

Turbulent Times

Financial Reporting Implications Related to Regions Experiencing Economic Struggles

Economic conditions in various parts of the world continue to be volatile. This financial reporting alert discusses certain key accounting and financial reporting considerations related to the current economic conditions in regions with significant economic uncertainty or volatility. It is divided into the following four sections:

- [Broad Financial Reporting Considerations.](#)
- [Financial Instruments.](#)
- [SEC Reporting and Disclosure Considerations.](#)
- [Income Tax Considerations.](#)

The alert also contains two appendixes. [Appendix A](#) summarizes additional financial reporting implications that would result from a country's decision to exit the eurozone.¹ [Appendix B](#) outlines certain disclosures recommended by the SEC staff in 2012 about European sovereign debt.

Although this publication discusses key financial reporting issues that typically arise in periods of economic uncertainty, entities must carefully consider their unique circumstances and risk exposures when analyzing how recent events may affect their financial reporting. Most importantly, they should ensure that their financial reporting and disclosures convey all material effects that have resulted, or could result, from these events. This may necessitate disclosures (in both the financial statements and MD&A or other sections of SEC filings) beyond those specifically required by U.S. GAAP or SEC regulations.

Broad Financial Reporting Considerations

General Considerations

As a result of the current economic turmoil, there could be a number of potential financial reporting implications for many entities that report under U.S. GAAP, particularly those with foreign subsidiaries, operations, investments, or joint ventures in regions experiencing such turmoil. Entities with significant suppliers, vendors, or customers in these regions, as well as entities that lend to or borrow from entities in these regions, also may experience financial reporting challenges. In addition, any "contagion" that spreads from entities in these regions could indirectly affect other entities that do not have direct exposure if events in these regions broadly cause widening interest rate spreads or otherwise increase global market volatility.

Consistency of Assumptions and Estimates

Entities may be required to use assumptions or estimates for more than one purpose (e.g., forecasted revenues may be an assumption used in multiple impairment tests and in assessments of the realizability of deferred tax assets and the entity's ability to continue as a going concern). When a single assumption is used in multiple analyses, entities should verify that the amount

¹ The eurozone comprises the 19 member states of the European Union: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

used for that assumption is the same in each analysis. Such consistency is particularly important for entities with multinational operations or entities with decentralized accounting and financial reporting functions.

In addition, an entity should consider external events and circumstances when assessing whether (1) changes made in assumptions and estimates from the previous period were appropriate or (2) it was appropriate in the current period not to have updated or changed assumptions used in the previous period.

Impairment of Nonfinancial Assets (Including Goodwill)

Entities should consider the guidance below when making their impairment assessments for nonfinancial assets.

Long-Lived Assets

Under U.S. GAAP applicable to property, plant, and equipment and the impairment or disposal of long-lived assets (as codified in ASC 360²), a long-lived asset or group of assets must be “tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable.” When making this assessment, an entity should consider the examples in ASC 360-10-35-21, including whether any of the following has occurred:

- “A significant decrease in the market price of a long-lived asset (asset group).”
- “A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition.”
- “A significant adverse change in legal factors, or in the business climate, that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator.”
- “A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group).”
- “A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.”

If the long-lived asset or asset group is not deemed recoverable (i.e., if the carrying amount of the long-lived asset or asset group “exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset” or asset group), the entity must write down the asset or asset group to its fair value (see ASC 360-10-35-17).

In some cases, entities may conclude that affected long-lived assets will be sold, abandoned, or otherwise disposed of. When the held-for-sale criteria in ASC 360-10-45-9 through 45-11 are met, the entity is required to measure the asset (or asset group) “at the lower of its carrying amount or [its] fair value less cost to sell.” A long-lived asset that will be abandoned will continue to be classified as held and used until it is disposed of. Such an asset is disposed of when it ceases to be used. However, “a long-lived asset that [is] temporarily idled [should] not be accounted for as if abandoned.” Further, when “a long-lived asset ceases to be used, the carrying amount of the asset should equal its salvage value, if any.”

Finite-Lived Intangibles

Events in the affected regions could trigger the need to test an entity’s finite-lived intangibles (e.g., customer relationships, royalty, or franchise agreements) for impairment. Entities should apply the recognition and measurement provisions in ASC 360-10-35-17 through 35-35 when reviewing finite-lived intangibles for impairment (see ASC 350-30-35-14). Thus, the analysis of finite-lived intangibles does not differ from the analysis for long-lived assets held and used discussed above.

