, other than contributions by owners, to a local government are received in the form of involuntary transfers, such as rates, taxes and fines, and voluntary transfers, such as grants and donations.

AASB 1004 is quite specific about the revenue recognition of grants received by local governments. In most cases, it requires a contribution, in this case a grant, to be recognised as income upfront, when control is obtained by a local council, irrespective of whether restrictions or conditions are imposed on the use of the grant.

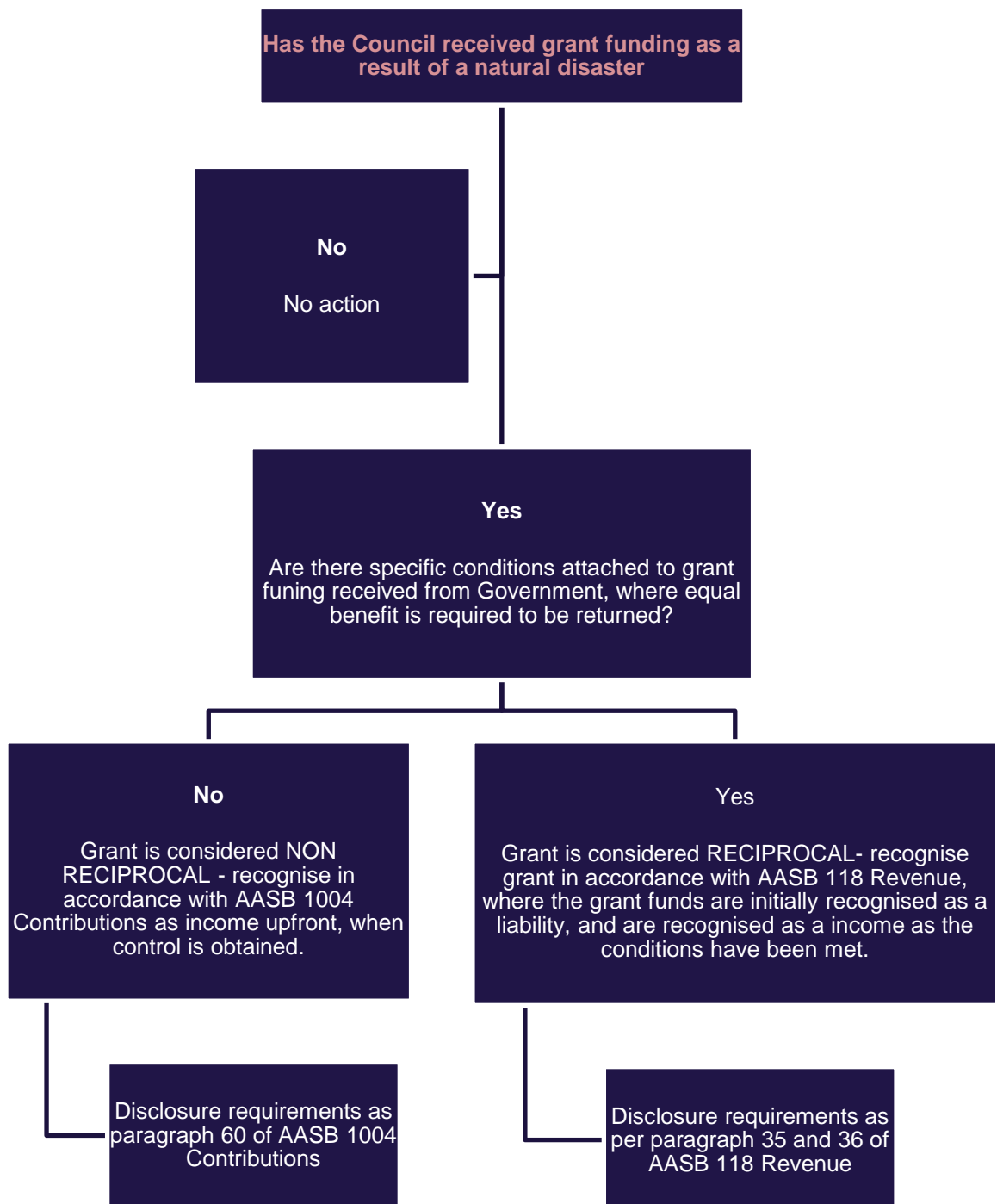
It discusses this concept by claiming that a recipient, (Local Council) does not have a present obligation to sacrifice future benefits to the grantor (i.e. Department) who provided the funding, even though the council will have responsibility to use the grant funding efficiently and effectively. This is because funding is generally provided to councils to benefit the community rather than providing benefits directly back to the grantor. As a result, the receipt of such funding cannot give rise to a liability.

