

# Financial Reporting in the Current Environment

December 2008

## The uncertainties facing Irish business in the current environment present new challenges for those involved in financial reporting.

In recent months we have seen the deepening of the economic downturn as the credit crisis continues, the collapse of the Icelandic banking sector and intervention by sovereign governments to maintain the stability of the banking system. As a result, many banks and corporates are finding it difficult to secure new and renewal funding. Many are also confronting increased credit risk from counterparties such as suppliers or customers in difficulties. For some this may even lead to going concern anxieties. Other areas of concern include impairments of financial and non-financial assets, the challenge of valuing assets and liabilities in the current illiquid markets and the volatility of pension scheme deficits.

The IASB responded to calls for a level playing field with US GAAP with an emergency amendment to IAS 39 allowing certain financial assets to be reclassified out of fair value measurement categories.

Meanwhile, Irish listed companies can now expect their annual and half-year reports to be subjected to review by the Irish Auditing and Accounting Supervisory Authority (IAASA) following the Transparency Regulations, 2007, or by the UK Financial Reporting Review Panel (FRRP), the latter for Irish companies quoted on AIM.

In this Bulletin we will take a look at some of these areas that are likely to be of concern, particularly to CEOs and CFOs:

- Funding and going concern issues
- Impairment of assets
- Defined benefit pensions
- Accounting estimates and judgements
- Changes in classification of financial assets – IAS 39 Amendment

We also discuss the wider topic of corporate reporting, as providing clear and transparent explanations of the effect of the credit crisis and its implications for business strategy, will be imperative in order to restore investor confidence. Our discussion also refers to views expressed by both analysts and by regulators, particularly the UK FRRP and IAASA.

These are uniquely challenging times for Irish business and uncertainty has become a major feature of the economic outlook. This uncertainty creates new challenges for all of us and this Bulletin looks at issues that many of our clients may not have needed to consider in depth in previous financial reporting seasons.

If you would like to obtain further information on the issues addressed in this Bulletin or to discuss any other matters, please contact a member of your PricewaterhouseCoopers service team.



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## Funding And Going Concern

The reduced availability of credit means that some banks are unwilling to confirm facilities, or are willing to offer committed facilities but only for shorter periods or at higher interest rates than in normal conditions.

Some companies may therefore have difficulty securing funds to meet short-term working capital requirements or to fund acquisitions or capital expenditure.

The credit crisis will inevitably affect many directors' consideration of whether it is reasonable to conclude that it continues to be appropriate to prepare their financial statements on the going concern basis.

For example, a company that merely has credit committee approval from a bank (but has not agreed terms such as the interest rate, and has not completed detailed documentation), may not have sufficient evidence to support the going concern assumption. Other examples of events or conditions that may individually or collectively cast significant doubt about the going concern assumption include:

- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Adverse key financial ratios.
- Significant deterioration in the value of assets used to generate cash flows.
- Inability to comply with the terms of loan agreements.

Auditors, too, have a judgement to make in relation to going concern. Where the auditors consider there is material uncertainty that may cast significant doubt on the ability to continue as a going concern, they are required to refer to this in their audit report.

As the UK Financial Reporting Council said in its recent Guidance on Going Concern and Liquidity Risk, "The difficult economic conditions being faced by many companies will necessitate careful consideration by directors in assessing whether it is reasonable for them to use the going concern basis of accounting".

For IFRS users, the specific disclosure requirements of IFRS 7 on liquidity risk will be key, including providing both qualitative and quantitative information on difficulties that may be encountered in discharging liabilities as they fall due.