Indefinite-Lived Intangibles Other Than Goodwill

An entity may also have experienced impairment in an indefinite-lived intangible. As noted in ASC 350-30-35-18, when an event or change in circumstances indicates that an indefinite-lived intangible asset is more likely than not impaired (see ASC 350-30-35-18B for guidance on this assessment), an entity would be required to test such asset for impairment even if its annual test for impairment occurs on a different date. Further, ASC 350-30-35-19 indicates that to the extent that an impairment is determined

² For titles of FASB Accounting Standards Codification (ASC) references, see Deloitte’s “Titles of Topics and Subtopics in the FASB Accounting Standards Codification.”

to exist, an entity should recognize an impairment loss equal to the excess of the carrying amount of the impaired intangible asset over its fair value.

Goodwill

Events in the affected regions may trigger the need for an entity to test goodwill for impairment. Entities are required to perform annual impairment tests for goodwill, or more frequently in certain circumstances (this requirement is similar to the guidance on other indefinite-lived intangibles). Specifically, under ASC 350-20-35-30, an entity should test goodwill for impairment when an “event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount.”

Disclosure Considerations About Impairments

Comprehensive disclosures about asset impairments will help investors and others understand the impact of the current economic uncertainties on an entity’s financial performance and position. Entities need to ensure that they provide all of the necessary disclosures about their impaired nonfinancial assets.

Going Concern

Economic changes brought about by recent events in the affected regions may force entities to consider whether their financial statements should continue to be prepared on a going-concern basis. Assessing whether an entity is a “going concern” may involve consideration of factors such as the following:³

- *Negative trends* — for example, recurring operating losses, working capital deficiencies, negative cash flows from operating activities, adverse key financial ratios
- *Other indications of possible financial difficulties* — for example, default on loan or similar agreements, arrearages in dividends, denial of usual trade credit from suppliers, restructuring of debt, noncompliance with statutory capital requirements, need to seek new sources or methods of financing or to dispose of substantial assets
- *Internal matters* — for example, work stoppages or other labor difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, need to significantly revise operations
- *External matters that have occurred* — for example, legal proceedings, legislation, or similar matters that might jeopardize an entity’s ability to operate; loss of a key franchise, license, or patent; loss of a principal customer or supplier; uninsured or underinsured catastrophe such as a drought, earthquake, or flood.

If any such factors are identified, entities also should consider management’s plans to address them.

Inventory

ASC 330 requires inventory to be measured at the lower of its cost or market value. In a volatile economic environment, it may be particularly important for an entity to challenge whether the utility of its inventory on hand has been impaired by changes in price levels or other causes. Entities should apply the guidance in ASC 330-10-35-1 through 35-11, which address adjustments of inventory balances to the lower of cost or market.

Long-Term Intra-Entity Foreign Investments

ASC 830-20-35-3(b) provides an exception that allows gains and losses on certain intra-entity foreign currency transactions “of a long-term investment nature” to be treated like translation adjustments instead of being recognized in net income. For a transaction to qualify as a long-term investment, the entity must be able to assert that “settlement is not planned or anticipated in the foreseeable future.” An entity that has characterized intra-entity transactions with a Greek entity as part of its net investment in the entity may need to reassess whether that designation is still appropriate in the current economic environment.

³ Obtained from PCAOB AU Section 341, *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern*.

The Effect of Restructurings

In today's difficult economic environment, entities may be considering (or implementing) restructuring plans to reduce their exposures to events in the affected regions; such plans may contemplate the sale or closure of parts of their business or downsizing their continuing operations. If economic conditions in the affected regions prompt entities to initiate measures to reduce their workforce, the accounting treatment for any associated termination benefits would depend on their nature and characteristics:

- *One-time involuntary termination benefits* — ASC 715-30-60-3 states that "one-time termination benefits provided to current employees that are involuntarily terminated under the terms of a one-time benefit arrangement" that, in substance, is not an ongoing benefit arrangement would be accounted for in accordance with ASC 420. In general, the obligation associated with the one-time termination benefit should be recognized as of the "communication date," as detailed in ASC 420-10-25-8, and measured at fair value in accordance with ASC 420-10-30-5. The communication date is defined as "the date the plan of termination . . . meets all of the criteria in [ASC] 420-10-25-4 and has been communicated to employees."
- *Involuntary termination benefits* — If termination benefits to be paid to terminated employees are part of a substantive preexisting ongoing employee benefit plan, ASC 420 is not applicable. Rather, such benefits should be accounted for in accordance with other guidance, such as ASC 715-30, ASC 715-60, ASC 712, or ASC 710.
- *Voluntary termination benefits* — Entities offering a voluntary termination benefit to employees in an effort to reduce their workforce should consider the guidance in ASC 712-10-25-1, which generally indicates that a liability and loss be recognized "when the employees accept the offer and the amount can be reasonably estimated."

