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Turbulent times 2nd edition
Key accounting considerations in today's volatile markets

Non-financial entities are also affected by declining asset values of their investments and employee benefit plans; they are exposed to the credit market due to the difficulties in securing finance and increased cost of borrowing. As many economies enter recession, impairment of goodwill and many other tangible and intangible assets will become more widespread.

This accounting alert focuses on the following:

- Determining fair values in inactive markets.
- Revised projections of economic outlook indicating impairment and lack of recoverability for many assets.
- Reduced availability of credit and increasing cost of finance.
- Increased levels of bankruptcy.
- The impacts on hedge accounting.
- Critical enhanced disclosure requirements.

The accounting considerations described apply to all entities – they are not unique to financial institutions. Non-financial entities are also affected by declining asset values of their investments and employee benefit plans; and they are exposed to the credit market due to the difficulties in securing finance and increased cost of borrowing. As many economies enter recession, impairment of goodwill and many other tangible and intangible assets will become more widespread.

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This accounting alert does not introduce new accounting guidance. All guidance below already exists in current IFRS. It highlights the accounting literature that is most likely to be relevant when assessing the accounting in today's volatile markets.

1. Determining fair values in inactive markets

Falling asset values
Equities, other financial assets and real estate are most affected. Entities are exposed to declining asset values both directly as a result of having invested in assets whose values are now declining, and indirectly, through exposures to pension and other benefit plans that invested in assets whose values are now declining.

1.1 Fair value of financial instruments
Determining fair value in today's turbulent markets

The IASB's Expert Advisory Panel issued on 31 October 2008 a report entitled *Measuring and disclosing the fair value of financial instruments in markets that are no longer active*. The report provides guidance on how to determine the fair value of financial instruments in markets that are no longer active and provides recommended best practice disclosures. The IASB website contains both the report and an IASB staff summary. The report:

- dispels some myths about what is fair value and clarifies the objectives of fair value measurement;
- provides guidance on identifying what is a forced transaction (and thereby which transactions are not representative of fair value);
- addresses inputs into a valuation technique and, in particular, the need to include the current market assessment of credit risk (both counterparty and own credit risk) and liquidity risk, both for derivative and non-derivative instruments; and
- addresses the reliance that can be placed on use of data from brokers and independent pricing services in determining fair value.

This report is not limited to those entities that subsequently measure instruments at fair value, i.e. items classified as at fair value through profit or loss (FVTPL) or as available-for-sale (AFS), but is relevant to *all entities* because, even if the financial instrument is not measured at fair value, its fair value must be disclosed in accordance with IFRS 7.25.

Investment in equity securities – AFS
IAS 39.67 requires the recycling of cumulative fair value losses from other comprehensive income (OCI) to profit or loss ('P&L') for equity securities when there is a "significant or prolonged decline in the fair value below its cost". IAS 39 does not provide a bright line as to what is 'significant' relative to cost or what is a 'prolonged' decline in the fair value… However, declines in equity markets have been, and continue to be, severe with many equity global indices down nearly 50% from their 12-month highs. In addition, the decline in equity indices is not a short-term fluctuation, with declines being experienced in many cases every month since July 2007.

Determining whether an equity investment is impaired will need careful consideration of the facts of the specific investment, e.g. what is its cost relative to current fair value, and how long has fair value remained lower than cost? In many instances equity investments will be impaired and amounts in OCI will need to be recycled to P&L.

If the fair value of an equity instrument continues to fall after an impairment loss has been recognised in P&L then these further declines should be recognised immediately in P&L. Reversals of impairments of available-for-sale equity securities through P&L are not permitted. As a result, any future increases in fair value are recognised directly in OCI.

Investment in debt securities – AFS
If an investment in an available-for-sale debt instrument is impaired the amount recycled from OCI to P&L is the *total* cumulative fair value loss in OCI – it is not the impairment amount that would have been recognised in P&L had the debt instrument been measured at amortised cost. In current market conditions the amount recycled can be significantly larger than the amount recognised for an equivalent asset measured at amortised cost because of the changes in fair value due to changes in risk-free rates and overall widening of spreads associated with credit risk and liquidity risk since the asset was initially recognised.

If the fair value of a debt instrument continues to fall after an impairment loss has already been recognised in P&L then these further declines are also recognised in P&L. If the fair value of an available-for-sale debt instrument increases and the increase can be related objectively to an event occurring after the impairment was recognised, then the increase in value is considered to be a reversal of the impairment and is recognised in profit or loss, up to the amount that has been previously recognised as an impairment loss.

Reclassifications

Following the IASB amendment to IAS 39 issued on 13 October 2008 limited reclassifications of non-derivative assets from held for trading (part of FVTPL) and AFS are permitted. A summary of the amendment is available in our IASplus newsletter on iasplus.com.

Some common questions answered:

Q: Does the amendment permit an entity to reclassify a loan commitment that was designated as at FVTPL?

A: No, for a number of reasons. The amendment does not apply to: derivatives (loan commitments meet the definition of a derivative); financial liabilities (a written loan commitment would be a liability if recognised), financial instruments that are classified as at FVTPL as a result of being designated as such under the fair value option (loan commitments may be designated under IAS 39.4(a)).

Q: If an entity wishes to reclassify an asset from FVTPL or AFS to Loan & Receivables (L&R) at what date should the entity apply the definition of L&Rs? The date of initial recognition, or date of reclassification?

A: The amendment is not clear and therefore we believe either date is appropriate provided the date chosen is applied consistently to all reclassifications as an accounting policy choice.

Q: Does the normal subsequent measurement guidance apply if an asset is reclassified?

A: Generally yes, however, in the case of a reclassified debt instrument if there are subsequent increases in the recoverability of cash flows after reclassification the carrying amount is not adjusted upwards as currently required by IAS 39.AG8. Instead, a new effective interest rate is determined and is applied from that date forward.