In very rare circumstances, grant funding received by councils may trigger the recognition of a liability. The standard specifies that for a **reciprocal transfer** to occur, assets such as cash are to be provided on the condition that the local government is to make a reciprocal transfer of equal economic benefits, and that transfer has not occurred prior to the reporting date. A liability should then be recognised as at the reporting date in respect of such amounts.

For a transaction to be deemed reciprocal for a council, the Department releasing the funds must have the right to receive the benefits directly. Therefore, if the Department is providing funds to the council to assist in 'Community Rebuilding', then they are not receiving a direct benefit of equal return. This is because the benefit is going directly to the community. If this occurs, then the transfer cannot be considered reciprocal.

To assist in assessing how to recognise the funding of a grant or contribution received or receivable as a result of financial assistance provided, the following decision tree can be utilised to work out which standard to apply.

Figure 6A Decision tree– What standard to apply when considering receipt of funding



AASB 1004 includes the following examples of situations deemed either reciprocal or non-reciprocal transfers to assist in understanding the fundamental concepts.

Table 6A – Examples of reciprocal and non-reciprocal transfers

Reciprocal	<ul style="list-style-type: none"> Where a user charge is provided to a council in advance for repairs to a private road, where the charge would be repayable directly to the provider or providers if the works were not performed. Where the grantor provides funding to a council, with the grantor receiving equal benefit back by way of the provision of goods or services and, the funding is based on specific conditions, where if council failed to meet the conditions part or all is required to be repaid. In this situation a liability and an expense would need to be recognised for the amount payable. In this circumstance, the council has a present obligation to the grantor that has arisen as a result of a past event: the failure of the transferee to meet the conditions for retention of the funding.
Non reciprocal	<ul style="list-style-type: none"> When a government provides a grant to a local government, it does not receive value directly in exchange, although it (or those it represents) would indirectly receive a benefit as a result of the local government deploying the grant in providing goods or services to beneficiaries that the grantor government represents.

6.4 What are the measurement requirements?

Non-reciprocal transfers

AASB 1004 *Contributions* states that contributions shall be measured at the fair value of the contributions received or receivable. In the situation of a grant, its fair value will be based on the formal correspondence issued by the grantor (in most cases a Department), such as a signed funding agreement.

Reciprocal transfers

AASB 118 *Revenue* states that revenue shall be measured at the fair value of the consideration received or receivable. In the situation of a grant, its fair value will be based on the formal correspondence issued by the grantor (in most cases a Department), such as a signed funding agreement.

6.5 What are the recognition requirements?

Non-reciprocal transfers

Paragraph 12 of AASB 1004 *Contributions*, imposes the recognition requirements of a non-reciprocal transfer:

Income arising from the contribution of an asset to the entity shall be recognised when, and only when, all the following conditions have been satisfied:

- the entity **obtains control** of the contribution or the right to receive the contribution;
- it is **probable** that the economic benefits comprising the contribution will flow to the entity; and
- the amount of the contribution can be **measured reliably**.

A council will be deemed to obtain control over a contribution when they can use funds, transfer funds to purchase goods and services or retain funds for future use, so as to obtain benefits from them. This of course also meets the requirement of the grant being able to be measured reliably.

Let's look at an example here:

Example 1 - Recognition of a non-reciprocal grant

Example

On 17 April 2011, Australian City Council ("City Council") was verbally notified by the Department of Planning and Community Development of a grant of \$50,000 as part of a 'Community Rebuilding Initiative' to assist in rebuilding local playgrounds.

The council is not required to return the funds to the department, yet they have the responsibility to utilise the funds effectively and efficiently to ensure the playgrounds are repaired and available for community use.

The council received formal confirmation of the grant, via a signed agreement on 15 July 2011.

How is this funding to be recognised in the financial statements?

The whole grant should be treated as income in the year of receipt. This is in accordance with the requirements of AASB 1004, as no reciprocal transfer exists. The council is receiving funds to rebuild playgrounds within the Community; the Department is not receiving a direct benefit as a result of this funding.

The funds, however, **cannot be recognised in 2011 financial year** as they were not received until 15 July 2011, (as control is presumed upon receipt).

