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Exiting the Euro
Financial reporting implications of a country's exit from the Eurozone

1. Introduction

The aim of this publication is not to attempt to predict with any certainty the financial reporting implications of a Eurozone exit for Greece or any other country, but to consider more broadly what the implications might be of a country exiting the Eurozone. As the probability of Greece exiting the Eurozone is greater than that of any other country, it is cited as the example below but the same principles and considerations are likely to apply to any other country that may exit.

Over the past month much has been written about the uncertainty of whether Greece will leave the Eurozone and change its currency from the Euro. Though none of the major political parties in the Greek election on 17 June were favouring an exit from the Eurozone, the probability of an exit was regarded as closely tied to the support of some left-of-centre political parties who wished to radically renegotiate the terms of the current official sector support.

The political and economic situation in Greece has led to much speculation about what an exit from the Eurozone might mean for that country; companies that operate in or trade with it and the impact more broadly on the global economy. It would be too ambitious to start making predictions about some of the broader impacts, however, the immediate business impacts and consequences for financial reporting can be considered. A country exiting from the Eurozone may precipitate other events such as legislative changes that may have implications for contracts and regulatory considerations which are not contemplated in this publication.

The financial reporting implications of a country's exit from the Eurozone for any entity will depend on its specific facts and circumstances. This publication is intended to chart out some of the issues and is not intended to be exhaustive in its consideration of the issues.

2. In the case of Greece…

How a country's exit from the Eurozone would actually occur in practice is far from clear. In the case of Greece, which currently depends on international support from the European Union and International Monetary Fund, a Eurozone exit would likely coincide with a default on its debt obligations. A new currency law, say reintroducing the Drachma, is likely to be accompanied by a redenomination of all domestic contracts, the imposition of exchange controls, securing the borders to limit capital flight and steps to introduce a paper currency[1]. It has been widely predicted that a new currency would be severely depreciated relative to the Euro and other currencies. The ability of Government, corporations and individuals in Greece to meet their financial obligations would be severely hampered by a weak currency, particularly where obligations in Euro were not redenominated.

The legal uncertainties about whether contracts denominated in Euro would be redenominated into a new currency make predicting the financial reporting implications even more difficult. However, for the purposes of this publication, it assumed that contracts subject to Greek law would be redenominated into Drachma (say at a predetermined opening exchange rate) and those subject to foreign law would not be redenominated and therefore would remain in Euro.

1 *Financial Times:* If Greece Goes… (2012)

As a Eurozone exit is unprecedented, it is reasonable to assume legal uncertainties would lead to legal disputes, and even if those legal disputes led to favourable judgements, enforcement could be difficult given exchange controls.

The Institute of International Finance (IIF) grouped the economic impact of a Euro exit for Greece as follows[2]:

- **Direct losses/default for the private sector:** losses would arise from amounts being owed by the Greek Government, as well as corporations and households in Greece. Losses would not be limited to amounts due under financial contracts but also potentially non-performance of other contractual arrangements.

- **Direct losses/default for the official sector:** for example, amounts owed by Greece to the European Central Bank and other Central Banks in the Eurosystem. This is not considered further in this publication.

- **Exposure to the Greek Banking System:** without support from the European Central Bank this would leave Greek banks unable to meet their obligations.

- **Contagion:** although Greece only accounts for 2.5% of the Eurozone economic output the impact of a country's exit from the Eurozone could hamper the ability of other Eurozone countries and financial institutions to raise new debt in the capital markets and negatively impact consumer confidence and economic output in other countries.

3. Broad financial reporting impacts

The major financial reporting impacts of a country exit from the Eurozone stem from the underlying business impacts. These impacts can broadly be categorised into two main groups:

- Foreign currency accounting and redenomination risk; and

- Recoverability and financial distress.