Q: If a debt instrument is reclassified out of AFS how should the amount in the AFS reserve in OCI be treated?

A: The guidance in IAS 39.54 for reclassifying AFS to HTM that existed in IAS 39 prior to the amendment applies. If the debt instrument has a maturity the amount in equity will be released to P&L as part of the new effective interest rate determined at the date of reclassification. If the debt instrument does not have a maturity, e.g. the instrument is perpetual, the amount in equity will be released to P&L when derecognised. In the case of subsequent impairment, amounts in equity will need to be recycled to P&L.

Q: Can an investment in a 'cash-CDO' (see iGAAP *2008 Financial instruments IAS 32, IAS 39 & IFRS 7 explained* page 201) be reclassified from FVTPL or AFS to L&R?

A: It will depend partly on the type of assets in the entity that has issued the cash-CDO note. IAS 39.9 states that "An interest acquired in a pool of assets that are not loans and receivables (for example, an interest in a mutual fund or a similar fund) is not a loan or receivable". Therefore, if the assets in the issuing entity do not meet the definition of L&Rs then the cash-CDO investment cannot be classified as a L&R. The instrument could therefore be reclassified from FVTPL to AFS or HTM only, or from AFS to HTM (provided the criteria for classification as HTM are met).

Q: Is an entity required to assess whether it needs to separate out embedded derivatives on the date of reclassifying out of FVTPL?

A: The standard does not explicitly address this point. At its meeting in December the IASB discussed this issue and agreed to issue an exposure draft proposing an amendment to IFRIC 9 *Reassessment of Embedded Derivatives* to require reassessment at the date of reclassification. This reassessment must be based on conditions existing at the inception of the instrument concerned. If an entity cannot establish a fair value for the embedded derivative, the entire contract must continue to be fair valued. It is proposed for the amendment to be effective for periods ending on or after 15 December 2008 and to require full retrospective application.

Fair value of collateral
For debt instruments that are not measured at FVTPL or AFS the fair value of collateral is critical in determining the amount of an impairment loss. In the case of debt instruments measured at amortised cost if there is a reduction in the recoverability of cash flows the fair value to be obtained from seizing the collateral forms part of the impairment calculation. In determining the amount of impairment the amount of collateral recoverable should reflect the fair value of collateral at the balance sheet date. This will be the case across many forms of collateralised lending, e.g. repurchase arrangements, investments in asset-backed securities, all types of secured lending including mortgage lending. Falling collateral values may lead to further impairment losses, irrespective of whether there is a further deterioration in the borrower's ability to pay.

1.2 Fair values of non-financial items
Much of the guidance on determining fair value for financial items will be useful in the assessment of fair value for non-financial items, as explained further below.

Fair value of investment property
The downturn in the economy has increased the volatility of prices in the real estate marketplace and restricted the level of comparator transactions against which to assess value. This has increased uncertainty around reported investment property fair value compared to 'normal' market conditions. For this reason, third party valuers are indicating that they will include valuation uncertainty paragraphs in their reports in order to draw the reader's attention to the financial backdrop against which the valuations have been assessed[1]. The uncertainty paragraphs identified to date do not caveat the valuation opinion provided, but reference major upheaval in the financial sector, reduced liquidity in the market place, restricted debt etc., and state that these events have caused increased uncertainty in respect of current real estate pricing.

There is a rebuttable presumption in IAS 40 that the fair value of an investment property can be reliably determined (IAS 40.53) on a continuing basis; there is no exemption in a period of significant valuation uncertainty, even if comparable market transactions become less frequent or market prices become less readily available. The reclassifications available for certain financial instruments under the 13 October revision to IAS 39 are not available for investment property. IAS 40 only permits the transfer of investment property to another asset category in the event of an evidenced change in use. It is only in exceptional cases, where there is clear evidence when the entity first acquires an investment property (or when an existing property first becomes an investment property after an evidenced change in use) that fair value is not reliably determinable, that the entity is permitted to measure that investment property at cost, while measuring its other investment properties at fair value. These exceptional cases are expected to be very rare.

Paragraphs 33-52 of IAS 40 set out the key considerations in respect of determining the fair value of an investment property. Paragraph 46 sets out the options available in a period where there is an absence of current prices in an active market:

46 In the absence of current prices in an active market of the kind described in paragraph 45, an entity considers information from a variety of sources, including:

(a) current prices in an active market for properties of different nature, condition or location (or subject to different lease or other contracts), adjusted to reflect those differences;

(b) recent prices of similar properties on less active markets, with adjustments to reflect any changes in economic conditions since the date of the transactions that occurred at those prices; and

(c) discounted cash flow (DCF) projections based on reliable estimates of future cash flows, supported by the terms of any existing lease and other contracts and (when possible) by external evidence such as current market rents for similar properties in the same location and condition, and using discount rates that reflect current market assessments of the uncertainty in the amount and timing of the cash flows.

This gives entities the option of using a number of sources of evidence to determine fair value. The 'Basis for Conclusions' to IAS 40 confirms that, although obtaining a third party valuation is encouraged, it is not required and therefore entities do have the option of using their own analysis to underpin their assessment of fair value, assuming that the valuation in question appropriately reflects the underlying information, for example through a DCF assessment based on underlying rental agreements, evidence which can be verified by their auditors.

1 Professional rules applicable to valuation experts may in fact require valuers to draw attention to uncertainty where this could have a material effect on the valuation, indicating the causes and degree to which this uncertainty is reflected in the valuation.

The guidance contained in the IASB Expert Advisory Panel's October 2008 report on 'Measuring and disclosing the fair value of financial instruments in markets that are no longer active' is relevant to the determination of fair value of investment property in the current economic climate.