The recognition required in July 2011 would be the following:

Dr Cash (asset)	\$ 50,000	
Cr Grants– non-recurrent revenue (income)		\$ 50,000

Reciprocal transfers

Paragraph 20 of AASB 118, imposes the recognition requirements of a reciprocal transfer, when the funding provided is for the provision of services.

20 When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the end of the reporting period. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

- (a) the amount of revenue can be measured reliably;
- (b) it is probable that the economic benefits associated with the transaction will

- flow to the entity;
- (c) the stage of completion of the transaction at the end of the reporting period can be measured reliably; and
- (d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

As discussed above, a common condition for reciprocal funding arrangements will be that if the funds are not spent in accordance with the objective of the funding agreement then the funds will be required to be repaid. Because of such a strong condition, it means that a council does not 'control' the funds until the conditions are met, regardless of whether they have received the cash. As a result, income shall only be recognised along the way, when each condition is met under the funding agreement. If, however, the conditions are such that the assessment of the scope cannot be identified until completion of all conditions, then a liability needs to be recognised in full.

6.6 What disclosure requirements are there for contributions?

Non-reciprocal transfers

AASB 1004 *Contributions*, requires the following disclosures in the financial statements:

- contributions recognised as income during the reporting period in respect of which expenditure in a manner specified by a transferor contributor, had yet to be made as at the reporting date, details of those contributions and the conditions attaching to them;
- contributions recognised as income during the reporting period that were provided specifically for the provision of goods or services over a future period;
- contributions recognised as income during the reporting period that were obtained in respect of a future rating or taxing period identified by the local government, GGS or whole of government for the purpose of establishing a rate or tax;
- the nature of the amounts of the above three points and the time period that points 2 and 3 relates;
- contributions recognised as income in a previous reporting period that were obtained in respect of the current reporting period.

Reciprocal transfers

AASB 118 *Revenue* requires the following disclosures in the financial statements:

- the accounting policies adopted for the recognition of revenue including the methods adopted to determine the stage of completion of transactions involving the rendering of services;
- the amount of each significant category of revenue recognised during the period including revenue arising from the sale of goods, the rendering of services, interest, royalties and dividends;
- the amount of revenue arising from exchanges of goods or services included in each significant category of revenue.

6.7 How do I recognise a contribution of voluntary services, as a result of a natural disaster?

Local councils may have received voluntary services from the community to assist in the cleanup and rebuilding. Councils can recognise volunteer services **only** when they:

- would have purchased the service if it were not for the contribution of volunteer services; and

- the donated services can be measured reliably.

Councils will be required to measure the volunteer services at fair value as income, and a corresponding expense, therefore having a nil impact on the Comprehensive Income Statement.

Please refer to the example below.

Example 2 – Recognition of voluntary services

Example

Australian City Council (“City Council”) had 10 volunteers offer their time to assist in the cleanup of the local library. The council initially looked in to the cost of this clean up being conducted and were quoted \$20,000.

Should these voluntary services be recognised in the financial statements?

The following journals are required to be recognised:

Dr Resources utilised for cleanup (income)	\$20,000
Cr Resources provided free of charge– cleanup (expense)	\$20,000

To recognise, at fair value, the resources provided free of charge to assist in the cleanup of the Local Library

Please note that this is required to be disclosed as a separate line item in the financial statements.

This requirement is reflected in paragraph 44 of AASB 1004 *Contributions*.

7 Debt collectability and impact on financial statements

Councils may have receivables from members of the community who have been affected by floods. These debtors may have difficulty in repaying these debts where they have been affected by the floods.

This section discusses how such debtors should be accounted for at 30 June.

7.1 What accounting standards need to be considered?

Trade and other debtors are financial assets under AASB 132 *Financial Instruments: Presentation* ("AASB 132"). AASB 7 *Financial Instruments: Disclosures* ("AASB 7") and AASB 9 *Financial Instruments* ("AASB 9") also cover the principles for recognition, measurement and presentation of financial assets. Debtors recognised in the Balance Sheet of councils may include:

- rates debtors;
- parking infringement debtors;
- loans and advances to community organisations; and
- other debtors.

The accounting policy for trade and other receivables in the Local Government Model Financial Report (LGMFR) is:

Receivables are carried at amortised cost using the effective interest rate method. A provision for doubtful debts is recognised when there is objective evidence that an impairment has occurred.

7.2 When will debtors have to be impaired?

AASB 9 sets out the impairment requirements for financial assets.

If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows.

The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss.

