Financial Market Volatility.

Recent months have been marked by increased volatility in global markets, falling oil prices, political unrest and slower than expected recovery in the Eurozone. The current economic environment has driven many to ask questions as they prepare year-end financial reporting.

Exchange rates

Exchange rates have been a recurring feature in the headlines. Most recently, the Swiss Franc was 'unpegged' from the Euro, removing the cap put in place some years ago. Skiing holidays suddenly became more expensive but more importantly, the price of Swiss shares suffered a significant fall. The Russian Rouble is going in the other direction with falling oil prices a major contributing factor. This has generated an increase in interest rates and a fall in the Russian stock market.

IAS requires the use of spot exchange rates at the reporting date. For example, Swiss impacted entities will need to consider the recent foreign exchange movements as a subsequent event and assess the level of disclosure they want to make regarding this issue.

Risk management

The turmoil in the economic environment affects more than just foreign currency. Some might look to hedge accounting to minimize volatility in the financial statements. This might mitigate exposure but hedge accounting has to be applied prospectively. Hedge accounting is well known for its documentation requirements. Therefore, entities will not be able defer volatility if no hedge relationship formally existed in 2014. There is also a risk that existing hedge relationships might no longer be effective and consequently might not be able to continue applying hedge accounting.

Negative interest rates

Negative 'real' interest rates have returned to the forefront of discussions. Although negative interest rates are not a new phenomenon, the scale being experienced today is indeed new. But what is 'negative' interest – is it really interest?

The IASB have confirmed that interest arising from a negative interest on a financial asset does not meet the definition of interest revenue because it is a gross outflow, instead of a gross inflow of economic benefits. Negative interest must therefore be presented in an appropriate expense classification. Entities are encouraged to disclose where they present negative interest and the amount.

Discount rates

Discount rates should reflect the conditions at year-end. Post year-end volatility is a non-adjusting subsequent event (similar to changes in exchange rates), which should be supported by sensitivity disclosures.

But what does negative interest mean for discount rates? Does it make sense to measure a long term provision expected to be settled at €90 in 30 years in today's balance sheet for €100? It seems unlikely. Negative interest rates in the long-term are likely to be combined with deflation, limiting the extent to which real rates are negative.

Impairment

Sharp volatility can be a potential indicator of impairment and is likely to lead to an increase in impairment reviews of non-financial assets. Assets and businesses in many industries will generate lower cash flows than expected, increasing the likelihood that impairment will be required.

If an impairment review results in a "near miss" the methodology probably needs a second look. First and foremost, the cash flows should be risk adjusted. A single point estimate is not risk adjusted. If a single set of cash flows is used, adequate risk should instead be built into the discount rate.

Also, the carrying amount of the cash generating unit (CGU) should be consistent with how the recoverable amount is determined. Only assets that generate future cash flows used to determine the value in use are included. Liabilities are not included unless the recoverable amount cannot be determined without their consideration.

If after review there is still a near miss, additional disclosure is required including the sensitivity of key assumptions. Impairment is always a hot topic with regulators and therefore disclosures need to be transparent.

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