Several sections, in particular, are relevant to the valuation of investment property such as:

- active vs inactive markets (paragraph 17 onwards);
- considerations with regard to forced transactions (paragraph 21 onwards); and
- valuation adjustments as market conditions change (paragraph 29 onwards).

Similar to the approach in the IASB's Expert Advisory Panel's Report, enhanced disclosures become key.

Entities should consider splitting their investment property valuations balance into those which are supported by observable market data and those which are not, thereby giving the reader of the financial statements a detailed understanding of the source of the valuation figures. This split would need to be determined through consultation with the valuers themselves.

Enhanced disclosures are needed to draw readers' attention to the increased uncertainty around fair values of investment property. The objective of the disclosure is to give the user enough information to judge whether the fair value properly reflects the uncertainties, assumptions and market conditions at the balance sheet date. Depending on the particular circumstances, it may be useful to include:

- the professional rules applicable to valuers[2] facing increased uncertainty with respect to their valuations;
- a sensitivity analysis on property yields or an indication of the range of potential valuation outcomes to the extent valuers are willing to provide this information within their valuation reports; and
- a reproduction of the additional wording included in the valuation report by the valuers if the report is not reproduced within the financial statements, or a suitable cross reference if it is.

In addition, the valuation of investment properties may be a critical accounting judgement and/or key source of estimation uncertainty required to be disclosed in accordance with IAS 1 *Presentation of Financial Statements*.

For entities in the real estate sector, investment property is likely to be the most significant item on the balance sheet and it is reasonable to conclude that the increased uncertainty in the current market represents "estimation uncertainty at the end of the reporting period" that has "a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year" for which additional disclosure is required by IAS 1. For entities not in the real estate sector but with significant investment property portfolios, this could also be the case.

If there has been a material reduction in asset values after the balance sheet date, whether arising from a specific event or not, disclosure of the non-adjusting event is required in accordance with IAS 10 *Events after the Reporting Period*.

Non-current assets or disposal groups held for sale

Entities seeking to improve their liquidity/capital ratios may raise cash by divesting assets or businesses. Determination of fair value less costs to sell for those assets or businesses meeting IFRS 5's criteria for classification as held-for-sale may require careful consideration. Where measurement under IFRS 5 leads to a write down to fair value less costs to sell, fair value is not value in a forced or distressed sale. Where an entity is forced to sell an asset or business, an additional loss on sale may arise.

Inventory valuation

Techniques for the measurement of the cost of inventories, such as the standard cost method or retail method may need to be revised in the light of current market conditions. For example, where an entity uses the retail method, i.e. selling prices less margin, and the result no longer approximates cost, the methodology will need to be revisited.

1.3 Pension and other employee benefit plan valuations

Falls in the value of pension scheme assets and any counterparty defaults on financial instruments held in the scheme will result in potentially significant increases in defined benefit pension scheme deficits, or could turn surpluses into deficits.

2 For example, in the UK, Guidance Note 5 of the Royal Institute of Chartered Surveyors (RCIS)

The guidance above on determining fair values in today's turbulent markets for financial assets and non-financial assets like real estate equally applies to assets held by pension schemes. The market turbulence may require a full out-of-cycle actuarial valuation reflecting significant changes to critical assumptions.

In times of financial crisis, it should be expected that pension fund liabilities' valuations measured for different purposes will diverge. In particular, funding valuations may show much higher deficits than those revealed under IAS 19. This will be the case where funding valuations are based on government bond yields which remain relatively low, while corporate bond yields, which drive accounting valuations, increase significantly. This may lead to requests or demands (where pension trustees have the power) for additional contributions (see Section 2 of this Alert on *Revised projections of economic outlook* below).

Pension scheme plan assets

Entities may have adopted a buy-in strategy whereby insurance policies are used to pay current pensions in payment. These will need to be valued correctly at the reporting date and the nature of such transactions considered carefully as to whether they are settlements, curtailments or past service costs.

Plans may also have holdings in hedge funds, structured products and other illiquid assets and it is important that such arrangements are also valued appropriately.

Some pension schemes have participated in stock lending or purchased derivative financial instruments to mitigate their funds' exposure to interest rate, inflation and equity market volatility. Where this is the case, directors need to consider counterparty risk (and actual default) when valuing their investments.

Pension scheme liabilities

The discount rate used to value accrued pension liabilities for accounting purposes should be set by reference to the yield available on high quality corporate bonds of appropriate term (or, where there is no deep market in such bonds, the market yields on government bonds). Typically AA rated bonds or similar bond yields have been used for this purpose.

In recent years, it has been common to refer to the average yield on an index of corporate bonds. Use of an index figure may overstate the discount rate (and thus understate the liabilities) for all but the most mature pension schemes. For less mature schemes, the implied mean term of the index may be lower than the mean term of liabilities.

The 'credit crunch' over the past year has also impacted the choice of discount rate as there has been a significant increase in the yields available on bonds as a result of perceived increased credit risk. The credit spread has increased significantly, in particular for bonds issued by financial institutions.

While this spread exists within the population of an index, entities should not seek to use an index rate without due consideration. Entities should consider the spread in yields in the constituents of any index, and, if an adjustment to the rate is deemed appropriate, consider the rationale used to make the adjustment. Entities should consider whether disclosure of the factors affecting the choice of rate used is required as a critical judgement or key source of estimation uncertainty under IAS 1.

In the US, there are moves to discount liabilities based upon the full yield curve rather than applying a single rate to apply to all liabilities. To date, this approach is rare for calculating accounting disclosures in other jurisdictions, but entities that are SEC registrants (or affiliates thereof) and/or with US pension schemes should be aware of the potential impact of adopting this alternative approach.