Objective evidence of an impairment loss occurs as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. The following events may provide objective evidence that a financial asset is impaired:

- significant financial difficulty of the issuer or obligor;

- a breach of contract, such as a default or delinquency in interest or principal payments; and
- observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including adverse changes in the payment status of borrowers in the group (e.g. an increased number of delayed payments).

An entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant.

For example, the council has noted that since the floods, repayment of parking fines has declined significantly. This would indicate impairment of the total of that group of debtors. As a result, the council may determine that parking fine debtors should be provided against where they are more than a number of days outstanding, e.g. more than 90 days.

If the council became aware that an individual specifically had become bankrupt, for instance, then that debtor would be fully impaired regardless of the days outstanding.

7.3 Can a provision for bad debts be reversed?

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss shall be reversed either directly or by adjusting an allowance account. The reversal shall not result in a carrying amount of the financial asset that exceeds what the amortised cost would have been had the impairment not been recognised at the date the impairment is reversed. The amount of the reversal shall be recognised in the Comprehensive Income Statement.

Example 1 – Consideration of debt collectability

Example

Australian City Council ("City Council") has \$2000 in outstanding parking fines recognised at 30 June 2011. Of the total, \$500 is not overdue, \$800 is between 30-60 days overdue, \$500 is 60-90 days overdue and \$200 is over 90 days overdue. The City Council has noted a significant increase in its overdue debtors in this area since the floods.

The City Council does not expect to receive payment for any of the fines that are more than 90 days overdue.

In addition, the Council is aware that one of the debtors in the 30-60 days category, with an individual debt of \$100 has been declared bankrupt.

How would the City Council account for these debts at 30 June 2011?

Based on the information provided, City Council would assess impairment of this group of debtors as \$300 (being \$200 for all 90 day debtors plus \$100 for the individually bankrupt debtor). The entry to record this is:

Dr Impairment expense – debtors (expense)	\$ 300	
Cr Provision for doubtful debts (liability)		\$ 300

To record the provision for doubtful debts at balance date

7.4 What disclosure requirements are required?

Specific disclosures pertaining to debtor collectability are set out in AASB 7.

When financial assets are impaired by credit losses and the entity records the impairment in a separate account (e.g. an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it shall disclose a reconciliation of changes in that account during the period for each class of financial assets.

The LGMFR requires disclosure of financial assets that are either past due or impaired, including:

- an analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired; and
- an analysis of financial assets that are individually determined to be impaired as at the end of the reporting period, including the factors the entity considered in determining that they are impaired.

8 How non-compliance with financing arrangements and creditor terms impact the financial statements

As a result of the floods, councils may have increased cash outflow requirements for repairs and assistance to communities. This may require councils to use cash for these purposes rather than paying their creditors.

If councils have borrowings, the related loan agreements may contain covenants that require the council to have a certain amount of net assets throughout the period and/or sufficient surpluses to make interest payments. If the covenants are breached, the effect will usually be that the loan becomes immediately callable by the lender, despite the fact that it may have a long term maturity. As a result of the damage caused by the floods, councils may have to write down the value of significant assets, such as infrastructure assets until they are repaired or replaced. This will affect net asset positions and may result in losses being incurred where insurance compensation and/or grant revenue in respect of that damage is not received until after year end. This in turn may affect loan covenants.

This section provides guidance on how such situations may affect the financial statements at balance date.

8.1 What needs to be considered when creditors are not being paid?

Short term creditors and payables are financial liabilities under AASB 132 *Financial Instruments: Presentation*. Late payment of creditors will not affect the measurement of these liabilities as they are recognised at the amount expected to be paid, unless interest will be incurred for late payment.

The key issues in this situation will pertain to financial instrument disclosures, which are required by AASB 7 *Financial Instruments: Disclosures* ("AASB 7").

AASB 7 does not require specific disclosures relating to short term payables and creditors; however, they will need to be included in the required disclosures around liquidity risk. These are found in AASB 7, paragraph 39 which requires disclosure of:

- a maturity analysis for non-derivative financial liabilities (including issued financial guarantee contracts) that shows the remaining contractual maturities;
- a maturity analysis for derivative financial liabilities; and
- a description of how it manages the liquidity risk inherent in these analyses.

In the circumstances described above, disclosure will be required as to how the risk is mitigated, that is, where the council is expecting cash inflows, e.g. from grants or insurance compensation, which would be noted as a mitigating factor.

