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FINANCIAL REPORTING CONSIDERATIONS IN AN ENVIRONMENT OF INFLATION AND RISING INTEREST RATES

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Effects of inflation, rising interest rates and other macroeconomic factors

Inflation has been increasing at rates not seen in decades. These increases have real effects on prices, which has resulted in new challenges and financial reporting considerations for entities. Volatile markets and customer demands make predicting future cash flows difficult and rising costs could reduce profit margins. In addition, supply chains continue to experience pressure as key suppliers experience significant backlogs due to the lingering effects of COVID-19, labor shortages, increases in delivery costs, government regulation and geopolitical issues like Russia's war in Ukraine, as well as tension between the U.S. and China. With all this going on, it is important that entities carefully evaluate the accounting and reporting implications of all the issues and challenges of the current environment.

Inflation impacts an entity's business overall as well as specific assets, liabilities, revenues and expenses. Many of the challenges arising from the implications of inflation manifest in accounting estimates, although there are also implications on other aspects of financial reporting. When preparing the entity's financial information, management should evaluate whether the forecasts and assumptions used in developing accounting estimates or other assumptions are consistent with forecasts used for business planning purposes.

Some matters for management and those charged with governance to consider include the following:

- How has the entity planned for and adapted to the various implications of an inflationary environment?
- How has increasing inflation, interest rates and uncertainty and subjectivity resulting from volatile markets (including foreign exchange, commodities and debt and equity capital markets) impacted the entity's risk factors, critical accounting policies and critical accounting estimates?
- Has the entity revisited its policies and procedures for preventing or detecting fraud due to the increased uncertainties in this economic environment, including the increasing complexity in models used for accounting estimates (e.g., estimating credit losses)? How is management and those charged with governance responding to heightened fraud risks and risks of management bias?
- Has the entity considered the indirect impacts of changes to inflation through increased or changing interest rates, foreign currency rates or market prices that impact discount rates and other aspects of fair values, such as the indirect impacts of other macroeconomic variables (such as expected GDP growth, housing price inflation and levels of unemployment), shifting customer behaviors and changes in product pricing more broadly? For example, has the entity considered how current macroeconomic factors may impact costs, such as inventory and freight costs, as well as employee compensation, and determined whether any increased costs will be able to be offset with pricing

adjustments? If an entity cannot procure the resources needed to produce and deliver goods and services, they may experience a significant decline in revenues, all of which should be factored into the entity's financial forecasts and cash flow projections.

Measurement of assets and liabilities

- In the past 12 months inflation in the U.S. hit rates not seen in over 40 years.
- Revolving credit in the U.S., which includes credit card borrowings, home equity lines of credit and personal and small business loans, increased significantly over the past year. With rising inflation, revolving credit could be a significant problem for consumers as their cost of borrowing increases. This problem will be compounded if unemployment rates begin to increase.
- The Federal Open Markets Committee has tried to tame inflation by hiking interest rates. As a result, we've seen the overnight borrowing rate, which is the interest rate that banks and other depository institutions lend money to each other, go from nearly 0% to over 4% in less than 12 months.
- Equity markets have experienced significant volatility in the past year. The S&P 500 declined almost 20% from where it was a year ago. Meanwhile the tech heavy Nasdaq composite ended the year more than 30% lower from where it started the year.

Note: the stats reported above are as of December 30, 2022.

In the current volatile environment, management should consider all significant inputs into models, where the model is either used to determine the fair value of an asset or a liability to be recognized or for impairment testing purposes. Some important considerations related to the inputs into models include (but are not limited to):

- An expectation that the risk-free rate that is often used as the discount rate in valuation models (or as the starting point for building yield curves) is correlated to the increases in the Federal Reserve Rate, which has significantly increased from what has been seen in recent years. This could have a significant impact on the valuation of both assets and liabilities.
- For debt instruments, the expectation that higher interest rates will result in significant decreases in the fair value of investments in fixed rate debt securities while the fair value of floating rate obligations increases. These changes could result in the need to restructure debt arrangements or could impact the ratios used in debt covenants, both of which could signify possible financial distress, resulting in further knock-on effects that need to be considered.
- Considering the impact of fluctuating rates in the global economy on other inputs into valuation models used, such as growth rates, consequential price increases to various inputs and movements in exchange rates (for example, the significant increase in the strength of the U.S. dollar against many other currencies including the British pound, Euro and Japanese yen).
- Considering whether there is a need for additional experts or specialists. For example, because of the volatility of interest rates or foreign exchange rates, an entity may enter into more complex hedging arrangements to protect against the market volatility for which specialists may be needed to determine the fair value and accounting treatment.
- Considering, when reassessing valuation models used in the current environment, whether additional inputs may be significant that may not have been considered significant previously because the inputs were determined in a more stable and predictable global economy. Management should challenge whether all factors reasonably expected to have an impact on the entity's operating expenses have been considered, such as increases in compensation, energy or other input costs.