Defined Benefit Plans

The current economic climate may affect the measurement of plan assets and defined benefit obligations.

Plan Assets

The considerations regarding fair value measurement of both financial assets and nonfinancial assets are also relevant to the measurement of plan assets under ASC 715. Pension plans may hold significant amounts of sovereign debt as well as investments in hedge funds, structured products, and other illiquid assets. It is important for entities to appropriately determine the fair value of such assets. Entities should also assess whether they need to update assumptions about the expected long-term rate of return on a plan's assets in light of the current economic conditions. In accordance with ASC 715-30-35-47, the "expected long-term rate of return on plan assets shall reflect the average rate of earnings expected on the funds invested or to be invested to provide for the benefits included in the projected benefit obligation."

Defined Benefit Obligations

The discount rate used to value defined benefit obligations under ASC 715 should be set by reference to the yield at which the benefits can effectively be settled. Typically, rates on high-quality bonds (at least AA-rated) that are available currently, and that are expected to be available during the period the pension benefits will be paid, have been used for this purpose.

In recent years, it has been common for entities to use either a hypothetical portfolio of high-quality corporate bonds, a yield curve based on such bonds, or the average yield on an index of corporate bonds. A volatile economic environment may present challenges to entities using such methods. A spread of yields among the bonds comprising the hypothetical portfolio, yield curve, or published index may indicate that some corporate bonds being included are no longer considered by the market to be of high quality even though their credit rating has yet to be adjusted. In these circumstances, the portfolio, yield curve, or index should be adjusted to exclude yields on such bonds.

The approach used by an entity for determining the discount rate should be applied consistently from one period to the next. Further, it may also be appropriate to consider the reasonableness of the outcome of the approach being used by comparing it with the outcome of other approaches used to set the discount rate. Finally, depending on the size of the obligation and the sensitivity to changes in discount rate, entities should consider disclosing whether their selection of a rate involved a critical judgment or significant accounting estimate.

Accounting Policies

In a volatile environment, disclosure of the accounting principles an entity followed and the methods of applying those principles may be critical to an investor's understanding of the entity's financial statements. Entities should carefully consider the disclosure requirements in ASC 235-10-50-1 through 50-3 related to accounting policies.

Subsequent Events

Given the ongoing turmoil in the affected regions and the likelihood that events will occur rapidly or unexpectedly, entities should carefully evaluate information that becomes available after the balance sheet date but before the issuance of the financial statements. ASC 855-10-25-1 requires the recognition of "the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet." In addition, ASC 855-10-50-2 requires disclosure of nonrecognized subsequent events, if needed, to "keep the financial statements from being misleading." Examples of the required disclosures include (1) the "nature of the event" and (2) an "estimate of its financial effect, or a statement that such an estimate cannot be made."

Financial Instruments

Impairment and Valuation Considerations

Given the current environment in the affected regions, entities should be mindful of the need to assess their investments and loans for impairment. Investments that may be affected include equity securities and private debt issued by an entity domiciled in one of these regions and in certain instances investments in sovereign debt. Moreover, events in these regions may cause additional volatility in the global markets, which may affect the fair values of investments not directly linked to the affected regions (e.g., credit spreads may widen or the creditworthiness of counterparties may be affected).

Entities need to review their holdings and assess whether they need to test those investments for impairment. When an entity performs such an assessment, it needs to apply the appropriate impairment model under U.S. GAAP. That model will depend on the investment's classification as:

- *Equity securities* — ASC 320-10-35-34 indicates that if an investment in an equity security is considered other-than-temporarily impaired, the cost basis of the impaired security must be written down to its fair value, with the amount written-down recognized in current-period earnings.

An equity security may be impaired if it has suffered a significant or prolonged decline in its fair value below its cost. Either the severity or the duration of the investment's decline in value alone may indicate that an investment is other-than-temporarily impaired.

Entities with equity securities should also refer to SEC Staff Accounting Bulletin Topic 5.M, "Other Than Temporary Impairment of Certain Investments in Equity Securities," (ASC 320-10-S99-1) for guidance on determining whether an impairment is other than temporary.