These two broad categories are discussed in more detail below, with Section 4 providing a more comprehensive list of the potential financial reporting implications. The focus of this section is on the key recognition and measurement impacts that would require consideration if a country were to exit from the Eurozone in the current financial reporting period. If a country's exit occurred outside of the financial reporting period but before the financial statements are issued, then disclosure about a non-adjusting post-balance sheet event may be necessary.

Foreign currency accounting and redenomination risk

The introduction of a new currency presents many legal questions. However, at its most basic, for accounting purposes it creates a new currency which may impact the assessment of an entity's functional currency. IAS 21 provides detailed guidance on how to account for a change in functional currency. At the level of the consolidated financial statements, a change in the functional currency of a foreign operation will impact how its results are included in the financial statements and what foreign currency risks are eligible to be hedged at the level of the net investment in the foreign operation. A change in functional currency for the reporting entity itself will also change what is considered a foreign currency for the entity which will have an impact on the accounting for transactions, translation of balances that have now become foreign currency balances, valuation of investments and reporting for subsidiaries not denominated in that same functional currency.

Both a change in the functional currency and the redenomination of a contract may give rise to a number of financial reporting issues. These could include: reassessment of debt/equity classification and reassessment of embedded derivatives under IFRIC 9 Reassessment of Embedded Derivatives. Also, the eligibility for hedge accounting may need to be reconsidered due to possible changes in the hedged risk or hedged instrument. This may result in dedesignation of existing hedging instruments and designation of the new hedging relationships. Adoption of a new currency would also raise questions about what exchange rate would apply on the date the functional currency changes. An 'official' exchange rate may be introduced as the basis for redenomination, but could be superseded quickly with a grey market or other market rate.

The risk of outstanding contractual arrangements being redenominated into a new currency as a result of a change in local law ('redenomination risk') presents challenging accounting questions, partly due to the legal uncertainties about redenomination. In the case of rights to receive or obligations to pay amounts in Euro, say for financial instruments, it raises the question whether for accounting purposes a redenomination from Euro to a new currency results in a new instrument being recognised with the old instrument being derecognised (with a potential gain or loss on derecognition).

2 Institute of International Finance, *Euro Briefing*, June 1, 2012, pp 4-6.

Recoverability and financial distress
With or without redenomination, any amounts due from entities (both public and private sector) or individuals that are exposed to the broader economic impact of a country exit from the Eurozone will be subject to a greater risk of impairment. Impairment extends from non-financial assets such as goodwill and other intangible assets, to financial assets that include direct claims such as debt securities, loans and other receivables to investments in equity securities.

Redenomination of a debt instrument, loan or other receivable (assuming concomitant currency devaluation) results in an impairment as a fixed amount of new currency would be worth less than the previous contractual claim of a fixed amount of Euros. Further consideration would then have to be given as to whether the counterparty could meet the new currency obligation bearing in mind that its creditworthiness may have worsened due to the deteriorating economic outlook. For those items not redenominated, the ability of the counterparty to pay Euro obligations could be severely hampered by the devaluation of the new local currency against the Euro. Therefore, even if a contract were legally unaffected by the introduction of a new currency, impairment could arise due to the worsening creditworthiness of the counterparty and/or exchange controls limiting the Euro amounts that the counterparty could remit to the party that is owed.

Market turmoil arising from economic instability would impact the fair values of assets, both financial and non-financial assets, as well as the fair value of financial liabilities. The relative liquidity of financial markets also could be affected which would impact fair valuation. Both counterparty credit risk and non-performance risk ('own credit risk') would directly impact fair valuation of financial instruments and these changes in fair valuation could impact the effectiveness and eligibility of hedge accounting.

A worsening economic outlook arising from a country exit from the Eurozone would also impact assessments of future cash flows that underpin many accounting estimates such as the assessment of impairment for goodwill and other assets. Discount rates used in determining recoverable amounts could also be impacted. Similarly, the determination of the discount rate to be used for measuring long-term employees' obligations would be affected. More widely, downward re-estimations of cash flows and revisions to the discount rates being used could impact an entity's ability to prepare financial statements on the basis of a going concern.