Management should also challenge whether growth rate assumptions appropriately reflect current economic conditions.

- Remaining alert, where carrying values are reported at fair value, to thinly traded markets and considering the reliability of the price information from those markets, including whether the valuation moves from a level 2 valuation to a level 3 valuation within the fair value hierarchy in Accounting Standards Codification (ASC) 820, *Fair Value Measurement*. In addition, management should challenge whether previous valuation methods are still appropriate in the current environment. The calibration of unobservable inputs may also be necessary to explain the impact of market conditions on fair value estimates.
- The importance of adequate disclosures about valuation methods/model and assumptions used cannot be overemphasized. In addition, consideration should be given to ASC 275, *Risks and Uncertainties*, that requires disclosure in financial statements about risks and uncertainties existing as of the date of the financial statements that could significantly affect the reported amounts in the near term.

Going concern

ASC 205-40, *Presentation–Going Concern*, requires an entity to evaluate, at each annual and interim reporting period, whether there is substantial doubt about its ability to continue as a going concern. Substantial doubt exists if it is probable that the entity will be unable to meet obligations as they become due within one year after the financial statements are issued[1] (or available to be issued[2] when applicable). Disclosure of substantial doubt is required even if it is mitigated by management's plans.

The impact of inflation on management's going concern assessment will be different for every entity. For some entities, inflation may significantly impact its revenues and costs, while for other entities it may have a minimal impact. Some matters for management and those charged with governance to keep in mind in the current environment when considering the requirements of ASC 205-40 include:

- Whether the entity has considered all relevant known and reasonably knowable quantitative and qualitative information about its ability to meet its obligations within one year of the date the financial statements are issued or available to be issued (see ASC 205-40-50-5).
- Whether the assumptions and projections used in the going concern calculations are:
  - Consistent with market-related rates and prices used when determining the values or recoverability of assets and liabilities that have been recognized (or disclosed) for the corresponding time period.
  - Up to date as the economic environment continues to evolve.
- Consideration of the reasonableness of estimated cost increases included in management's going concern assessment where the estimates are based on variable market based or related rates and prices (in particular, those that may impact the entity's liquidity).

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[1] Financial statements are considered issued when they are widely distributed to shareholders and other financial statement users for general use and reliance in a form and format that complies with GAAP (U.S. Securities and Exchange Commission registrants also are required to consider the guidance in ASC 855-10-S99-2.).

[2] Financial statements are considered available to be issued when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained, for example, from management, the board of directors, and/or significant shareholders. The process involved in creating and distributing the financial statements will vary depending on an entity's management and corporate governance structure as well as statutory and regulatory requirements.

- Consideration of the impact on cash flows of any breaches (or possible breaches) of debt covenants, if applicable, in the next 12 months, including the impact of increases in interest rates on variable rate debt interest expense.
- Assessment of the recoverability of assets that are predicted to generate cash inflows in management's going concern assessment, where such assets are linked to interest rates and foreign exchange rates, and the impact of possible changes in these rates on the predicted cash flows, including their timing.
- Where applicable, the sufficiency and feasibility of management's plans to mitigate substantial doubt about the entity's ability to continue as a going concern.
- The importance of adequate and complete disclosures, including related controls over their development.

Foreign currency matters

Inflation generally affects interest rates, which in turn impacts foreign exchange rates. ASC 830, *Foreign Currency Matters*, discusses the accounting for foreign currency transactions. In addition to monitoring the inflationary status of countries in which entities have operations, there are a few foreign-currency–related accounting considerations that entities should keep in mind.

Use of exchange rates

Generally, revenue and expense items attributed to foreign-currency transactions are recognized (or translated) using the exchange rate in effect at the date the item was recognized. However, ASC 830 allows entities to use an appropriately weighted average exchange rate for a reporting period because measuring (or translating) all revenue and expense items using the exchange rate on the date they are recognized would be impractical. Whenever there is a sudden and significant change in foreign-currency exchange rates, that weighted average may be affected.