Typically, if the fair value of an equity security continues to fall after an impairment loss has been recognized in earnings, these further declines should be recognized immediately in earnings.⁴ Conversely, once an investment in a security is considered other-than-temporarily impaired, the cost basis of the previously impaired security cannot be adjusted through earnings for subsequent recoveries in the value of the security.

In the case of cost method investments that do not have readily determinable fair values, ASC 320-10-35-25 provides the following guidance on determining whether the investment is impaired:

- a. If an entity has estimated the fair value of a cost-method investment . . . that estimate shall be used to determine if the investment is impaired for the reporting periods in which the entity estimates fair value. . . .
- b. For reporting periods in which an entity has not estimated the fair value of a cost-method investment, the entity shall evaluate whether an event or change in circumstances has occurred in that period that may have a significant adverse effect on the fair value of the investment (an impairment indicator).

⁴ An entity should continue to evaluate subsequent declines in the fair value of an impaired equity security under ASC 320 to determine whether the decline is other than temporary. However, it may be difficult for the entity to conclude that further declines in the fair value of an equity security previously determined to be other-than-temporarily impaired are only temporary.

If the entity determines that such a cost method investment is impaired, it must then assess whether the impairment is other than temporary and whether it must recognize an impairment loss.

- *AFS and held-to-maturity (HTM) debt securities* — Under ASC 320-10-35, the impairment of a debt security is considered other than temporary if the entity (1) intends to sell the security as of the measurement date or (2) has determined that it is more likely than not that it will be required to sell the security before the recovery of its amortized cost basis. Further, if an entity has determined that (1) it does not intend to sell the security and (2) it is not more likely than not that it will be required to sell the security before recovery of the security's amortized cost basis, an other-than-temporary impairment is considered to have occurred if the entity does not expect to recover the entire amortized cost basis of the debt security (i.e., a credit loss is considered to have occurred).

In determining the amount of impairment loss to recognize, entities should refer to the guidance in ASC 320-10-35-34B through 35-34D and ASC 320-10-35-33D:

If an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. . . .

If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be separated into both of the following:

- a. The amount representing the credit loss
- b. The amount related to all other factors.

The amount of the total other-than-temporary impairment related to the credit loss shall be recognized in earnings. The amount of the total other-than-temporary impairment related to other factors shall be recognized in other comprehensive income, net of applicable taxes.

In determining whether a credit loss exists, an entity shall use its best estimate of the present value of cash flows expected to be collected from the debt security. One way of estimating that amount would be to consider the methodology described in Section 310-10-35 for measuring an impairment on the basis of the present value of expected future cash flows. . . . Briefly, the entity would discount the expected cash flows at the effective interest rate implicit in the security at the date of acquisition.

- *Investments in equity method investments and joint ventures* — Entities with equity method investments or joint ventures that are adversely affected by turmoil in the affected regions may need to evaluate whether decreases in an investment's value are other than temporary. For these investments, ASC 323-10-35-31 requires the recognition of a loss that is other than temporary even if such a decrease in value is greater than what would otherwise be recognized if the equity method were applied. Evidence of a loss in value might include a lack of ability to recover the carrying amount of an investment or the inability of an investee to sustain an earnings capacity that would justify the carrying amount of the investment. Further, ASC 323-10-35-32 states that a "current fair value of an investment that is less than its carrying amount may indicate a loss in value of the investment."
- *Loans* — Creditors that lend to entities that may be adversely affected by economic instability in the affected regions will need to assess whether events have occurred (such as a downgrade in borrower credit ratings or declines in cash flows and liquidity) that indicate that an impairment evaluation is required. It is also possible that the economic uncertainty could result in loan modifications that may need to be accounted for as troubled debt restructurings in accordance with ASC 310-40.
- *Receivables* — Receivables from entities in affected countries or entities with significant exposure to those countries may need to be evaluated for collectibility. Particular attention should be given to assessing recoverability when receivables are overdue, even if the entity has the right to charge interest for late payment. Entities may incur additional write-offs of receivables deemed uncollectible or may be required to establish additional reserves on receivables due from entities affected by the economic turmoil.

Other Fair Value Considerations in the Application of Impairment Models

The continued economic turmoil in certain countries has led to a decrease in market activity for certain financial instruments and to questions about how to establish the fair value of financial instruments in markets that are no longer active (and, potentially, whether a fair value can be considered “readily determinable”). Key considerations include the following:

- Determining whether the market for the relevant financial instrument is active or inactive.
- Evaluating the inputs in 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 nonderivative instruments.
- Assessing whether an entity can rely on data from brokers and independent pricing services when determining fair value.