4. Potential financial reporting impacts

The financial reporting impacts for some entities could be limited; for other entities they could be pervasive. The financial reporting impacts included in the following table are not intended to be exhaustive and their relevance will depend on the facts and circumstances of the particular entity.

Scenario and issue	Financial reporting considerations
Non-Greek parent with a Greek subsidiary, JV, associate or other Euro risk subject to redenomination	
Effect on the recoverable amounts of non-financial assets (property, plant and equipment, goodwill and other intangible assets)	• Impairment.
Functional currency	• Change in functional currency to the new currency (say 'Drachma'). • Gains/losses arising in the entity's separate financial statements either due to the redenomination of contracts without a change in functional currency, or without redenomination but with a change in functional currency. • Change in functional currency may impact the functional currency assessment for entities higher or lower up in the group (based on them being treated as an extension of the parent etc.). • Change in functional currency (of either parent or foreign operation) would not cause the recycling to profit or loss of exchange differences in relation to the net investment in the foreign operation (in the absence of those conditions requiring recycling). • Emergence of additional foreign currency denominated subsidiaries (for example, those that still have the Euro functional currency), where the parent's functional currency changes which create new foreign currency risks such as translation of intercompany balances and additional foreign currency translation exposures.

Scenario and issue	Financial reporting considerations
Foreign currency translation of Drachma-denominated transactions and items	• Selection of an appropriate exchange rate for the Drachma versus other currencies for transactions, translation of monetary items and net assets given possible availability of various rates of exchange (official/unofficial/dividend remittance rates) and possible restrictions over the exchangeability of the Drachma.
Net investment hedging	• Failure of hedge accounting or high ineffectiveness due to change in functional currency and/or reduction in net assets. • Change in functional currency (of either parent or foreign operation) would not cause the recycling to profit and loss of hedging gains/losses already recognised in the foreign currency hedge reserve in equity.
Highly probable transactions no longer highly probable (e.g. no longer in Euro)	• Discontinuation of hedge accounting, possible recycling of amounts in the cash flow hedge reserve in equity if transactions are not expected to occur.
Change of risk exposure due to redenomination	• Redesignation of hedge relationships as a result of hedge accounting failure due to redenomination (amounts deferred in OCI not recycled as a result of redenomination or change of functional currency as long as transactions are still highly probable). • Potential hedge accounting failure in the future due to designation of off-market derivatives.
Offset arrangements	• May no longer be subject to offset if one leg of the arrangement is redenominated (Greek law) but the other is not (foreign law).
Reclassifications	• Overall decline in market volumes may lead to further demand for reclassifying financial assets out of fair value through profit or loss (due to 'rare circumstances') or out of available-for-sale investments (as no longer quoted in an active market).
Sale of held to maturity investments (HTM); change in intention and ability to hold to maturity	• Assessment of whether any sale(s) meet(s) the exception to avoid tainting the remaining the HTM portfolio. • Assessment of whether ability and intention to hold to maturity for retained assets is present.
Convertible bonds originated in Euro, redenominated in Drachma	• Assessment of whether the compound accounting can be maintained or the instrument needs reclassification in terms of financial liability/equity assessment.
Financial guarantee contracts written by parent over subsidiary	• For the entity's separate financial statements remeasurement of guarantees under IAS 37 as there is an increasing probability the guarantor will be called upon to pay an outflow under the guarantee.
Effect on recoverable amounts of non-financial assets (goodwill, intangible assets and property, plant and equipment)	• Impairment – the cash flow forecasts and assumptions used to determine value-in-use will require assessment and the fair values movements may be significant as a result of market volatility.
Costs incurred in connection with converting systems for use in Drachmas, moving operations to other countries, costs of restructuring, relocating operations)	• Assessment of appropriate accounting (whether any costs can be capitalised or all are expensed).
Possible loss of control over subsidiary, joint control over a joint venture or significant influence over an associate (e.g. as a result of action of government, courts in response to a country exit from the Euro).	• Appropriate accounting for loss of control, joint control or significant influence including gain or losses arising in profit or loss.

