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January 2013

iGAAP Alert
Critical issues in uncertain times

This publication provides a summary of some critical issues to consider in year-end reporting. More detailed information can be found in our Global publications *IFRS in Focus* Critical issues in uncertain times.

Uncertain and varied economic conditions set the backdrop for the preparation of financial statements for the current reporting period. And below we set out some of the key financial reporting considerations stemming from these conditions. However it should be stressed that the unique circumstances and risk exposures for each reporting entity must be assessed comprehensively and reflected appropriately in the financial statements. It is important that the financial statements and management commentary convey all material uncertainties. Additional disclosures, not specifically required by any IFRS, may be necessary to achieve a fair presentation of the financial position and performance of the entity.

The European Securities and Markets Authority (ESMA) has identified the following ***common enforcement priorities for 2012 financial statements***:

- financial assets;
- impairment of non-financial assets;
- defined benefit obligations; and
- provisions that fall within the scope of IAS 37.

Some of these priority financial reporting topics are discussed in more detail below.

Impairment of non-financial assets
ESMA notes that: "particular attention should be paid to the valuation of goodwill and intangible assets with indefinite life whenever significant amounts are recognised in the financial statements. ESMA emphasizes the need to use assumptions that represent realistic future expectations".

Information about asset impairments will be critical in helping investors and others understand the impact of the current economic conditions on an entity's financial performance and position.

At a time when markets are sluggish and sometimes contracting, it is important that entities explain in their financial statements how such events are expected to impact the recoverability of asset balances – particularly goodwill. As a result, disclosure of the basis on which the recoverable amount has been measured and the key assumptions used to determine that value must be provided in sufficient detail. For example, providing the specific assumptions for material cash generating units (CGU), rather than a range of assumptions across CGUs, makes it easier for a reader to assess recoverability. ESMA has emphasised the need for more granular disclosures around goodwill, in particular to provide an understanding of the CGU to which goodwill is allocated by explaining the forecast period, the growth and discount rates applied, and the consistency of assumptions made with past experience.

Defined benefit obligations – discount rate

The discount rate used to value defined benefit obligations under IAS 19 should be set by reference to the yield available on high quality corporate bonds of an appropriate term (or where there is no deep market in such bonds, the market yields on government bonds). The IFRS Interpretations Committee (IFRS IC) is currently considering a request for guidance on the determination of the rate used to discount post-employment benefit obligations. Following the financial crisis, the number of corporate bonds rated "AAA" or "AA" has decreased in some jurisdictions. IAS 19 is silent on what credit rating is required to evidence a bond is 'high quality' although the IFRS IC noted that predominant past practice has been to consider bonds that have received one of the two highest ratings given by a recognised rating agency. Until there is more clarity from the IFRS IC, the rates for AA and AAA-rated bonds should continue to be used where they have been previously.

ESMA, in its European common enforcement priorities for 2012 financial statements cautioned that "entities should wait for a clarification to come from the IFRS IC and should not change their approach to determining discount rates".

Exposures to Greek sovereign debt

The ***IFRS IC*** concluded that the restructuring of Greek Government Bonds (GGBs) in March and April 2012 should lead to the derecognition of the old GGBs and recognition of new GGBs received.

The new GGBs issued in the PSI exchange need to be assessed for potential impairment at the end of the reporting period. At 31 December 2012, market yields for the new GGBs that were issued in March and April 2012 were at a lower level than the yield when they were issued.

Exposures to other Eurozone sovereign debt

Also at 31 December 2012, we do not consider the sovereign debt of other Eurozone countries including Portugal, Italy, Ireland and Spain to be impaired under IAS 39 (or IFRS 9 Financial Instruments).

Eurozone sovereign debt disclosures

Following its ***reviews*** performed in 2012, ESMA encourages issuers to enhance the quality and granularity of country-by-country disclosures of exposures to sovereign debt, non-sovereign exposures and the impact of credit derivatives.

Renegotiation of financial liabilities and financial assets

The increasing number of entities experiencing financial difficulty has led to a greater number of borrowings being renegotiated (for example, to extend maturity, modify how the debt is collateralised, reduce the coupon or relax the covenant terms). An assessment is required of whether the renegotiation results in a modification or an extinguishment. Where it creates a substantially different instrument, it is accounted for as an extinguishment of the original liability and the recognition of a new liability, resulting in a profit or loss impact. In the case of debt-for-equity restructurings, where debt is exchanged for equity of the borrower, the requirements of IFRIC 19 *Extinguishing Financial Liabilities with Equity* Instruments are applicable.

Similar considerations apply to the renegotiation of financial assets. A key issue to consider is whether the renegotiation gives rise to terms that are substantially different in which case there may be a derecognition event and a new asset recognised.

In responding to difficult market conditions, some entities will look to 'sales' of assets and other rights for liquidity purposes. This may be in the form of 'sale and leaseback' transactions, securitisations and other forms of unbundling the benefits of an asset. Again, it is important to consider whether the derecognition criteria have been met and whether there is any continuing involvement such that the entity has not transferred substantially all the risks and rewards to the counterparty.

ESMA emphasises that because transfers of financial instruments are typically complex transactions, improved disclosures should be provided in accordance with IFRS 7.42A-42H. Those disclosure requirements are applicable for the first time in 2012.

Disclosures

The golden rule in uncertain market conditions is that disclosures of estimation uncertainty and significant judgements become more important. Regulators have emphasised the importance of enhanced disclosures particularly around financial assets, impairment, pensions and provisions.

In addition to the requirements of IFRSs, many local laws or regulations (for example, SEC Regulation S-K and the EU Transparency Directive as implemented in each Member State) require disclosure of the risks facing the entity. In the current economic environment, entities should consider whether new risks have emerged or previously identified risks have become more significant.

Management Commentary

It is important that entities explain how they are affected by economic uncertainty. Management commentary should be consistent with the events and conditions described in the financial statements and help explain the risks and other key factors affecting an entity's financial performance and position.

Deloitte recently issued a study of financial reporting in the United Kingdom *Joined up writing – Surveying annual reports*. In that study we noted that: "annual reports now require a serious level of content, cohesion and connected thought and information. The best of them, as the survey shows, create a platform which effortlessly explains the business model, performance and future strategic hopes of a company to its shareholders, stakeholders and other users". The survey found that although financial reporting has improved markedly over the years there is still considerable scope for improving the linkages between the 'front-end' of the annual report and the financial statements to convey a clear and consistent story.

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Designed and produced by The Creative Studio at Deloitte, London. 24195A