Tainting of HTM Investment Portfolios

As a result of the ongoing economic uncertainty, entities holding HTM investments issued by entities that may be adversely affected by events in the regions experiencing economic turmoil may choose to transfer those investments out of the HTM classification or sell them. A decision to transfer or sell an HTM investment could call into question or “taint” the entity’s intent to hold other investments in its HTM portfolios in the future unless the sale or transfer qualifies for one of the limited exceptions in ASC 320-10-25. Therefore, entities will need to carefully evaluate whether their sales or transfers of HTM investments meet one of those exceptions.

Classification of Current and Noncurrent Financial Liabilities

Liabilities are generally classified as current in an entity’s balance sheet if they are reasonably expected to be settled by the entity within 12 months of the end of the reporting period (see ASC 210-10-45-5 through 45-12 for additional discussion). Unstable trading conditions in affected regions may increase the risk that entities breach financial covenants (e.g., fail to achieve a specified level of profits or interest coverage). If such a breach occurs on or before the end of the reporting period and provides the lender with the right to demand repayment within 12 months of the end of the reporting period, the liability would generally be classified as current in the borrower’s financial statements.

Renegotiation of Financial Liabilities

An increase in the number of entities experiencing financial difficulty because of events in the affected regions may lead to a greater number of debt restructurings (e.g., to extend the maturity, reduce the coupon rate, or ease the covenant terms). Under ASC 470-50-40, a borrower must assess whether such a restructuring results in a substantially different instrument, in which case the modification is accounted for as an extinguishment of the original liability and the recognition of a new liability. ASC 470-60 provides guidance on whether a debtor should account for a debt restructuring as a troubled debt restructuring.

Impact on Hedge Accounting

The current economic situation in the affected regions could have a significant effect on both (1) the ability of entities to apply hedge accounting under ASC 815 and (2) the earnings impact of hedge accounting. Entities should consider the following:

- Whether the occurrence of forecasted transactions remains probable. For example, an entity could change its intent to make purchases or sales or lose its intent or ability to roll over debt given its financial difficulties or the general economic difficulties in the affected regions. Also, the ability of counterparties and customers to buy from or lend to the reporting entity may be adversely affected, which could limit an entity’s ability to hedge certain transactions. For instance, an entity’s ability to hedge probable sales to customers or probable interest payments on a loan issued by a bank may be questionable if those counterparties might be unable to perform in the current economic environment.
- The effect of any impairment on hedge effectiveness. For example, the cash flows of a receivable or debt security that is hedged for interest rate risk or foreign currency risk should not be included in the hedge effectiveness assessment if they are not expected to be recovered. Entities should also carefully consider the impact of credit risk and liquidity risk on hedge effectiveness since both risks can be a source of hedge ineffectiveness. The impact could be particularly significant on entities that have uncollateralized hedging instruments with financial institutions domiciled in affected countries (since the fair value of the instruments could be significantly influenced by changes in the credit risk of the institutions).

NPNS Election Under ASC 815

Among other criteria, for an entity to apply the normal purchases and normal sales (NPNS) scope exception in ASC 815 to a contract, it must be able to assert that it is probable that the contract will not settle net and will result in physical delivery both (1) at inception and (2) throughout the term of the contract. Accordingly, a significant economic event or ongoing turmoil may call into question whether contracts with affected entities will actually physically settle, which could in turn make it more difficult for entities to assert that such contracts meet the criteria for the NPNS election.

Fair Value Disclosures

The disclosures required under ASC 820 are extensive, particularly about fair value measurements involving significant, unobservable inputs (i.e., Level 3). Entities may need to consider whether a significant economic event or ongoing economic turmoil would affect the level in which an affected financial instrument is disclosed in the fair value hierarchy (e.g., a financial instrument previously classified in Level 2 would need to be transferred to Level 3 if the fair value consists of significant unobservable inputs). ASC 820 also requires an entity to describe the valuation techniques and inputs used to determine fair values (by class of financial assets and financial liabilities). In addition, an entity must disclose a change in a valuation technique, and the reason for that change.

SEC Reporting and Disclosure Considerations

SEC Regulation S-K, Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations," requires SEC registrants to disclose in their MD&A any known trends, events, or uncertainties that are reasonably likely to have a material effect on their liquidity, capital resources, or results of operations. When determining what disclosures to provide, registrants may find it helpful to consider guidance issued in January 2012 by the SEC's Division of Corporation Finance on European sovereign debt exposure, which recommended a number of disclosures (excerpted in [Appendix B](#) of this alert) that could apply in today's economic environment.