Intercompany foreign-currency transactions of a long-term investment nature

Gains and losses related to an intercompany foreign-currency transaction of a 'long-term investment nature' are reported in other comprehensive income (OCI) rather than through income when the entities to the transaction are consolidated, combined or accounted for by the equity method in the reporting entity's financial statements. That is because intercompany foreign-currency transactions that are of a long-term investment nature are considered to be part of the net investment. More specifically, they are intercompany accounts, such as advances and demand notes, for which settlement is not planned or anticipated in the foreseeable future. Intention alone is not sufficient to overcome a presumption of planned or anticipated settlement; the existence of a compelling business purpose for maintaining an intercompany account that is of a long-term nature, and the ability to control whether repayment will be made, also should be considered. The Russia/Ukraine war, global inflation, supply chain challenges and other geopolitical issues may cause entities that have characterized intercompany transactions with entities in countries impacted by these factors to revisit their assertions and long-term plans for such intercompany transactions to determine whether those transactions still qualify for the subsequent measurement exception in ASC 830.

Highly inflationary economies

Entities are responsible for monitoring inflation statistics in countries in which they have operations to determine the inflationary status of those countries. Under ASC 830, the determination of a highly inflationary economy begins by calculating the cumulative inflation rate for the three-year period that precedes the beginning of the reporting period, including interim reporting periods. If that calculation results in a cumulative inflation rate in excess of 100%, the economy should be considered highly inflationary in all instances (as described in ASC 830-10-55-24, Case A). If the economy is considered

highly inflationary, the entity should reassess its functional currency as of the beginning of the reporting period.

In an effort to facilitate greater consistency, the Center for Audit Quality International Practices Task Force (IPTF) developed a framework for compiling inflation data to assist entities with this determination. The information is intended to be helpful to entities when applying ASC 830 in conjunction with its internal controls over financial reporting, to reach a conclusion on whether a country's economy should be considered highly inflationary.

Revenue and inventory

Increases in oil and gas prices, supply chain disruptions for certain raw materials and component parts, and higher employment costs are impacting the inputs to many entities' products and services, and as a result, forecasted revenues may be affected. Management should consider the following:

- Will the entity pass along the increased costs of production to its customers in the form of price increases? Does the entity have the ability to do so?
- If an entity is unable to pass along higher costs to customers, the carrying amount of the inventory may not be recoverable. As a result, the entity may be required to assess the realizable value of inventory under ASC 330*, Inventory*.
- Whether general price increases and higher borrowing costs increased the likelihood of customer default on bills. As discussed below, matters related to collectibility may not only impact whether a contract passes Step 1 under the 5-step model in ASC 606, *Revenue from Contracts with Customers*, but also the assessment of credit impairment after a receivable is recognized under ASC 606.

Collectibility

The current economic environment could impact collectibility and affect whether a contract passes Step 1 under the 5-step model in ASC 606*.* An entity must conclude that collection of substantially all of the amount to which it will be entitled in exchange for the goods or services that will be transferred to the customer is probable (i.e., likely to occur) in order to conclude a contract with a customer exists under ASC 606. It's important to remember that the evaluation is done on a contract-by-contract basis. As a result, the assessment of collectibility on new contracts, including new purchase orders under existing master service agreements that do not meet the definition of a contract on their own, could differ from the assessment for a prior contract entered into by the same customer. Further, an evaluation of collectibility is also required for existing contracts that previously were determined to meet the collectibility criterion if there is a significant change in facts and circumstances.

An example of a significant change in circumstances related to whether collectibility continues to be probable is a significant deterioration in a customer's credit risk and ability to access credit due to the loss of major customers. If this criterion is not met at contract inception or upon re-evaluation due to a significant change in facts and circumstances, the entity should reassess the criteria in subsequent reporting periods (as necessary) to determine whether all of the criteria subsequently are met. Until this criterion (among others) is met, an entity must defer revenue (or stop recognizing future revenue in the case of a re-evaluation) until one of the three events noted in ASC 606-10-25-7 occurs. While under typical circumstances an entity would meet this criterion when entering into a revenue contract and would not be required to re-evaluate this criterion for ongoing contracts, in the current environment heightened scrutiny should be placed on this evaluation.

Spotlight

After a receivable is recognized in conjunction with the accounting for a contract in accordance with ASC 606, the subsequent accounting for that receivable is based on the guidance in ASC 310,

Receivables, or ASC 326, *Financial Instruments—Credit Losses* (for those entities that have already adopted the new credit losses accounting standard). Any impairment or credit losses recognized in accordance with ASC 310 or ASC 326-20 are presented as an expense and not a reduction of revenue.

Modifications

An entity that amends an existing contract with a customer (e.g., to effectuate a change in price or volume) must also follow ASC 606 to determine the appropriate accounting for the modification. An entity that waives a penalty fee for cancellation or reduction in volume of an existing contract because the customer agrees to enter a subsequent contract should consider whether that forgiveness represents a write-off of a bad debt on the first contract versus a price concession on the second contract (which could cause the second contract to be considered a modification of the first contract).