### What can be done?

- Reconsider the principal risks facing the business in the current environment
- Review and update cash flow forecasts based on realistic assumptions about the key drivers of the business, including revenue, margins, costs and the timing of operating and capital cash flows
- Consider the sensitivity of the cash flow forecasts to changes in the assumptions
- Identify non-core assets that could be disposed of.
- Assess banking covenants and headroom
- Negotiate facilities early, bearing in mind that whilst renewals may be available, banks may seek higher rates of interest and/or fees
- Consider drafting the relevant disclosures for the financial statements, such as details of current financing arrangements, committed and uncommitted, and their adequacy, covenants, other credit arrangements, dependence on key suppliers and customers, and the potential impact of the economic outlook on business activities.

## Impairment Of Assets

Over the last year of increased volatility in global markets and the economic slowdown, we have seen big write-downs and write-offs of investments and loans in the financial sector in particular, but the external events that have triggered these impairments do not just affect banks and financial assets. The value of non-financial assets, such as goodwill and property, plant and equipment, may also have fallen. Consequently, we can expect to see many businesses having to conduct an impairment review of their non-financial assets to assess whether their carrying values need to be written down to their recoverable amount.

The recoverable amount of goodwill and property, plant and equipment is often based on their value in use, rather than their fair value. As value in use can be difficult to calculate, we set out below some key steps in the process of assessing the value in use of operating assets in order to identify whether an impairment write-down is required.

1. Identify the separate cash generating units making up the total business, within which the relevant non-financial assets are situated.
2. Use up-to-date forecast cash flows approved by management (adjusted to exclude the effects of both capital expenditure that will enhance the asset and future restructuring). Ensure these forecasts are reasonable and supportable, and reflect attainable growth rates and margins.
3. Use a discount rate that reflects current conditions, including cost of borrowing, credit spreads, equity risk premium and the uncertainties inherent in the forecasts.
4. Be prepared to justify or reconcile the value in use calculation to external measures such as market capitalisation.

The impairment test process takes time; time to identify impairment indicators, assess or reassess the cash flows, determine the discount rates, test the reasonableness of the assumptions and benchmark the assumptions and results with the market. It may be felt that using probability-weighted cash flows would now be more appropriate than using a single best-estimate set of cash flows. The process should start in good time to avoid last minute surprises. Goodwill can be tested for impairment before the year end, with an update at year end if further impairment is indicated.

## Irish property values

Irish commercial property valuations can also be expected to show a significant decline. Valuations of investment property are affected by the rise in yields and the low level of transactions, while development property values have been affected by the decline in residential prices and the shortage of funding.

## Post balance sheet events

Directors may identify that asset values have declined still further after the balance sheet date and will need to consider the accounting consequences of this.

Events occurring between the balance sheet date and the date of approval by the directors may need to be reflected in the financial statements as adjusting or non-adjusting events. Adjusting events provide further evidence of conditions that existed at the balance sheet date. Non-adjusting events relate to conditions that arose after the balance sheet date.

For example, a decline in the market value of investments or the credit rating of a counterparty between the balance sheet date and the date when the financial statements are authorised for issue does not normally relate to the conditions at the balance sheet date but reflects circumstances that have arisen subsequently. Accordingly, the amounts recognised in the financial statements are not adjusted, but if the amounts are material, their nature and estimated financial effect should be disclosed.

## Defined Benefit Pension Schemes

Falls in the equity markets have wiped billions from pension plan assets, inflation has acted to increase plan liabilities, and volatility in bond yields has led to volatility in reported pension deficits.

Both IAS 19 and FRS 17 require post-employment benefits to be valued using a discount rate based on high-quality corporate bond yields. In the past, the charts that plot yield against duration showed only a few outliers and a narrow range of plausible yield curves. This year, the same charts are more scattered, with a spread measured in hundreds of basis points rather than tens, with the higher yielding bonds being issued by financial institutions. The bonds are still rated 'AA' by the credit agencies, but the markets seem to take the view that some 'AA'-rated bonds are not as high quality as others.

Where does this leave preparers when it comes to setting discount rate assumptions? There are two main issues:

- The methodologies that have been used in the past to set assumptions may not be robust enough to cope with current circumstances; and
- The range of assumptions that can be reasonably justified, both in absolute terms and without being inconsistent with past practice, may be wider.