The SEC staff has also provided informal guidance for registrants with foreign operations in countries or geographic areas that may be affected by poor economic conditions. In doing so, the staff noted that many registrants have foreign operations throughout the world that may be subject to material risks and uncertainties, such as political risks, currency risks, and business climate and taxation risks. Further, the staff reminded registrants that the effects on their consolidated operations of an adverse event related to these risks may be disproportionate to the size of their foreign operations. Therefore, the staff encouraged registrants to discuss in their MD&A any trends, risks, and uncertainties related to their operations in individual countries or geographic areas and possibly supplement such disclosure with disaggregated financial information about those operations.

Accordingly, if a registrant (1) has foreign operations in the affected regions or (2) is otherwise exposed to business or financial risks resulting from recent economic events, and either exposure is reasonably likely to have a material effect on the registrant's liquidity, capital resources, or results of operations, the registrant should consider disclosing information about the following:

- The extent of the registrant's operations in the affected region(s) (e.g., percentage of sales generated from the region), possibly supplemented with disaggregated financial information about those operations.
- How the economic uncertainty may affect the registrant's operations in the affected region(s) and, ultimately, its liquidity, capital resources, or results of operations.
 - Any other business or financial risks of the registrant related to the affected region (e.g., reliance on significant vendors or customers from the region) and how such risks could affect the registrant's liquidity, capital resources, or results of operations.
 - Any business plans of the registrant to respond to the circumstances in the affected region.

Income Tax Considerations

Entities should consider how liquidity and impairment concerns that could result from the current economic environment might also affect their income tax accounting. ASC 740 requires the recognition of a valuation allowance against a deferred tax asset to the extent that it is more likely than not that some or all of the deferred tax asset will not be realized. A reduction in forecasted performance should lead to a reassessment of the extent to which deferred tax assets are not expected to be realized. To the extent that declining valuations or impairments generate net operating losses (NOL), an entity needs to consider the character (i.e., capital or operating) of the components of the associated NOL and evaluate whether there is sufficient appropriate income to fully realize the related deferred tax asset.

Entities may also need to reconsider any assertions about whether undistributed earnings of subsidiaries are indefinitely reinvested. ASC 740 requires an entity that asserts that undistributed earnings are indefinitely reinvested to document its plans for reinvestment of those unremitted earnings on a subsidiary-by-subsidiary basis. If an entity or its subsidiaries have liquidity issues, or other issues resulting from the economic environment, those issues may affect or change the entity's plans and associated assertion that the unremitted earnings of one or more subsidiaries are indefinitely reinvested.

Appendix A — Financial Reporting Considerations Related to a Country’s Exit From the Eurozone

The possibility of a European Union country’s departure from the eurozone has been extensively covered in the news media in recent years. This economic turmoil has led to much speculation about how a country’s exit could affect the operations and financial reporting of affected entities. Broadly, the accounting and financial reporting implications could be limited for some entities and pervasive for others.

The table below outlines some potential consideration points for affected entities. References to “redenomination” in the table describe the circumstance in which an exiting country would convert domestic euro-denominated contracts into that country’s new currency. Note that the items in the table are not intended to be exhaustive, and their relevance will depend on an entity’s individual facts and circumstances.