8.2 What needs to be considered when borrowing terms have been impacted?

Borrowings are financial liabilities under AASB 132 *Financial Instruments: Presentation*. As noted above, loans will normally include debt covenants within their conditions which, if breached, will result in the loan being payable on demand rather than on maturity. This affects the classification of the loan such that it would be a **current** rather than a **non-current liability** as required by AASB 101 paragraphs 74-75:

When an entity breaches a provision of a long-term loan arrangement on or

before the end of the reporting period with the effect that the liability becomes payable on demand, it classifies the liability as current, even if the lender agreed, after the reporting period and before the authorisation of the financial statements for issue, not to demand payment as a consequence of the breach. An entity classifies the liability as current because, at the end of the reporting period, it does not have an unconditional right to defer its settlement for at least twelve months after that date.

However, an entity classifies the liability as non-current if the lender agreed by the end of the reporting period to provide a period of grace ending at least twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.

In addition, AASB 7 paragraph 18 will require disclosure of the following:

- details of any defaults during the period of principal, interest, sinking fund, or redemption terms of those loans payable;
- the carrying amount of the loans payable in default at the end of the reporting period; and
- whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.

What if the lender agrees to waive terms after the balance date?

If the lender agrees to a period of grace after the end of the reporting period but before the financial statements are signed, then this is considered a non-adjusting subsequent event. (Refer *Section 10 How will events relating to a natural disaster that occur after balance date, impact the financial statements?* for further discussion of subsequent events). This is outlined in AASB 101, paragraph 76. In this case disclosure would be made in the financial statements of details of the waiver however the loan would remain classified as a current liability.

Example 1 – Non-compliance with borrowing covenants

Example

Australian City Council (“City Council”) has borrowings from the bank which have covenants regarding net assets and interest coverage. As a result of the floods the City Council have had significant asset impairments which have resulted in them not meeting these requirements during the year ended 30 June 2011.

Is there any effect on the 30 June 2011 financial statements?

Yes. The borrowings will be classified as current liabilities in the balance sheet and specific disclosure will be required in the notes to the financial statements providing details of the breach.

9 Going concern implications (potential guarantees for financial assistance or announced funding, ongoing financial viability)

The *Framework for the Preparation and Presentation of Financial Statements*, paragraph 23 notes that financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

The concept of going concern includes both the ability to pay debts as and when they fall due and the ability to continue in operation for the foreseeable future.

AASB 101 *Presentation of Financial Statements* ("AASB 101") paragraph 25 requires financial statements to be prepared on a going concern basis unless the entity will be liquidated or cease trading. It also requires entities to make an assessment of their ability to continue as a going concern. When there are material uncertainties related to events or conditions that may cast significant doubt upon the council's ability to continue as a going concern, AASB 101 requires disclosure of those uncertainties.

This section will assist councils in making an assessment of the ability to continue as a going concern and when appropriate disclosures are required to be made.

9.1 What is included in a going concern assessment?

AASB 101 paragraph 26, notes that this assessment will take into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period. The degree of consideration will depend on the facts in each case.

If a council has a history of profitable operations and ready access to financial resources, the council may reach a conclusion that the going concern basis of accounting is appropriate without detailed analysis. This would be the case where losses have not been made and the council has positive working capital (current assets) and net assets in their balance sheet.

In other cases, such as where there are losses and/or working capital and net asset deficiencies, a wide range of factors may need to be considered, including current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate.

For example, if a council has incurred expenses as a result of the floods because they have had to pay for repairs it may be that they have resulted in a greater than expected deficit in the Comprehensive Income Statement. This will be emphasised because of the fact that insurance recoveries cannot be booked as revenue until the receipt of the claim is virtually certain. This may occur in a different period to the expense being incurred. In addition, the requirement to impair asset values and/or to incur liabilities may result in net current assets and / or net assets in the balance sheet being negative. Negative current assets is an indicator of solvency issues as it indicates that more liabilities are required to be paid in the next 12 months than there will be cash or other assets available to use for payment.

9.2 What disclosures need to be made?

Where the financial statements appear to indicate uncertainties surrounding going concern, it is advisable for councils to make disclosure regarding the facts behind the financial performance and position. This will enable readers of the financial reports to understand the

true solvency position of the council after all factors are taken into account, for example insurance recoveries not yet recognised and financing to be received in the future.

The required disclosures will be made in note 1(a) to the financial statements and will need to describe the uncertainties surrounding the going concern assumption. For most councils this will be a reference to the indicators of going concern issues such as the balance sheet position or income deficit. A statement of fact is then made as to the factors which mitigate these uncertainties and provide the council with evidence to support the application of the going concern assumption.