The current economic climate has other effects on pension schemes:

- The majority of benefits may be linked to price inflation. The discount rate itself will depend on the price inflation assumption, including the effect of the credit crunch on demand for government fixed and indexed bonds which has affected market views of future price inflation.

- The scheme's assumptions must remain reasonable in the context of current market conditions and the scheme's investment strategy. This includes assumptions on expected returns on assets.

- There are increased levels of redundancies and these may lead to significant changes in the scheme membership since the last formal valuation of the scheme; similar changes may also arise where a subsidiary employer has been sold. This may trigger the need for a more detailed reassessment of the liability.

- As a result of recent market volatility, trustees may be reviewing the existing funding agreement and, in particular, their view of the ability of an entity to fund any deficit over the agreed period. This may result in increased demands for contributions from employers.

  – Directors will need to consider whether the assumptions they are using to produce forecasts on which the going concern assumption is based reflect an up-to-date expectation of actual pension-related cash flows.

  – Trustee powers may have an influence on whether the entity is a going concern. Some scheme rules give Trustees powers to wind-up the scheme in certain circumstances (for example where they no longer believe the entity is capable of fully funding the scheme). If exercised, these powers could create a statutory debt large enough to make the entity insolvent. Although trustees should consider all relevant interests (including those of the entity) before exercising such powers, it is important that the impact of them doing so is fully understood.

  – Entities subject to solvency or regulatory capital requirements will need to consider, on a regular basis, the impact of changes in their pension fund valuations on their ability to comply with these requirements. Regulators are focusing on stress testing and liquidity testing, and pension scheme funding is likely to be an area of focus.

Directors will need to consider whether the increased volatility in investment prices has had a material impact on the valuation of their pension assets since the year-end, triggering the need for disclosure of a non-adjusting post balance sheet event. In considering this issue, directors need to consider whether the movement would be likely to affect decision-making by a user of the financial statements. Relevant factors could include the potential impact on funding requirements and trustee behaviour. Other examples of material post balance sheet events could include a significant counterparty default or material change to the composition of the scheme due to redundancies.

It is unlikely that calculating a precise value of the pension assets at a date shortly before signature of the financial statements will provide meaningful information, but consideration should be given to disclosure of the percentage movement and volatility in the relevant markets and a description of the possible effects, e.g. that it may affect future funding considerations.

2. Revised projections of economic outlook

Cash flow projections
For the purposes of determining asset and liability valuations cash flow forecasts must be updated and consistent with the economic conditions entities face. Cash flow projections used in measuring fair values, goodwill or asset impairment calculations and in assessing restructuring provisions must be supportable and reasonable. Appropriate disclosures as required by the relevant Standards must also be provided.

2.1 Impairment of non-financial assets (including goodwill)

Recent declines in the prices of equity securities traded in public markets, increases in the cost of finance due to reduced availability of credit, significant decreases in market prices of non-current assets or asset groups and adverse changes in the business climate may indicate an impairment of many of an entity's assets. These include:

- goodwill and intangibles;

- land, buildings, machinery and equipment;

- investment property carried at cost;

- biological assets carried at cost;

- investments in subsidiaries, associates, and joint ventures (in the scope of IAS 36 *Impairment of Assets* even though they are financial assets); and

- assets carried at revalued amounts under IAS 16 *Property Plant and Equipment* and IAS 38 *Intangible Assets*.

Questions to consider include:

- Has the entity encountered recurring operating losses and working capital deficiencies?

- Has there been a decline in revenues because of losses or declines in sales in major markets or to specific customers?

- Has the entity been liquidating assets, selling business units, or making other changes in operations in response to the current economic environment and liquidity needs?

An asset will be impaired whenever its carrying amount exceeds its recoverable amount (the higher of value-in-use and fair value less costs to sell). If any indication of impairment exists, the entity will be required to estimate the recoverable amount of the asset to determine the existence and amount of any impairment loss.

Intangible assets with an indefinite useful life, intangible assets not yet available for use and goodwill acquired in a business combination, are not only to be tested for impairment annually, but also between annual tests if there are indicators of impairment.

IAS 36 includes the following (non-exhaustive) list of external and internal impairment indicators; which are likely to be triggered as entities face adverse economic conditions.

External indicators of impairment:

- carrying amount of the net assets of the entity exceeds its market capitalisation;

- significant changes with an adverse effect on the entity during the period, or expected to take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated;

- increases in market rates of return which are likely to affect the discount rate used in calculating an asset's value in use and hence decrease the asset's recoverable amount; and

- a decline in an asset's market value during the period that is significantly more than would be expected as a result of the passage of time or normal use.

Internal indicators of impairment:

- cash flows for acquiring the asset, or subsequent cash needs for operating or maintaining it, significantly higher than those originally budgeted;

- actual net cash flow or operating profit or loss worse than budgeted; and

- a significant decline in budgeted future net cash flows or operating profit, or a significant increase in budgeted loss, flowing from the asset.

Value-in-use calculations

Careful consideration of the cash flow projections, discount rates and 'current' sales prices used in value-in-use calculations will be critical in terms of their supportability and reasonableness given market conditions.

Key principles to bear in mind include:

- estimated cash flows and discount rates should be free from both bias and factors unrelated to the asset in question;

- estimated cash flows or discount rates should reflect a range of possible outcomes, rather than a single, most likely, minimum or maximum possible amount;

- cash flow projections should be based on the most recent financial budgets/forecasts approved by management, covering a maximum period of five years, unless a longer period can be justified; and

- projections of cash flows beyond the period covered by the most recent budgets/forecasts should be estimated by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified based on objective information about patterns over a product or industry lifecycle. This growth rate should not be overly optimistic and should not exceed the long-term average growth rate for the products, industries, or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified. In some cases, it may be appropriate for the growth rate to be zero or negative.