Item or Scenario	Financial Reporting Considerations
U.S. parent with a foreign subsidiary, joint venture, equity method investee, or other interests subject to redenomination of the euro:	
Functional currency	<ul style="list-style-type: none"> Change in functional currency from the euro to a new currency. Gains/losses in the stand-alone financial statements of the entity either (1) due to the redenomination of contracts without a change in functional currency or (2) without redenomination but with a change in functional currency. Change in functional currency may affect the functional currency assessment for entities higher or lower in the consolidated group (e.g., because they are an extension of the parent). If other-than-temporary lack of exchangeability between currencies, reassess propriety of consolidation/equity method.
Foreign currency translation of transactions denominated in a new currency	<ul style="list-style-type: none"> Selection of the appropriate exchange rate for transactions and translation given the possible availability of various rates of exchange (e.g., official, unofficial, and dividend remittance rates) and possible restrictions on the exchangeability of the new currency.
Change of risk exposure due to redenomination	<ul style="list-style-type: none"> Redesignation of hedging relationships as a result of hedge accounting failure due to redenomination (amounts deferred in accumulated other comprehensive income (AOCI) would not be recycled as a result of redenomination or change of functional currency unless it is probable that the forecasted transactions will not occur). Potential hedge accounting failure in the future due to designation of off-market derivatives.
Master netting arrangements and similar agreements	<ul style="list-style-type: none"> May no longer be subject to offset if one leg of the arrangement is redenominated (e.g., Greek law) but the other is not (e.g., foreign law).
Costs incurred in connection with converting systems for use in a new currency, relocating operations to other countries, and restructuring	<ul style="list-style-type: none"> Assessment of appropriate accounting (whether any costs can be capitalized or all are expensed).
Possible loss of (1) control over an entity or (2) significant influence over an equity method investee (e.g., as a result of a government action or court ruling)	<ul style="list-style-type: none"> Appropriate accounting for loss of control or significant influence, including whether any gain or loss would be recognized in earnings.
Breaches of covenants of borrowing arrangements of a subsidiary or investee located in the exiting country	<ul style="list-style-type: none"> Balance sheet classification considerations (i.e., current vs. noncurrent).
Possible imposition of capital controls on deposits and cash balances after a country’s exit	<ul style="list-style-type: none"> Balance sheet classification considerations (i.e., current vs. noncurrent).
Translation of comparative amounts in euros for a foreign subsidiary whose functional currency has changed to a new currency	<ul style="list-style-type: none"> Determining how to present prior-period comparative amounts in which the new currency did not yet exist.
Effect on operating segments of the group	<ul style="list-style-type: none"> Possible revisions to operating segment disclosures.
Litigation and legal costs of redenomination or contract changes, and other legal aspects of a country’s exit from the eurozone	<ul style="list-style-type: none"> Appropriate accounting for provisions, disclosure of contingent liabilities, and contingent assets.
Sales to government or other entities that rely on government support or trading (e.g., pharmaceutical companies)	<ul style="list-style-type: none"> Appropriate revenue recognition policies and possible need to discount receivables.
Effect on existing securitization structures with payments denominated in predecessor currency	<ul style="list-style-type: none"> Treatment of foreign currency derivatives in trust (e.g., foreign currency swaps between foreign denominated assets into the predecessor currency).

Financial contracts with a foreign entity located in the exiting country:

Amounts due from an entity in the exiting country. Examples include euro time deposits in a bank located in the exiting country, debt investments issued, and loan/trade receivables from the entity in the exiting country. Each may be (1) redenominated into the country's new currency or (2) not redenominated and enforceable in euros under foreign law. Linked balances that were previously in one currency (e.g., euro) may now be in different currencies (e.g., euro and the new currency)

- Impairment.
- Fair value measurement.

Derivatives, with a counterparty located in the exiting country, that are either (1) gross or net settled with one or both legs redenominated or (2) gross or net settled with no redenomination

- In all cases, the fair value measurement should reflect credit risk as well as the effects of redenomination and devaluation.
- If designated in a hedging relationship, credit risk will have an impact on effectiveness.
- If redenominated (but the hedged item is not), possible hedge accounting failures.

Loan payable to an entity in the exiting country either (1) redenominated into the country's new currency or (2) not redenominated and enforceable in euros under foreign law.

- If redenominated, potential derecognition of an old financial liability and recognition of a new financial liability.

Nonfinancial contracts with a foreign entity located in the exiting country:

Construction contracts with a customer located in the exiting country

- Enforceability of partially performed or remaining contracts.

Supply contracts or lease agreements denominated in euros redenominated into a new currency

- Foreign currency translation, impairment, onerous contracts, and whether an embedded derivative is clearly and closely related.

Supply contracts or lease agreements denominated in euros not redenominated (consideration of an embedded derivative if the entity is not a euro functional currency entity)

- Impairment.
- Analysis of whether an embedded derivative is clearly and closely related.

Other considerations. (Note that the items below are also discussed at length in the body of this publication. While they have broader implications, they will most likely be more pertinent in the event of a country's exit from the eurozone.):

Goodwill

- Impairment.

Net investment hedging

- Failure of hedge accounting or high ineffectiveness due to a change in functional currency or reduction in net assets.
- Determine whether change in functional currency (of either a parent or foreign operation) would cause the recycling to profit and loss of hedging gains/losses already recognized in AOCI.

Effect on recoverable amounts of nonfinancial assets (e.g., intangible assets, property, plant, and equipment)

- Impairment.