Example 1 – Going concern disclosure

Example

Australian City Council (“City Council”) incurred significant expenditure to repair roads damaged in the flooding during the year ended 30 June 2011.

They have made an insurance claim in relation to this expenditure but notification of the approval of this claim has not yet been received. The Council will also be eligible for government assistance and expect to receive confirmation of the amount after signing the financial statements. Furthermore, an impairment expense has been incurred in respect of a bridge which has not yet been rebuilt. As a result the Council’s Comprehensive Income Statement is showing a deficit for the year ended 30 June 2011 of \$1,000,000. As a result of the significant cash outflows, and increase in slow-paying fines debtors, the balance sheet is showing a net current liability position at 30 June 2011 of \$100,000. The impairment of the bridge has also resulted in a net liability position at 30 June 2011 of \$500,000.

What disclosures should be made in the financial statements for the year ended 30 June 2011 regarding going concern?

The following disclosure should be made in note 1(a) *Basis of accounting* of the financial statements

Going concern

The financial statements have been prepared on the going concern basis, which contemplates continuity of normal activities and the realisation of assets and discharge of liabilities in the normal course of providing services to the local community.

As disclosed in the financial statements, the Council incurred a deficit of \$1,000,000 for the year ended 30 June 2011. As at that date they had net current liabilities of \$100,000 and net liabilities of \$500,000.

The Councillors believe that it is reasonably foreseeable that the Council will continue as a going concern and that it is appropriate to adopt the going concern basis in the preparation of the financial report after consideration of the following factors:

- the deficit has primarily resulted from significant expenditure to repair roads damaged in the flooding during the year and the write-down of value in a bridge destroyed in the floods
- insurance claims have been lodged in relation to this expenditure but notification of the approval of this claim
- has not yet been received. Receipt of the insurance compensation will result in income being recognised in the year ended 30 June 2012
- the Council will also be eligible for government assistance announced in May 2011 and expects to receive
- confirmation of the amount in October 2011. This will also be recognised as income in the year ended 30 June 2012
- receipt of funding and reconstruction of the bridge is expected to bring the Council back into a net current
- asset and net asset position as at 30 June 2012.

10 How events relating to a natural disaster that occur after balance date, impact the financial statements

This section deals with the accounting treatment of events occurring after the reporting period which are classified into two types – adjusting and non-adjusting events.

The vast majority of impacts from the floods on councils occurred during the reporting period which will need to be recognised in the Comprehensive Income Statement and Balance Sheet where appropriate. However, further events may occur after the reporting period where councils will need to assess the impact of these events and determine whether they are to be classified as adjusting or non-adjusting events and either recognise them in the financial statements, or merely disclose them.

The purpose of disclosing subsequent events in the financial statements is to allow the users of the financial statements to understand any material transactions or circumstances that have occurred post balance date, which may impact on their interpretation of the councils current and future position.

Guidance on how to account for these events is provided below.

10.1 What is an event after the end of a reporting period?

Paragraph 3 of AASB 110 *Events after the Reporting Period* ("AASB 110") states that an 'events after the end of the reporting period' are:

Those events, favourable and unfavourable, that occurs between the end of the reporting period and the date when the financial statements are authorised for issue.

Two types of events can be identified:

- those that provide evidence of conditions that existed at the end of the reporting period (**adjusting events** after the end of the reporting period); and
- those that are indicative of conditions that arose after the end of the reporting period (**non-adjusting events** after the end of the reporting period).

