

TS Insights

Financial reporting in an uncertain economy

How the economic slowdown leads to added financial reporting complexities

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The global recession has left an indelible mark on the economy through shaken credit markets, volatile debt and equity prices, government bailouts for ailing industries and the revenue and earnings declines reported by a vast array of companies. Early indicators of a potential end to the recession notwithstanding, pundits are predicting a long and painful post-recession recovery to follow. While financial reporting can be complex even in the best of times, many transactions and the attendant reporting issues can be even more daunting during troubled economic times and the recovery period that follows.

Why would financial reporting become more complex during troubled economic times? In many cases, transactions can be complex in and of themselves, and so it follows that the reporting is also complicated. Some transactions like troubled debt restructurings and bankruptcy reorganizations also just aren't all that frequent during normal cycles and so the requisite expertise can be scarce. For others, like certain derivative trades that must be tracked at fair value, the accounting is highly sensitive to today's market volatility and illiquidity. Lastly, without transparent advance warnings, impairment charges may serve as surprise signals to the market that troubled water is deeper than expected. Given these and other complexities, and general market sensitivities to reported results, financial reporting during a recession and the post-recession recovery period warrants management's close attention.

What types of transactions and issues can arise that require heightened attention today? They are as varied and multi-faceted as the commercial and economic drivers facing today's business world. Examples range from voluntary and involuntary restructurings and financings to goodwill and asset impairment assessments, as well as the income tax reporting that can go hand in hand with each. A representative sample of challenging topics that financial statement preparers may face today includes:

- Debt restructurings and repurchases. A downturn in the economy can present an opportunity to restructure or repurchase outstanding debt securities that are trading at historical lows. How changes in the debt are reflected in the financial statements, particularly with respect to the amount of gain or loss recognized, can vary significantly depending on how these modifications are structured. As a result, financial reporting impact may merit substantial attention during the negotiation phase.
- Leasing restructurings. As with debt vehicles, lease renegotiations are becoming more common in the current environment, especially for lessees undergoing restructurings. There are a variety of features that can be complex to negotiate and account for in accounting for a renegotiated lease. Examples include upfront charges, guarantees and synthetic leases. It is well known that lease accounting can be quite complex and lease restructurings are no exception.
- Chapter 11 reorganizations. As bankruptcy protection becomes more common, companies must consider substantive changes to the way a bankrupt entity presents and reports the results of its operations as well as other additional reporting requirements. Filers are also faced with a barrage of new financial reporting stakeholders and may need to contend with

severely reduced or dwindling financial reporting resources. Tightly controlled financial reporting processes and bankruptcy specific expertise are imperative in the context of Chapter 11 reorganization.

- Private investments in public enterprises (PIPEs) and other complex financings. PIPEs are just one example of demanding financing terms that are becoming more prevalent in today's credit markets. Many PIPE structures require separate reporting for embedded derivatives and beneficial conversion features, which can have a dilutive effect on earnings per share. Issuers should be aware of these dilutive features in advance of using PIPEs to raise funds.
- Exchanges, alliances, and partial acquisitions. During M&A market lulls, it is not uncommon to see increased exchange, alliance and partial acquisition activity. These transactions are perceived to be vehicles for continued investment in growth opportunities, that may avoid the risk, cash flow, and financing issues associated with traditional M&A. Significant operational and financial reporting challenges exist that should be considered in advance of finalizing these complex transactions.
- Derivative and hedging activities. Turbulence in the commodities and foreign exchange markets, as well as credit risk volatility, may impact hedge effectiveness and the related treatment in the financial statements. Further, companies may seek to employ new hedging strategies given the current volatile environment. Hedge qualification and continued monitoring is a complex process that warrants heightened scrutiny in volatile markets.
- Fair value measurements of financial instruments. The guidance on measuring financial assets and liabilities at fair value is relatively new and is still undergoing interpretive changes. For complex, highly structured instruments, fair value can be difficult to determine even during times of healthy, robust market activity. Illiquid markets and low trading activity can compound the issues, as decisions must be made regarding whether the market activity that does exist represents fair value, and if not, how to estimate fair value absent market-based pricing.
- Asset and goodwill impairments. Business climate downturns and increased market volatility can trigger a requirement to test whether an asset or goodwill is

impaired, which could lead to significant impairment write-downs. Evaluating interim impairment testing triggers, the testing process, and value estimates that are required to record impairment charges all involve significant judgment and management estimates.

- Deferred tax asset (DTA) recoverability assessments. DTAs may be recorded when a company reports deductions or operating losses that are deductible in tax filings after they are recognized for "book" purposes. Worsening financial results and/or forecasts may call into question the recoverability of DTAs. A valuation allowance and related charge may be needed to reduce the DTA for the amount that is not recoverable. Whether, how much, and when to record a valuation allowance are highly subjective questions that many companies will be forced to face in an economic downturn.

What this means for your business

Though the financial reporting standards that apply to these transactions and events are in many cases not new, the issues are still challenging. Add to that today's pace of new standards and interpretations on topics such as fair value measurements, consolidation of variable interest entities, accounting for noncontrolling interests, and more, and it is easy to understand why financial statement preparers and users might struggle to ensure their financial reporting expertise stays current and relevant. When the issues become too daunting to handle internally, a trusted professional advisor can step in to relieve the burden with up-to-the minute knowledge and pertinent expertise.

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To help CFOs and their teams successfully navigate the current economic environment, PricewaterhouseCoopers is launching a series of *TS Insights* focused on financial reporting in an uncertain economy. The series helps to educate financial statement preparers about transactions and reporting issues that require special attention in today's environment. *TS Insights* is a publication of the Transaction Services group at PricewaterhouseCoopers, which includes approximately 1,000 professionals in 16 US cities.

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