Going-concern basis of accounting

- Consideration of the wider economic impact of a country's exit on the ability of the entity to continue as a going concern, including the ability of the entity to secure financing in the event of a potential curtailment in bank lending.

Current and deferred tax balances in the exiting country

- Measurement and recognition of deferred tax assets and liabilities (e.g., impact on realizability of deferred tax assets given impact on future profits; deductibility of losses from ability to repatriate profits from foreign subsidiaries).

Defined benefit assets and obligations, redenomination of pension obligations, and pension plan assets

- Redenomination of obligation.
- Treatment of resulting changes to obligations.
- Use of appropriate discount rates for pension obligations.

Appendix B — SEC Staff’s Recommended Disclosures About European Sovereign Debt

To enhance investors’ understanding of financial statements, entities should consider disclosing their material direct and indirect exposures to eurozone sovereign debt (e.g., guarantees and other financial instruments). On January 6, 2012, the SEC’s Division of Corporation Finance issued Disclosure Guidance: Topic No. 4, “European Sovereign Debt Exposures,” which notes that “[t]his guidance is not a rule, regulation or statement of the Securities and Exchange Commission.” However, the release does contain information about the types of disclosures registrants are expected to provide. Specifically, the SEC staff encourages registrants to consider the following in determining “what disclosure is relevant and appropriate” given their particular circumstances:

I. Gross Funded Exposure

a. Countries

- i. The basis for the countries selected for disclosure.
- ii. The basis for determining the domicile of the exposure.

b. Type of Counterparty

- i. Separate categories of exposure to Sovereign and Non-Sovereign counterparties.
 1. Sovereign exposures consist of financial instruments entered into with sovereign and local governments.
 2. Non-Sovereign exposures comprise exposure to corporations and financial institutions. To the extent material, separate disclosure may be required between financial and non-financial institutions.

c. Categories of Financial Instruments

- i. Categories to be considered for disclosure include loans and leases, held-to-maturity securities, available-for-sale securities, trading securities, derivatives, and other financial exposures to arrive at a gross funded exposure.
 1. For loans and leases, the gross amount prior to the deduction of the impairment provision and the net amount after impairment provision.
 2. For held-to-maturity securities, the amortized cost basis and the fair value.
 3. For available-for-sale securities, the fair value, and if material, the amortized cost basis.
 4. For trading securities, the fair value.
 5. For derivative assets, the fair value, except that amount could be offset by the amount of cash collateral applied if separate footnote disclosure quantifying the amount of the offset is provided.
 6. For credit default contracts sold, the fair value and notional value of protection sold, along with a description of the events that would trigger payout under the contracts.
 7. For other financial exposures, to the extent carried at fair value, the fair value. To the extent carried at amortized cost, the gross amount prior to the deduction of impairment and the net amount after impairment.

II. Unfunded Exposure

- a. The amount of unfunded commitments by type of counterparty and by country.
- b. The key terms and any potential limitations of the counterparty being able to draw down on the facilities.

III. Total Gross Exposure (Funded and Unfunded)

- a. The effect of gross funded exposure and total unfunded exposure should be subtotaled to arrive at total gross exposure as of the balance sheet date, separated between type of counterparty and by country.
- b. Appropriate footnote disclosure may be provided highlighting additional key details, such as maturity information for the exposures.

IV. Effects of Credit Default Protection to Arrive at Net Exposure

- a. The effects of credit default protection purchased separately by counterparty and country.
- b. The fair value and notional value of the purchased credit protection.
- c. The nature of payout or trigger events under the purchased credit protection contracts.
- d. The types of counterparties that the credit protection was purchased from and an indication of the counterparty’s credit quality.
- e. Whether credit protection purchased has a shorter maturity date than the bonds or other exposure against which the protection was purchased. If so, clarifying disclosure about this fact and the risks presented by the mismatch of maturity.

V. Other Risk Management Disclosures

- a. How management is monitoring and/or mitigating exposures to the selected countries, including any stress testing performed.
- b. How management is monitoring and/or mitigating the effects of indirect exposure in the analysis of risk. Disclosure should explain how the registrant identifies their indirect exposures, examples of the identified indirect exposures, along with the level of the indirect exposures.
- c. Current developments (rating downgrades, financial relief plans for impacted countries, widening credit spreads, etc) of the identified countries, and how those developments, or changes to them, could impact the registrant's financial condition, results of operations, liquidity or capital resources.

VI. Post-Reporting Date Events

- a. Significant developments since the reporting date and the effects of those events on the reported amounts.