Feel the impact

Executive summary

- The credit crunch is affecting businesses in many ways. As well as causing practical problems it has accounting implications that companies should not overlook.

Newspaper and magazine pages have been filled with stories about the credit crunch. Many opinions have been given about how, and why, a rising tide of defaults in the US sub-prime mortgage markets came to shake financial markets across the globe and led to a broader credit crunch, involving a widespread shortage of liquidity and a general widening of credit spreads. Much speculation has ensued as to the future of the world's major economies.

But less attention has been given to an equally important topic: the implications of the credit crunch for accounting and reporting. There are some serious issues to be addressed, and not just by banks. Large corporates and pension funds, many of which bought the complex financial products into which sub-prime loans were packaged, are also affected. This would be a good time for a company treasurer to conduct a credit crunch accounting health-check. The following issues should be on your list for review:

- determining the fair value of financial instruments;
- hedge ineffectiveness;
- impairment of financial assets;
- impairment of non-financial assets;
- guarantees and loan commitments;
- pension valuations;
- disclosures;
- auditing considerations, particularly going concern;
- consolidation of special purpose entities;
- embedded derivatives; and
- reclassifications.

DETERMINING FAIR VALUE Some financial instruments need to be shown at fair value, but establishing those values may prove more difficult if there is no longer an active market; fair value is not the amount received in a forced transaction, involuntary liquidation or distress sale. That said, a lower than normal volume of transactions, or even a short absence of transactions, does not mean the market is inactive. Under international financial reporting standards (IFRS), if there is a quoted price in an active market, this must be used.

If the market for a financial instrument is not active, a valuation technique is applied instead. The technique should reflect current market conditions, so any change in credit spread and relative liquidity needs to be taken into account. Companies using the services of a third-party valuer (such as a broker quote or pricing service) should understand how the valuation was derived and ensure that the prices, indices and other variables used are reliable.

HEDGE INEFFECTIVENESS Companies should be alert to the possibility that hedge ineffectiveness could result from the recent turbulent market conditions. For example, a designated hedged risk might no longer exactly match the hedging instrument when the two have different credit spreads.

In some cases the retrospective effectiveness test in the financial instruments standard IAS 39 may be failed because the hedge will be judged not to have been highly effective during the period. If so, hedge accounting should cease from the last date on which hedge effectiveness was demonstrated. However, if the event or change in circumstances that caused the hedging relationship to fail the effectiveness criteria is identified, and it can be demonstrated that the hedge was effective before then, the hedge accounting is discontinued from the date of that event or change in circumstances.

Companies that have hedged forecast debt issuances, including the rollover of commercial paper, will need to ensure that the hedged debt issuance still has a high chance of occurring. If not, the criteria for hedge accounting are no longer met, and the hedge accounting should cease.

IMPAIRMENT OF FINANCIAL ASSETS It is important to check for impairment of financial assets. Under IAS 39, a significant or prolonged decline in the fair value of an investment in an equity instrument below cost is evidence of impairment. A debt instrument is considered impaired if there is a decrease in the estimated future cashflows arising from it. However, if an entity has debt securities whose fair value has decreased because of illiquidity and rising interest rates, that on its own is not considered objective evidence of impairment under IFRS.

IMPAIRMENT OF NON-FINANCIAL ASSETS Non-financial assets – such as goodwill and intangible and tangible fixed assets – may also have become impaired. Key assumptions may have to be adjusted (for a decrease in future growth and an increase in discount rates), while more sensitivity disclosures may be required if headroom is reduced.

TAKE THE CREDIT CRUNCH ACCOUNTING HEALTH CHECK, SAYS **YANN UMBRICHT**.

GUARANTEES AND LOAN COMMITMENTS The fair value of those financial guarantees and loan commitments measured at fair value may be affected. Financial guarantees that are not measured at fair value may have to be re-evaluated if the probability or amount of a cash outflow has changed. A liability adequacy test should be performed for financial guarantees measured under the insurance contracts standard IFRS 4. Loan commitments not measured at fair value may have become onerous.