Early engagement with the actuaries to identify the appropriate bond yields and discount rates is advisable. A key issue for many businesses will be assessing how the effect of increases in discount rates since last year, and the consequent reduction in actuarial liabilities, compares with the negative effects of the fall in equity values and other factors, such as inflation and mortality assumptions.

## Disclosures

The FRRP considers there is room for improvement in disclosing how the expected return on assets has been calculated, analysing the types of assets held as funds and showing the maturity of liabilities. On the positive side, the FRRP found an improvement in disclosures about mortality assumptions and sensitivity analysis.

## FRS 17 revised

Companies using FRS 17 will need to give more disclosures than before as the disclosure requirements of FRS 17 have been upgraded to IAS 19 level.

The enhanced disclosures include the full movement in the year of both pension assets and liabilities, and in most cases the mortality assumptions used to calculate the actuarial liability.

## ASB Statement of Best Practice for Pension Disclosures

The ASB also issued a best practice reporting statement on retirement benefits disclosures in December 2006, and it recommends increased disclosures in the following six areas:

- Relationship between the reporting entity and the trustees of defined benefit schemes.
- Information about the principal assumptions, especially mortality rates.
- Sensitivity analysis for principal assumptions.
- How defined benefit liabilities are measured, including disclosure of the liability on a buy-out basis.
- Future funding obligations in relation to defined benefit schemes.
- Nature and extent of the risks and rewards arising from financial instruments held by defined benefit schemes.

## Other Areas Of Accounting Estimates And Judgements

Financial statements inevitably include a number of estimates where management has had to exercise varying degrees of judgement. These include the areas discussed above such as impairment reviews and pension liabilities.

Other areas that may well require more judgement than usual in the current environment include restructuring provisions, share-based payment arrangements, revenue recognition, inventory provisions and deferred tax assets. For example, a restructuring programme may involve the departure of employees with unvested share options (and indeed, even for continuing employees, the share option expense may need to be reconsidered where vesting conditions are linked to achieving certain profit targets). Other companies may need to defer the recognition of revenue where their customers' financial position casts significant doubts on its recoverability, and, of course, more inventory may need to be written down to reflect realistic expectations of its net realisable value.

Undoubtedly, preparers of financial statements will need to place a renewed focus on drafting the uncertainties underlying the numbers in those financial statements, and in many cases, providing sensitivity analysis to give an indication of how the numbers might change if different assumptions were used.

## Changes In Classification Of Financial Assets - IAS 39 Amendment

Banks and insurers contending with huge write downs in asset values have been exerting pressure on the EU and IASB to relax fair value accounting rules that force them to 'mark to market'. The resulting amendments to IAS 39 permit certain reclassifications out of fair value measurement categories. Similar reclassifications were already permitted under US GAAP; IFRS reporters have therefore been granted a more level playing field with their US GAAP counterparts.

The need for urgent action led the IASB to suspend its normal due process (exposure draft and comment letters, for example) so that the amendments could take effect in the third quarter of the calendar year. Reclassifications may be made retrospectively in the window from 1 July 2008 until 31 October 2008 – any made on or after 1 November 2008 take effect from the date of reclassification.

The amendment applies only to certain financial assets classified as available for sale or held for trading, that are currently measured at fair value. It does not apply to financial liabilities, derivatives, equity investments or financial assets designated as at fair value through profit and loss on initial recognition. Reclassifications could be made to certain other categories if the financial asset meets the definition of that category.

### In summary, reclassifications are permitted in the following circumstances:

1. A held for trading financial asset (if not designated under the fair value option) may be reclassified to:
  - loans and receivables if it meets the definition of a loan or receivable and the entity now has the intent and ability to hold it for the foreseeable future or to maturity; or
  - held to maturity or available for sale if it does not meet the definition of a loan or receivable, only in rare circumstances. The IASB has confirmed that the current deterioration in world financial markets is 'rare'.