2.2 Events and circumstances indicating an impairment of goodwill

Particularly at a time of falling markets, it is critical for preparers to reassess the recoverability of any goodwill balances. Disclosure of the basis on which recoverable amount has been measured, i.e. value-in-use or fair value less costs to sell, and the key assumptions used to determine that value must be spelt out in sufficient detail. For example, providing the specific assumptions for material cash-generating units, as opposed to a range of assumptions across cash-generating units, makes it easier for a reader to assess the recoverability of goodwill.

It should be possible from the level of disclosure required under IAS 36 to assess whether management's approach to assessing impairment is reasonable. The carry forward of historical assumptions with due explanation as to how these can be evidenced to be valid by reference to current external market data, or alternatively, where these are adjusted, details of what they have been adjusted for and how, is critical to ensuring that management's approach can be concluded to be reasonable. Where the outcome is highly sensitive to the assumptions made, entities should provide disclosure of the effect of a reasonably possible change in assumptions on the recoverability of goodwill, quantified where possible, for example, by providing a sensitivity analysis (see Section 7 of this Alert on *Critical enhanced disclosure requirements* below).

2.3 Equity-accounted interests in associates and joint ventures

IAS 28.33 states that because goodwill included in the carrying amount of an investment in an associate is not separately recognised, it is not tested for impairment separately under the principles of IAS 36. Instead the entire carrying amount of the investment is tested under IAS 36 for impairment by comparing its recoverable amount with its carrying amount, whenever application of the requirements in IAS 39 indicates that the investment may be impaired. The investment, therefore, is treated as a whole, and the goodwill is not treated separately; thus, there is no prohibition against restoring the carrying amount of the investment to its pre-impairment value, in appropriate circumstances.

2.4 Investment property carried at cost

In addition to the indicators detailed above, the following conditions may indicate that an entity may be unable to realise the carrying amount of an investment property carried at cost:

- The entity recently sold a portion of its income-generating investment properties and realised losses on the sale transactions.
- The business plan indicates that the entity may liquidate a portion of its investment property portfolio in the coming year, but has not identified yet which properties will be sold.
- Income-generating properties have significant vacancy rates or are expected to be vacant in the near future (e.g. because of non-competitive lease terms).
- Depressed market conditions are adversely affecting the rental or sale activities of significant properties.
- The entity does not appear to have the ability to recover the current net carrying amount of investment properties from future cash flows because of a decline in rental rates or occupancy rates.

Judgement is required to identify circumstances that may indicate impairment in the carrying amount of an investment property or group of properties.

For investment properties at fair value, please see section 1.2 above.

2.5 Recoverability of deferred tax assets

Where entities previously recognised deferred tax assets, it will be necessary to consider whether the asset recognition criteria continue to be met. It is likely that previous assumptions regarding the entity's profitability may no longer be supported by current performance and revised budgets.

3. Reduced availability of credit and increasing cost of finance

3.1 Breaches in borrowing covenants

Declines in profitability and net asset values may trigger breaches in existing borrowing arrangements. In some cases, breaches of covenants permit the holder to demand immediate repayment from the borrower and as such will require borrowings to be presented at the reporting period end as current liabilities in accordance with IAS 1. Refinancing, or the receipt of a waiver of the lender's right to demand payment, that occurs after the reporting period should not be taken into account in determining the presentation of a liability at the period end.

3.2 Liquidity risk management

IFRS 7.39 requires specific disclosures on liquidity risk – the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities. Two elements are required to be disclosed: (i) disclosure of a maturity analysis showing the undiscounted contractual cash flows of the entity's recognised and unrecognised financial liabilities, and (ii) disclosure of how an entity manages its liquidity risk.

Due to the tightening in availability of credit the liquidity risk management disclosures are more important than ever. IFRS 7.IG31 describes a list of factors an entity might consider in determining what to provide in this disclosure, including:

- when liabilities are expected to be settled in the case where the borrower has the choice to repay early or the counterparty has the right to force early repayment;

- the extent of written undrawn loan commitments expected to be drawn;

- whether there are committed borrowing facilities (e.g. commercial paper facilities) or other lines of credit (e.g. stand-by credit facilities) available that can be accessed to meet liquidity needs;

- whether there are financial assets for which there is no liquid market, but which are expected to generate cash inflows (principal or interest) that will be available to meet cash outflows on liabilities;

- whether deposits held at central banks can be used to meet liquidity needs (subject to consideration of counterparty risks);

- whether diverse funding sources are available; and

- if there a significant concentration of liquidity risk in either its assets or its funding sources. (IFRS 7.IG18 states a concentration of liquidity risk "may arise from the repayment terms of financial liabilities, sources of borrowing facilities or reliance on a particular market in which to realise liquid assets".)

An entity's consideration of its ability to obtain funding, whether through rolling over existing funding, replacement or new capital funding, and the ability to generate cash flows from operations and existing assets will be fundamental to an assessment of the ability of the entity to continue as a going concern.

4. Changes in remuneration schemes

4.1 Cash-settled share-based payments

Due to demands on cash and market pressure, entities may modify existing remuneration packages either to defer cash payments or settle in kind, for example in shares or other non-monetary assets.

Whether a deferral of a cash award is simply that or, in fact, a modification will require careful consideration and judgement.

4.2 Equity-settled share-based payment awards

An entity may restructure senior executive remuneration packages for example, to:

- restore value to underwater share option awards by reducing the option strike price therefore increasing their fair value or by making new additional grants; or

- re-align outstanding share awards with revised risk management strategies (and market pressure) by deferring vesting.

Modifications to awards and cancellation of awards with identifiable replacement awards granted are treated in the same way. Any incremental fair value granted to the employee as determined at the date of the modification must be expensed over the remaining vesting period along with the original grant date fair value.