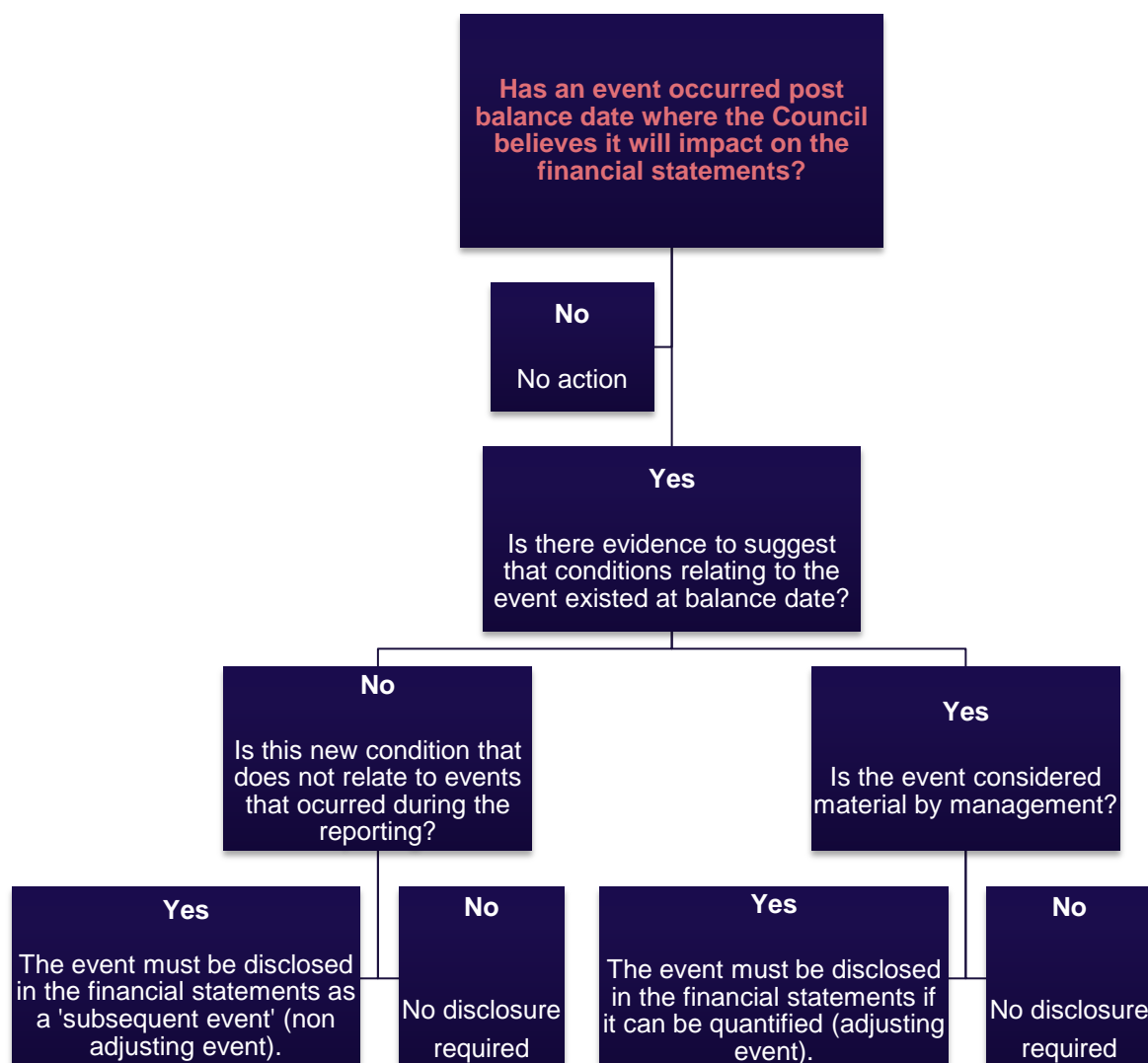
10.2 What accounting standards relate to subsequent events

AASB 110 *Events after the Reporting Period* ("AASB 110") prescribes the requirements for accounting for events after the reporting period.

For councils, there is a substantial amount of time between the end of the reporting period, being 30 June, and the authorisation of the financial statements, generally being late August. When subsequent events occur after the end of the reporting period and prior to the authorisation, AASB 110 requires that the event be identified as either an adjusting or non-adjusting event, depending on whether there is evidence of conditions to prove that it existed at the end of the reporting period.

The following decision tree should help you determine the required treatment when a specific event has occurred after balance date and prior to the authorisation of the financial statements.

Figure 10A Decision tree – subsequent events that trigger either adjustment or disclosure in the financial statements



10.3 What measurement and recognition requirements exist for subsequent events?

Adjusting Events after the End of the Reporting Period

In accordance with paragraph 8 of AASB 110, an entity **is to adjust** the amounts recognised in its financial statements to reflect adjusting events after the end of the reporting period, where conditions existed at balance date and the event can be quantified (and is material).

Non-Adjusting Events after the End of the Reporting Period

In accordance with paragraph 10 of AASB 110, an entity **is not to adjust** the amounts recognised in its financial statements to reflect non-adjusting events after the end of the reporting period where conditions did not exist at balance date.

10.4 Examples of adjusting and non-adjusting events

Example 1 – Claim lodged against the Council; either pre or post balance date

Example

A ratepayer has lodged a lawsuit for a claim for damages of \$10,000 against the Council.