2. An available for sale financial asset may be reclassified to loans and receivables if:
  - It meets the definition of a loan or receivable; and
  - The entity now has the intent and ability to hold it for the foreseeable future or to maturity.

At the date of reclassification, the fair value of any financial asset reclassified under these provisions becomes its new cost or amortised cost as applicable.

IFRS 7 has also been amended to incorporate extensive disclosure requirements relating to any assets reclassified as a result of this amendment to IAS 39. This includes disclosure of the carrying amounts and fair values for all financial assets that have been reclassified until they are derecognised, together with details of the fair value gain or loss that would have been recognised in the income statement or equity if the financial asset had not been reclassified.

### Fair value accounting

The IASB has acted quickly in other areas too, issuing guidance on fair value measurements in illiquid markets and proposing further revisions to IFRS 7 to enhance transparency of fair value disclosures. The IASB guidance reiterates that the quoted price in an active market is most representative of fair value, while acknowledging that "determining that a market is not active requires judgement". After the IASB amended IAS 39, the European Commission asked the IASB to address urgently a number of other aspects of IAS 39, including fair value accounting.

### Other accounting consequences of the credit crisis

Further accounting consequences include the risk that hedges may become ineffective, embedded derivatives may become material and special purpose entities may need to be consolidated when their funding or decision-making processes have changed.

## Corporate Reporting

In this rather depressed environment for financial reporting, is there anything that can be done to brighten up your Annual Report?

Well, corporate reporting is not just about financial information. It serves as a valuable communication tool for boards to tell their particular story to the market. The increasing length and complexity of financial reporting has led to users placing a much greater reliance on non-financial and contextual information presented by companies. Indeed, effective communication with the capital markets can improve confidence and act to reduce share price volatility.

### Directors' Report – Legal Requirements

1. The directors' report should contain:
  - a fair review of the business; and
  - a description of the principal risks and uncertainties facing the business.
2. The review should be a balanced and comprehensive analysis of:
  - the development and performance of the business during the year
  - the position at the end of that year, consistent with the size and complexity of the business.
3. The review should, to the extent necessary for an understanding of the development, performance or position of the business, include:
  - analysis using financial key performance indicators; and
  - where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters.

(Small and medium-sized companies are exempt from item 3.)

### What does the FRRP say?

The FRRP recommends that the financial crisis and other market changes may cause directors to contemplate risks and uncertainties previously thought to be too remote to have warranted serious consideration.

Some companies provide a long list of risks and uncertainties without identifying the principal ones and without giving proper descriptions.

So, what steps can management take to make their corporate reporting more accessible and effective?

## 1. Objectives and strategy

Use your objectives and strategy to underpin your reporting and provide the context for your activities and performance. Strategic statements should not be set in isolation from the rest of your reporting.

- Is your strategy outlined early on and is it highly visible?
- Have you included specific measures to assess progress, alongside targets and comparatives?
- Have you discussed the actions you have taken in the current year to achieve your strategy?
- If targets have not been met, have you explained why and what is now being done to meet them?
- Have you provided detail about your likely future performance?

### What do the analysts say?

'Really good management usually have really good discussions because they know what is important to their company. The poorly managed companies do not have that level of confidence.'

### What does the FRRP say?

Reports that clearly set out the company's business model are those which are easiest to understand.

## 2. Market trends

Put your results in the context of market trends. Provide management's perspective on the competitive landscape and macro environment to allow the reader to evaluate your strategic choices and actions along with the quality and sustainability of performance.

- Have you analysed what drives your markets?
- Have you covered general macro-economics (e.g. the credit crunch), competitors (e.g. your comparative market share) and regulatory matters (e.g. pricing)?
- Have you supported qualitative statements with quantitative evidence?
- Have you clearly referenced the source of external market data?