Variable consideration

An entity must account for variable consideration in customer contracts (such as variability due to a consumer price index or other inflation adjustment) according to ASC 606, which requires that estimated variable consideration be reassessed each reporting period until the underlying uncertainty is resolved. An estimate of the variable consideration to which an entity expects to be entitled should be included in the transaction price (and ultimately recognized as revenue) to the extent it is probable that its inclusion will not result in a significant reversal of cumulative revenue recognized when the uncertainty giving rise to the variability is resolved. An entity's previous estimates of variable consideration may significantly change in the current environment. For example, there may be more product returns and resulting refunds than originally anticipated, the criteria for earning certain performance bonuses may no longer be likely to be met, or there may be unanticipated penalties incurred that would warrant a reduction to previously recognized revenue and may impact future revenue recognition.

Investments

Inflation, rising interest rates and other macroeconomic factors may cause an entity to reconsider its investment strategy, including the type of securities it invests in. If an entity with held-to-maturity (HTM) debt securities can no longer hold the securities until maturity, the securities can no longer be classified as HTM. The sale or transfer of an HTM security may taint an entity's assertion to hold its remaining HTM securities until maturity, so any tainting must also be considered. Entities also must continue to record impairments and credit losses on their investments as appropriate under ASC 320, *Investments—Debt Securities*, and ASC 326, as applicable.

Many entities have elected the measurement alternative under ASC 321, *Investments – Equity Securities*, to revalue investments in equity securities that don't have readily determinable fair values. Any security for which this election has been made is remeasured to its fair value when the reporting entity identifies an observable price change in an orderly transaction for the identical or similar investment of the same issuer.

At each reporting period, any security for which the measurement alternative has been elected (and that continues to qualify for the election) is evaluated for impairment under the one-step impairment model outlined in ASC 321-10-35-3. Under this model, if a qualitative analysis indicates impairment exists, the fair value of the security will need to be estimated, and any excess of its carrying value over its fair value will be recognized in net income. No consideration is given to whether the impairment is permanent or temporary. Impairment indicators to consider include, but are not limited to, the following:

- A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee

- A significant adverse change in the regulatory, economic, or technological environment of the investee
- A significant adverse change in the general market condition of either the geographical area or the industry in which the investee operates
- A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the carrying amount of that investment
- Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

Goodwill

Steps to take before evaluating goodwill for impairment

Before evaluating goodwill at the reporting unit level for impairment under ASC 350, *Intangibles – Goodwill and Other*, an entity should first consider the other assets included in that reporting unit and whether there are impairments that may need to be recognized. In general, the following steps should be followed:

- Step 1 – Evaluate assets outside the scope of ASC 360-10, *Property, Plant, and Equipment*, to determine whether the carrying amounts need to be adjusted. Such assets include, but are not limited to, inventory (ASC 330), loans and receivables (ASC 310), investments in debt and equity securities (ASC 320 and ASC 321, respectively) and indefinite-lived intangible assets (other than goodwill) (ASC 350).
- Step 2 – Evaluate long-lived assets, such as property, plant and equipment, leasing right-of-use assets (ASC 842, *Leases*) and finite-lived-intangible assets for impairment under ASC 360-10.
- Step 3 – Evaluate goodwill for impairment by comparing the adjusted book value of the reporting unit (to the extent impairments of other assets were recognized from the first two steps) to the fair value of the reporting unit to determine whether an impairment should be recognized.

Other considerations when evaluating goodwill and other intangible assets for impairment

- The existence of year-end impairment triggers even if goodwill and other intangible assets were assessed for impairment as of an interim date (e.g., September 30).
- The period of time that has passed since the entity last performed a quantitative test.
- The amount of headroom (i.e., the cushion of fair value over carrying value) that existed at the time the entity last performed a quantitative test.
- Rising inflation and interest rate levels along with the potential for a recession in the U.S. and in other major economies.

Spotlight

Entities that have relied on a qualitative impairment test in recent years may need to perform a quantitative test in the current environment because it may be difficult to qualitatively conclude that it's more likely than not that the fair value of the reporting unit exceeds its carrying value.

Scenarios that might call for a quantitative test this year end include:

- Recent acquisitions, especially if they are their own reporting unit, and
- Assets for which impairments were recognized earlier in the year when valuations were higher or for which the last quantitative test resulted in little headroom.