Scenario and issue	Financial reporting considerations
Breaches of covenants of borrowing arrangements of Greek subsidiary/associate	• Impact on current/non-current classification.
Possible imposition of capital controls on deposits/cash balances within Greece following a country exit	• Impact on current/non-current classification.
Translation of comparative amounts in Euro for a foreign subsidiary whose functional currency has changed to Drachma	• Determining how to present prior-period comparative amounts in which the new currency did not yet exist.
Effect on operating segments of the group	• Possible revisions to operating segment disclosures.
Litigation and legal costs around redenomination/contracts changes and other legal aspects of a country exit from the Euro	• Appropriate accounting for provisions, disclosure of contingent liabilities and contingent assets.
Sales to government or other entities that are reliant on government support or trading (e.g. pharmaceutical companies)	• Appropriate revenue recognition policies and possible need to discount receivables.
Going concern basis of accounting	• Consideration of the wider economic impact of a country exit on the ability of the entity to continue on a going concern basis, including the ability of the entity to secure financing in light of a potential curtailment in bank lending. Possible need to prepare financial statements on basis other than a going concern.
Financial contracts with a Greek entity	
Amounts due from a Greek entity. Examples include: Euro time deposits in a Greek bank, debt investments issued and loan/trade receivables from a Greek entity; each may be (i) redenominated into Drachma, or (ii) not redenominated and enforceable in Euros under foreign law. Linked balances that were previously in one currency (say Euro) may now be in different currencies (Euro and Drachma)	• Impairment, fair value measurement.
Derivatives with Greek counterparty, either (i) gross or net settled with one or both legs redenominated or (ii) gross or net settled with no redenomination	• In both cases the fair value measurement should reflect credit risk as well as the effects of redenomination and devaluation. • If designated in a hedge relationship, credit risk will impact effectiveness. • If redenominated (but the hedged item is not) then hedge accounting may fail.
Loan payable to a Greek entity either (i) redenominated into Drachma or (ii) not redenominated and enforceable in Euros under foreign law	• If redenominated, likely derecognition of old financial liability and recognition of a new financial liability.
AFS equity investments in Greek entities or entities with significant exposure to Greece	• Impairment, fair value measurement.
Changes in level of market activity for financial instruments measured at fair value (equity investments, derivatives, bonds)	• Reassessment of disclosure within the IFRS 7 fair value hierarchy (levels 1, 2 or 3).

Scenario and issue	Financial reporting considerations
Non-financial contracts with a Greek entity	
Construction contracts with a Greek customer	• Enforceability of partly performed contracts enforceable? Is the remaining contract enforceable?
Supply contracts or lease agreements denominated in Euros redenominated into Drachma	• Foreign currency translation, impairment assessment, onerous contract assessment; assessment of whether the embedded derivative is closely related.
Supply contracts or lease agreements denominated in Euros not redenominated (consideration of embedded derivative if entity is not a Euro functional currency entity)	• Impairment assessment, onerous contract assessment; assessment of whether embedded derivative is closely related.
Other issues	
Greek current/deferred tax balances	• Measurement and recognition of deferred tax assets and liabilities (e.g. impact on recoverability of deferred tax assets given impact on future profits, deductibility of losses and ability to repatriate profits from Greek subsidiaries).
Greek defined benefit scheme assets and obligations, redenomination of pension obligations and pension plan assets	• Redenomination of obligations (including plan assets); treatment of resulting changes to obligations; use of appropriate discount rates for pension obligations.
Effect on existing securitisation structures with payments denominated in predecessor currency	• Treatment of foreign currency derivatives in trust.
Provisions	• Provisions recognised under IAS 37 would need to be remeasured to take into account redenomination; similar considerations to those for financial liabilities are also likely to be relevant.
Insurance liabilities	• Claims and other insurance related liabilities will need to be redenominated and discount rates and cash flows reassessed.

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