Where an equity-settled award is modified in a way that is not beneficial to the employee, the entity must continue to account for the services received as if the modification has not occurred, i.e. the originally determined grant date fair value will be expensed over the original vesting period. A cancellation of an award for which there is no replacement award will result in an immediate hit to P&L for the expense which would otherwise have been recognised over the remaining vesting period.

Entities may modify awards from being solely cash-settled to solely equity-settled due to liquidity constraints. At the date of modification, the cash-settled liability award is effectively settled by the issue of an equity instrument. The existing cash-settled liability is therefore reclassified to equity. The cash-settled compensation cost recognised to date is not adjusted. The compensation cost to be recognised over the remaining vesting period is determined based on the fair value of the equity instrument granted at the time of the modification.

In some schemes, entities may choose the method of settlement. For the classification of such schemes, the entity must determine whether it has a present obligation to settle in cash. Classification as equity-settled is appropriate only if the entity has the intent (stated policy) and a substantive ability to settle in shares, and has no past practice of settling in cash. An entity's intention and ability to share settle may change as a consequence of market conditions. A careful reassessment will be necessary to determine whether such changes require a change in classification of the scheme from equity- to cash-settled or cash- to equity-settled.

5. Increased levels of bankruptcy

The accounting considerations for entities with exposures to other parties that have entered into bankruptcy or other similar proceedings will vary greatly depending on facts and circumstances. The collapse of Lehman Brothers, some Icelandic Banks, as well as non-financial institution entities presents some challenging accounting questions. It is imperative that there is a thorough understanding of (i) the legal status of entities that are subject to bankruptcy proceedings and (ii) a thorough understanding of the terms and conditions of the contractual relationship and how the arrangement is impacted by the proceedings.

5.1 Understand the legal status of entities

When a reporting entity, which is often a group of entities, files for bankruptcy protection or other forms of administration not all entities within a group are necessarily included. Understanding exactly which entities form part of the bankruptcy and which counterparties the reporting entity has a contractual relationship with is critical before trying to determine the accounting outcome. For example, not all entities within the Lehman Brothers group have been placed under bankruptcy law (a list of entities can be found in the Lehman Brother's 8-K filings on the SEC website). Also, entities may have been sold as part of the bankruptcy proceedings and therefore the reporting entity's contractual relationships may be with new counterparties.

The legal status of the entity may have a direct or indirect impact on the contractual terms of instruments with that entity. For example, the filing of a Voluntary Petition (Chapter 11 for US entities) constitutes an event of default, or termination event, and causes the automatic and immediate acceleration of all debt outstanding under a number of instruments and agreements relating to direct financial obligations of the entity (e.g. an unsecured cash capital credit facility, secured bilateral cash capital facilities, commercial paper, senior, subordinated and junior indebtedness). Also, the filing of a Voluntary Petition constitutes an event of default and automatic early termination under *certain* of the master agreements that govern derivatives contracts and, in other instances, constitutes an event of default allowing the applicable counterparties to terminate agreements.

Entities in different jurisdictions may be subject to different bankruptcy laws. Differences in law will have different accounting implications even if the terms of the instrument are the same. Entities may need to seek legal advice where appropriate.

5.2 Typical accounting issues

The issues below are not unique to scenarios where an entity has a contractual arrangement with an entity that is subject to bankruptcy proceedings. Much of what is detailed below is explained to a greater degree in the rest of this accounting alert.

(i) Fair value and hedge accounting
The fair value of financial instruments will include the market's assessment of risk, including credit risk. To the extent a reporting entity has an investment in or an amount due from an entity that is in bankruptcy proceedings the fair value of the asset will reflect the various probabilities and timings of any amounts to be recovered as a result of the bankruptcy proceedings. Care will be needed to ensure the fair value reflects any collateral that the entity will have access to that can be enforced.

In cases where there are still market transactions in amounts due from the bankrupt entity, consideration will need to be given to whether these transactions are forced transactions (and therefore are not representative of fair value). The fact that an entity is itself subject to bankruptcy procedures does not mean transactions between that entity and willing buyers and sellers are forced transactions. As recognised in the IASB's Expert Advisory Panel report consideration should be given to whether:

- the observed transaction was subject to a legal requirement to transact;

- it was necessary to dispose of an asset immediately without sufficient time to market the asset to be sold; or

- only a single potential buyer existed as a result of the legal or time restrictions imposed.

A thorough understanding of the observed transaction is needed before concluding a transaction is forced and therefore not representative of fair value.

Derivative positions with entities in bankruptcy will need to be carefully considered to determine whether they have been terminated (due to default), novated to another institution or if they continue to exist under the original contractual terms. A reporting entity may have outstanding derivatives with the bankrupt entity (or an entity that is in financial difficulty) that are designated in a hedge accounting relationship. IAS 39.IG.F.4.7 is clear that credit risk can have an impact on the effectiveness of a hedging relationship. Where it is likely that the counterparty will not meet its obligations under the instrument the hedge relationship will no longer qualify for hedge accounting as the entity cannot have an expectation of offsetting changes in fair value or cash flows attributable to the hedged risk.

This qualitative evidence would outweigh any quantitative assessment that may still indicate that the hedging relationship is highly effective (e.g. a regression analysis based on historical data). In such circumstances, it would not be appropriate for the entity to apply hedge accounting for any period after the date the hedging relationship was last assessed as being highly effective. Typically, this would be the end of the preceding reporting period.