PENSION VALUATIONS The recent market conditions can have an effect on the value of both pension plan assets and plan liabilities. Pension plans may have invested in assets backed by sub-prime exposures, so the value of their plan assets may have fallen. Looking at the liability side, one of the assumptions used in the projected unit credit method is a discount rate that references market yields. Given the volatility in the markets, it is possible that those rates may have changed.

DISCLOSURES The credit crunch is likely to mean that companies need to make a number of additional disclosures. Given that many companies will be adopting the financial instrument disclosure standard IFRS 7 for the first time this year, care will be required, in particular over the required disclosures of sensitivities to market risk. In addition, companies will need to consider how they disclose key sources of estimation uncertainty and the significant accounting judgements that have been made.

AUDITING CONSIDERATIONS The reduced availability of credit and illiquidity in short-term funding (for example, commercial paper programmes) could cause serious problems for some businesses. Companies may have difficulty securing funds to meet their short-term borrowing requirements or to fund acquisitions or capital expenditure projects. This could raise questions about whether the accounts of such companies can still be prepared on a going-concern basis.

Auditors will be looking out for warning signs, such as:

- 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 debtors and other creditors;
- adverse key financial ratios;
- significant deterioration in the value of assets used to generate cashflows; or
- inability to comply with the terms of loan agreements.

SPE CONSOLIDATION Companies with special purpose entities (SPEs) that have not been consolidated under interpretation 12 of the Standing Interpretations Committee (SIC-12) may have to reconsider this decision if they have stepped in to support an SPE when they had no contractual obligation to do so, or have otherwise changed how an SPE is funded or how key financial and operating decisions are made.

RECLASSIFICATIONS IAS 39 prohibits the reclassification of a financial instrument into or out of the fair value through profit or loss (FVTPL) category while it is held. It is therefore not appropriate to reclassify financial instruments out of the FVTPL category as a result of recent market events. Nor is it appropriate to reclassify financial assets out of the available-for-sale category into loans and receivables.

ATTENTION REQUIRED Managing through the credit crunch will require considerable skill and care. Accounting considerations may not be top of everyone's list for urgent attention, but they must not be overlooked. Specialist help should be sought early if any doubts arise, not only about the commercial impacts of the credit crunch, but how those impacts are accounted for and reported.

Yann Umbricht is a Partner in the Treasury Group of PricewaterhouseCoopers.
yann.umbricht@uk.pwc.com
www.pwc.co.uk

"THE CREDIT CRUNCH HAS CAUSED A STEP CHANGE IN THE COST AND AVAILABILITY OF DEBT FOR TREASURERS BUT HAS ALSO RESULTED IN A SIGNIFICANT INCREASE IN THE RISK OF DEFAULT BY COUNTERPARTY BANKS."
Nick Mourant, Group Treasurer, Tesco

"THE CRUNCH HAS MEANT TERMS OFFERED BY BANKS CAN VARY SIGNIFICANTLY. COMPANIES MORE THAN EVER SHOULD CONSIDER FUNDING COMPETITIONS TO ENSURE THEY ARE GETTING THE BEST DEAL."
Paul Davies, Partner in Debt Advisory Practice, PricewaterhouseCoopers

"THE DRAMATIC WIDENING OF SPREADS AND THE EFFECTIVE CLOSURE OF SOME DEBT MARKETS HAS DRIVEN REFINANCING RISK AND LIQUIDITY MANAGEMENT TO THE TOP OF THE AGENDA FOR CORPORATE TREASURERS."
Jon Drown, Director, Group Treasury, Rexam

"LIQUIDITY REMAINS BUT BORROWERS NEED TO WORK HARDER AND PAY MORE TO ACCESS IT."
David Swann, Group Treasurer, British American Tobacco