### What do the analysts say?

'I need an analysis of what markets they are in and what drives those markets: what their position is and what drives their business model. But you very rarely find anything like that.'

### 3. Transparent analysis

Provide an honest and open analysis of both the upsides and the challenges the company faces.

Explain how any areas of underperformance are being addressed.

#### What do the analysts say?

'You always read it with a pinch of salt ... Even a company that has lost a billion dollars highlights the positives.'

### 4. Liquidity and financing

Clearly explaining liquidity and financing arrangements will be essential in the current environment. Debt information is traditionally scattered throughout the report. Bring it together in one place. Include items not typically recognised in the financial statements, such as operating leases. Many analysts like a net debt reconciliation showing changes in cash and funding over the period, as it is an easy way of seeing whether a significant increase in cash is in fact due to an increase in debt.

- Have you given sufficient granularity in the maturity table?
- Have you disclosed banking covenants (and how any breaches have been addressed) and how much headroom on covenants you have?
- Have you disclosed funding facilities available to you and their term?

#### What do the analysts say?

'Companies are quick to provide the information you need when issuing a bond. They are not very good at keeping that relationship going ...'

### 5. Cash flow reporting

Consider including a detailed disclosure about your operating cash flow strategy and performance, including cash conversion ratios, sensitivity to key factors, repatriation restrictions, and so on.

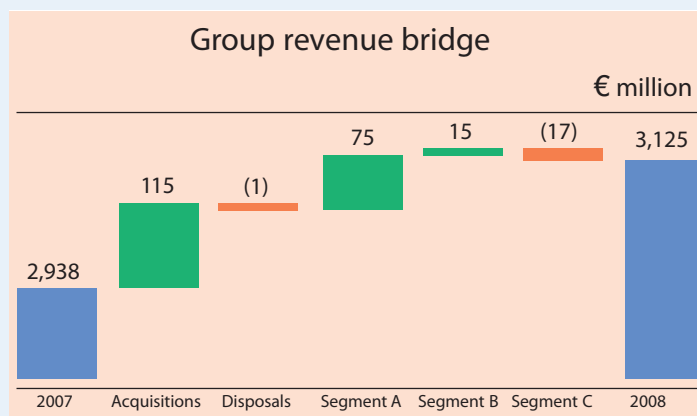
- Have you provided segmental cash flow information?
- Have you separated cash flow information relating to acquisitions and disposals such that the underlying cash flow trend can be seen?

#### What do the analysts say?

'Let's clear up the cash flow statement because, at the end of the day, it is our best indicator of what's real.'

### 6. Sustainable growth

Consider using bridge charts to help investors understand what is driving revenue and profit growth. Is the growth sustainable, or not?



#### What do the analysts say?

'You can't tell whether a company's growth is coming from volume growth versus pricing; whether it is organic versus acquired.'

### 7. Key risks

Highlight principal risks, not all risks. How might they derail your strategy? How are they managed? What is the sensitivity of underlying performance to changes in these risks?

- Do you rigorously assess the risks to the business regularly?
- Have you disclosed more than 10-15 risks? Is this too many?
- Have you distinguished between risks that can be controlled and those that cannot?
- Have you explained how each risk is identified, monitored and mitigated?
- Have you assessed the likelihood of a risk occurring and its likely impact?

#### What do the analysts say?

'They throw in the kitchen sink. The important things are no more prominent than the things that aren't important.'

## 8. Segment Reporting

Challenge whether the segment analysis makes visible the different dynamics in the business. Consider including a few additional line items such as working capital, operating cash flow and capital employed for each segment.

- Is the front half analysis consistent with the segments in the financial statements?
- Have you considered giving strategy information, risks and KPIs by segment?
- Have you highlighted any segmental priorities and risks that differ from the group as a whole?

### What do the analysts say?

'The area where there is greatest potential for increased disclosure that would add value is in the segment information.'