Even in the case where it is not probable that the counterparty will default, the reporting entity should still consider the effect of credit risk on the effectiveness of hedge accounting relationships. A derivative's fair value will be significantly affected by deterioration in credit standing of the counterparty in the case of a derivative asset, or by deterioration in credit standing of the reporting entity in the case of a derivative liability. This effect on the fair value of the hedging instrument in a fair value hedge, will not offset the fair value movements of the hedged risk for the hedged item (e.g. interest rate risk) and in a cash flow hedge will not offset the change in fair value of the hedged transaction.

A reporting entity may have previously asserted that a forecast transaction is highly probable where the counterparty is now a bankrupt entity. To the extent the forecast transaction is no longer highly probable, hedge accounting should be discontinued prospectively and, if the forecast transaction is not expected to occur, amounts deferred in other comprehensive income in the cash flow hedge reserve will need to be reclassified to profit or loss immediately.

(ii) Cash
If an entity has funds with a deposit-taking institution which previously met the definition of 'cash or cash equivalents', careful consideration must be given to determine whether such treatment remains appropriate. Deposits are often frozen at bankruptcy and therefore the deposit holder cannot access the cash held on deposit. IAS 7 defines cash equivalents as "short term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value". The reporting entity's inability to access the cash and the potential risk of irrecoverability may result in the deposit failing the definition of cash or cash equivalents.

(iii) Impairment
Amounts due from bankrupt entities will be assessed for impairment to the extent the financial asset is not fair valued through profit or loss. An entity should not assume amounts due are impaired simply because the parent entity of a group has filed for bankruptcy. A thorough understanding of the contract, the collateral under the contract, and the legal status of the borrower is needed. To the extent there is an impairment for a financial asset measured at amortised cost, e.g. a loan or receivable, the impairment in income will be equal to the difference between the carrying value and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. If the instrument is an available-for-sale debt or equity instrument the cumulative amount recognised in other comprehensive income will reclassified to profit or loss as an impairment loss.

A thorough understanding of assets held with an institution in trust will be required. For example, in the case of Lehman Brothers, a standard brokerage agreement required the bank to hold its clients' securities in trust for those clients. The client's securities held in trust were available as collateral for any sums owed by the client to the bank. However, the agreement may have given the bank the right to use the client's securities for its own purposes, for example as security for its own borrowings. Since the client's securities may have been used as collateral for the bank's own obligations, which are now in default, other third parties may have a right to those securities in priority to the reporting entity. Consideration will need to be given by an entity to its rights in respect of the securities placed in trust and amounts potentially recoverable.

Where guarantees have been purchased from entities, e.g. insurance companies or other institutions, to protect against credit losses on a separate financial asset, the impact of the guarantor's ability to pay under the guarantee should be considered. For example, a guarantee may have been purchased from an institution that has since started bankruptcy proceedings; the guarantee aimed to provide credit protection on a financial asset of the reporting entity and was therefore taken into account in determining whether the financial asset was impaired. If the reporting entity believes it can no longer claim because the writer of the guarantee will not pay due to financial difficulty, then the guarantee no longer provides protection to the reporting entity and an impairment of the financial asset will be required.

If information relating to credit losses comes to light after the end of the entity's reporting period, an assessment of the evidence of conditions that existed at the period end will be required in order to determine whether such information constitutes an adjusting post balance sheet event. Where the information clarifies credit loss conditions that existed at the period end, a post balance sheet adjustment to the impairment loss is required. If the information relates to credit loss conditions arising after the balance sheet date, this is non-adjusting. However, disclosure may be required under IAS 10 describing the nature of the event and an estimate of its financial effect or a statement that such an estimate cannot be made.

6. The impacts on hedge accounting

6.1 Impact of credit risk adjustments on hedge accounting
The inclusion of changes in the entity's own credit risk or the counterparty's credit risk in derivative valuations will potentially impact the assessment of hedge effectiveness for hedge accounting relationships and may result in the recognition of hedge ineffectiveness in profit or loss and/or discontinuation.

To the extent a derivative asset or liability is uncollateralised, or under-collateralised, changes in credit risk will impact its fair value. In some cases, a master netting agreement will reduce the exposure to credit risk by netting all exposures with the same counterparty in the event of the entity or the counterparty being in default. An understanding is needed of the basis of derivative valuations supplied by third parties and, specifically, whether the valuation is credit risk adjusted or not.

As changes in credit risk impact a derivative's fair value it will also impact the hedge effectiveness assessment for hedges where the hedged item is not credit risk adjusted. In many hedge accounting relationships, the hedged item is not hedged for credit risk, e.g. hedges of interest rate risk, foreign currency risk, commodity price risk. Therefore changes in the fair value of the derivative hedging instrument will not perfectly offset changes in the fair value of the hedged risk (in a fair value hedge) or changes in the present value of the forecast transaction (in a cash flow hedge). These differences are exaggerated when there are significant changes in the credit quality of entities as has been highlighted by recent widening of credit default spreads.

6.2 'Highly probable' assessment in cash flow hedge accounting

When an entity applies cash flow hedge accounting of forecast transactions it relies on the assertions that the transaction is highly probable. It is common for entities to cash flow hedge forecast sales and purchases, particularly for foreign currency risk. Consideration must be given as to whether previously designated forecast transactions are still highly probable in light of the worsening economic conditions. Revisions to forecasts are likely to result in hedge ineffectiveness being recognised in P&L, potential cessation of hedge accounting going forward, and where the transaction is no longer expected to occur, immediate recycling of amounts in the cash flow hedge reserve to P&L.

6.3 Hedging forecast debt issuance

Many entities enter into strategies to hedge the interest rate risk associated with their forecast borrowings. Typical hedging instruments include forward-starting interest rate swaps and 'treasury locks' which aim to hedge an entity's forecast exposure to interest rates. Critical in achieving hedge accounting is the entity's ability to demonstrate that the exposure to interest rates in the future that results from forecast borrowings remains 'highly probable'.