The claim has been lodged as the ratepayer believes that the Council has been negligent with cleanup services for the community as a result of the floods because a local road was still under water and blocked the ratepayer's private road to his farm.

He was therefore unable to transport goods from his farm which resulted in a loss of income.

The Council does not believe it will have to pay the damages. How should this claim be treated in the 30 June 2011 financial statements?

The answer will depend on when the lawsuit was brought against the Council.

If the law suit was brought against the Council after 30 June

If the lawsuit was brought against the council after 30 June, then although the lawsuit did not exist at reporting date, it arose out of events (i.e. the floods) that occurred before the end of the reporting period and so should be reflected in the financial statements.

Although the council does not expect to pay the amount, at a minimum, it should disclose the event in the notes to the financial statements as a contingent liability, including quantification of the damages being claimed.

The council may need to recognise a provision in the financial statements if:

- upon assessment of evidence obtained on the lawsuit, it appears to result in a potential obligation by the council; and
- it can be reliably measured.

For guidance on when a provision can be recognised, please refer to *Section 5 How are future expected costs or claims lodged against the Council by ratepayers recognised in the financial statements?*

If the law suit was brought against the Council before 30 June

If the lawsuit was brought against the Council before 30 June, but has not been settled before the financial statements are authorised, then this situation clarifies conditions that existed at the end of the reporting period.

The amount of the proposed claim (\$10,000) has been quantified. If deemed material, quantification of the amount must either be recognised in the financial statements as a provision or disclosed as a contingent liability.

The recognition will be dependent on management's assessment of the evidence available for the lawsuit. Disclosing the claim in the notes to the financial statements without the damages being quantified in this situation is

insufficient.

Please refer to Section 5 for guidance on when a provision or contingent liability should be recognised.

If the lawsuit was settled before the financial statements were authorised

If the lawsuit was settled before the financial statements were authorised, then the settlement confirms that the council had a present obligation at 30 June.

The council would need to adjust any previously recognised provision related to this lawsuit in accordance with AASB 137 *Provisions, Contingent Liabilities and Contingent Assets* ("AASB 137").

The council could not disclose this event as a contingent liability because the settlement provides additional evidence to management that conditions existed at the end of the reporting period.

Example 2 – Damage to sites discovered post balance date

Example

The water from the floods did not subside from a main road until July 2011.

At that time, the Council discovered significant damage to a large portion of the road which will have to be repaired. Repairs are estimated at approximately \$500,000. The Council expects that their insurance policy will cover the cost.

How should this damage be treated in the 30 June 2011 financial statements?

This damage arose out of events (i.e. the floods) that occurred before the end of the reporting period and so should be reflected in the financial statements. Information has subsequently arisen to confirm the expected amount of the damage. The likely adjustments to occur in this situation will be in relation to the impairment of the road.

Refer to *Section 1 How are items of property, plant, equipment or infrastructure damaged or destroyed, accounted for in the financial statements?* for discussion on the recognition and measurement requirements of property, plant, equipment and infrastructure impairments. Also, the treatment of the related insurance claims has been discussed in *Section 4 How are actual or anticipated insurance recoveries accounted for as a result of a natural disaster?*

Generally, the claim will be disclosed as a contingent asset until notification has been received by the council that the claim has been approved; hence the reimbursement is 'virtually certain'.

If the insurance claim is approved before the financial statements are authorised, it is required to be disclosed as a subsequent event, however no adjustment will be made in the

Balance Sheet or Comprehensive Income Statement. Approval of the claim is a non-adjusting event as the claim arose after the end of the reporting period.

Disclosure of the event must occur in accordance with paragraph 21 of AASB 110. The Council is required to disclose in the financial statements:

- the nature of the event; and
- an estimate of the financial effect, or a statement that such an estimate cannot be made.

When disclosing the nature and effect, care should be taken if commentary is included regarding potential insurance coverage, particularly if the extent of coverage has not been confirmed by the insurer, as we do not want to mislead the reader.

Example 3 – Announcements after 30 June

Example

The State Government announced in July 2011 that they will provide financial assistance to Councils as a result of the recent floods.

The Council was notified in August 2011 that it will receive \$100,000 from the Government in September 2011.

How should this assistance be treated in the 30 June 2011 financial statements?

This is a non-adjusting event because it does not represent a condition that existed at the end of the reporting period.

The announcement is made after 30 June 2011 and the council did not have any entitlement to the assistance until August 2011. Information in relation to the nature and financial impact is required to be disclosed in the notes (rather than adjusting the financial statements).