## 9. Bridging the GAAP

Embrace non-GAAP measures but apply certain ground rules: reconcile non-GAAP back to GAAP; provide clear definitions of terms used; make sure that the reader can quickly identify which are the non-GAAP numbers; and explain the rationale for the use of non-GAAP numbers.

### What do the analysts say?

'I like non-GAAP measures: they help me increase my understanding of the underlying performance of the business.'

## 10. KPI reporting

Clearly identify key performance indicators, explain the rationale for their use and highlight the links to strategy. Explain how KPIs are used to incentivise management.

- Have you stated why each KPI has been included, defined it and detailed how it is calculated?
- Have you given prior year comparatives or trend data and future targets?
- Do you use operating as well as financial KPIs?
- Are you consistent year on year, or if KPIs have changed have you explained why?

### What do the analysts say?

'Management action is inextricably linked to the structure of their compensation. Simple and clear communication about the KPIs that govern pay is critical.'

### What does the FRRP say?

It is likely that the panel will challenge boards to support the absence of any KPIs. KPIs should be clearly identified and applied in the analysis of the company's performance.

## A practical approach

Key information and messages can get lost in the volume of data and the use of jargon. Take a step back. Are you helping the reader to understand key strategic messages and navigate easily through your report by using clear and consistent headings along with tables and charts?

- Who has overall responsibility for the front half?
- Are your messages coherent and consistent?
- Have you clearly signposted information, for example using tabs, headings or colour?
- Do you cross-refer to other sources of information, for example your website or CSR report?
- Do you make good use of graphics, charts, tables and diagrams to express information simply and memorably?
- Have you provided a glossary and an index?

### What do the analysts say?

'It's both a problem with lack of granularity, but also a problem with sometimes providing so much granularity that you can't see the wood for the trees.'

## Interim Reporting

Both IAASA and the UK Listings Authority have identified areas where interim reports have not been up to scratch. These, together with our own experience of reviewing interim reports under the Transparency Regulations, identify the following areas of concern:

- Principal risks and uncertainties not disclosed. Although the principal risks and uncertainties disclosed in the annual report will often remain valid at the half-yearly reporting date, it is good practice to state that the principal risks and uncertainties have not changed, provide a summary of those principal risks and uncertainties, and cross reference to the principal risks and uncertainties in the annual report.
- No disclosure of the impact of the credit crunch. This could include disclosure of any significant changes in the financial risk management approach, changes to the entity's exposure or sensitivity to financial or market risks, material impairments or fair value losses, and changes to valuation techniques for financial instruments in this illiquid market.
- Omission of (i) explanations of material changes in assets, liabilities, equity, income and cash flows since the comparative period, (ii) the nature and amount of items that are unusual by their nature, size or incidence and (iii) material changes in estimates, e.g. provisions, defined benefit pension obligations and impairments.
- Omission of some or all of the required disclosures for business combinations during the period or after the period end: IAS 34 requires extensive disclosure in line with IFRS 3, 'Business Combinations'.
- Omission of details of significant purchases and sales of property, plant and equipment.
- No explanations of the effect of seasonality on operations.
- Basis of preparation note incorrect (for example, absence of reference to IAS 34, or IFRS as adopted by the EU).
- Name and function of persons making the responsibility statement not given (or responsibility statement omitted entirely). To comply with the Transparency Regulations, it is good practice to give this disclosure in full, either for the whole board, or for those directors signing on behalf of the board.

## Concluding Comment

In the weeks that remain before the annual reporting season kicks off in earnest, we can expect to see keen corporate efforts to sharpen the assessment of the risks and uncertainties facing business, a reshaping of business and financing strategies to respond to both the opportunities and challenges presented by the current environment and refining of cash flow forecasts to reflect those strategies.

We believe that these vital management activities will also make a key contribution to ensuring the continued reliability and usefulness of corporate reporting in the early months of 2009.