Continuing turbulence in the credit market has resulted in entities finding it more challenging to borrow, which has led to delays in the timing of anticipated borrowings or entities seeking alternative sources of finance, e.g. capital-raising through direct equity issues or equity rights issues. In the former, entities may in some circumstances be able to demonstrate that, despite a delay in the timing of future borrowing, the borrowing is still highly probable, in which case the delay will result in some degree of hedge ineffectiveness in P&L being reflected, with some amounts still deferred in the cash flow hedge reserve in OCI. In other instances, the forecast borrowings will be less certain and cash flow hedge accounting may have to cease. If the forecast borrowing, although not highly probable, is still expected to occur, the amount previously deferred will remain in OCI.

7. Critical enhanced disclosure requirements

7.1 Key sources of estimation uncertainty

IAS 1 requires the disclosure of judgements management have made in applying their accounting policies and the assumptions covering the future and other key sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities in the next financial year.

Disclosure should not be limited to the nature of an assumption or other estimation uncertainty. The degree of sensitivity of the carrying amount of assets to changes in the assumptions underlying the calculation is necessary, or and only if this is not practically possible, a statement to the effect that it is reasonably possible that actual results within the next financial year may vary from the assumptions at the reporting date.

7.2 Fair value

Part of the IASB's Expert Advisory Panel report referred to in 1.1 above includes best practice disclosures. Although some of the disclosures go beyond the requirements of the existing standard, IFRS 7, entities should give due consideration to these disclosures because:

- Regulators have issued reports and statements endorsing the work of the IASB's Expert Advisory Group as well producing their own best practice disclosures. Examples include: Senior Supervisors' Group's report on *Leading-Practice Disclosures for Selected Exposures* issued 11 April 2008 available from the NY Federal Reserve website, as well as from other regulators that are signatories to the report; The Committee of European Securities Regulator's statement on *Fair value measurement and related disclosures of financial instruments in illiquid markets* issued on 3 October 2008 available from CESR's website.

- Many large IFRS reporters have chosen to provide these additional disclosures partly because their competitors, reporting under US GAAP, have done so when applying FAS 157 *Fair value measurement*.

- Many of the additional disclosures included in the report are included in an exposure draft to amend IFRS 7, *Improving Disclosures about Financial Instruments*, issued in October 2008.

The Expert Advisory Panel report highlights the following:

- **the aggregation and granularity of disclosure**: aggregation of disclosures in a way that reflects how management views fair value measurements, while maintaining sufficient granularity;

- **the frequency of disclosure**: inclusion of disclosures similar to those in the annual financial statements in any interim financial statements when fair values have moved significantly and any new disclosures necessary to reflect changing market conditions;

- **disclosure of the control environment**: a description of the entity's governance and controls over the valuation processes;

- **disclosure of valuation techniques**: an understandable and suitably detailed description of the valuation techniques used in measuring fair values;

- **disclosure within a fair value hierarchy**: a quantitative (numerical) disclosure about fair value measurements in a tabular, hierarchical format;

- **a reconciliation of movements in fair values of instruments measured using unobservable inputs**: a reconciliation of the carrying amounts from the start of the period to the fair values at the end of the period showing the increase or decrease in value caused by fair value gains and losses as well as other movements such as sales and purchases;

- **disclosure of unobservable inputs**: a sufficiently detailed disclosure about the unobservable inputs used and how these have been estimated, as well as disclosure of the sensitivity of valuations to reasonably possible alternative unobservable inputs at an appropriate level of granularity; and

- **disclosure of changes in own credit risk**: an explanation of how movements in the fair value of liabilities caused by changes in the entity's own credit risk are calculated, and of the source of the inputs used in the calculation.

7.3 Market risk

IFRS 7 requires an entity to disclose the entity's exposure to market risk by disclosing either a sensitivity analysis or disclosing Value at Risk. The former requires an entity to flex the sensitivity analysis for movements in market risk that are reasonably expected to occur between the period end and the next reporting date. An entity must ensure the extent of flex in the sensitivity analysis is reasonable given current conditions. Equally the assumptions and inputs into the Value at Risk calculations must reflect current market conditions.

7.4 Impairment

Appropriate disclosures around impairment as required by the relevant Standards must be provided.

For cash generating units containing goodwill or intangible assets with indefinite useful lives, if a reasonably possible change in a key assumption on which management has based its determination of the unit's (or group of units') recoverable amount would cause the unit's (or group of units') carrying amount to exceed its recoverable amount, the entity must disclose:

- the amount by which the unit's (or group of units') recoverable amount exceeds its carrying amount;

- the value assigned to the key assumption; and

- the amount by which the value assigned to the key assumption must change, after incorporating any consequential effects of that change on the other variables used to measure recoverable amount, in order for the unit's (or group of units') recoverable amount to be equal to its carrying amount.

7.5 Events after the balance sheet date

Careful consideration will be required distinguishing between what is an adjusting and non-adjusting event when calculating/establishing impairments and fair values. In a falling market care must be taken to determine those conditions that existed at the balance sheet date. The fair value of assets at the date of approval may not be indicative of their value at the balance sheet date.

Where assets have fallen in value since the balance sheet date and the effect of this could be material, disclosure of the non-adjusting event should be provided in the financial statements, including the nature of the event, an estimate of its financial effect, or a statement that such an estimate cannot be made. Where the fall in value is due to general ongoing volatile market conditions (rather than a specific event), it may be necessary not only to give an estimate of the financial effect but also to refer to the volatility of the market.

8. Final reminder

As can be seen from this Alert, there is a great deal to consider in respect of the key accounting implications of current turbulent times. Entities should provide enhanced disclosures that demonstrate 'joined-up thinking' in the financial statements, including the narrative reporting.

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