Management needs to keep in mind that even if businesses (or assets) are performing as expected when acquired (or the last time that the impairment test was performed), current macroeconomic factors, or the increased discount rate alone, could mean that an impairment exists.

Income taxes

Recoverability of deferred tax assets

Entities should reconsider their assumptions regarding whether any recognized deferred tax assets are recoverable. Determining whether a valuation allowance for deferred tax assets is necessary often requires an extensive analysis of positive and negative evidence regarding realization of the deferred tax assets and, inherent in that, an assessment of the likelihood of sufficient future taxable income. The amount of weight given to the evidence considered should be tied to the extent to which it can be objectively verified. For example, estimates of future income are inherently more subjective than objective evidence, such as that of cumulative losses. As a result, a cumulative loss in recent years is a significant piece of objective negative evidence that is difficult to overcome with projections of future taxable income. Further, assessing the likelihood of sufficient future taxable income is inherently judgmental and is even more complex given the current economic conditions. Entities should consider the impact of the current economic environment when making their projections and ensure that similar projections are also used in other areas, such as the entity's going concern analysis and goodwill impairment assessment. These projections should include any entity specific impacts related to the economy, including but not limited to inflation, rising interest rates and any supply chain challenges.

Indefinite reinvestment of earnings from foreign subsidiaries

Entities should consider the impact of current economic and geopolitical conditions (e.g., inflation, US-China trade war and shift of foreign production out of China, etc.) on their intent and ability to indefinitely reinvest earnings from foreign subsidiaries. The "indefinite reinvestment" assertion, when supported, provides an exception to the basic ASC 740, *Income Taxes*, rules and permits entities not to record a deferred tax liability on the excess of the book basis over the tax basis of such investments in foreign subsidiaries, which generally represents the undistributed earnings of such subsidiaries.

Current circumstances may require an entity to transfer working capital from one jurisdiction (domestic or foreign) to another, which may impact its ability to continue to assert that it will indefinitely reinvest earnings in one or more foreign subsidiaries. As a result, an entity should project its cash flows and other investment needs in those foreign jurisdictions as part of its overall forecasts, and ensure that it has adequate support for continuing to assert its intent and ability to indefinitely reinvest those earnings. If the entity concludes that it cannot support the indefinite reinvestment assertion, and thus expects undistributed earnings of one or more foreign subsidiaries to be remitted to the parent in the near (or foreseeable) future, the entity must record a deferred tax liability on the portion of the earnings that it expects to remit in the period in which the entity reaches that conclusion.

Interest expense deductions

The Tax Cuts and Jobs Act in 2017 limited the deductibility of interest expense for years beginning after December 31, 2017; however, the impact of these limits was not as broad due to the very low interest rates at the time. Rising interest rates, and the related increases in interest expense, may limit interest deductions for many entities for the first time, and for other entities may result in larger amounts being

limited. These factors should be considered in an entity's current year income tax provision analysis, as well as the impact of the realization of future deduction carryforwards, as applicable.

Leases

Lease accounting may also be impacted by the current economic environment:

- Increasing interest rates impact the incremental borrowing cost of the lessee, which is an integral factor in the measurement of the lease liability under ASC 842. Higher interest rates result in lower lease liability balances being recognized by lessees.
- Inflation has the potential to impact lease accounting in a number of ways. For example, a lease for a store in a shopping center might include a provision for rental amounts based on sales. As prices increase, the stores revenue may be impacted which, in turn, would lead to changes in the amounts owed under these variable lease payment provisions. Additionally, inflation (combined with other factors in these challenging times) might lead to lease modifications. Refer to our guide, *A guide to lessee accounting under ASC 842*, for additional guidance on accounting for lease modifications.

Hedge accounting

Given the current interest rate environment and the anticipation of further rate increases, some entities have already renegotiated their interest rate swap contracts, while others plan to do so. When an interest rate swap that was designated as a hedging instrument is modified, the reporting entity needs to document a new hedging relationship involving the modified swap contract to be allowed to use hedge accounting. Reporting entities will also need to carefully consider whether the modified swap meets the definition of a derivative in its entirety or is a hybrid instrument that contains an embedded interest rate swap requiring bifurcation and separate accounting. In addition, if after being modified, the interest rate swap meets the definition of a derivative in its entirety, it will have a fair value of other than zero that entities will need to consider in their ongoing hedge effectiveness tests.

The current interest rate environment has also resulted in many debt arrangements being restructured and may result in further restructurings in the future. If the interest payments related to the debt prior to restructuring were designated as forecasted hedged transactions in a cash flow hedge, depending upon how the hedging relationship was documented, those forecasted transactions (i.e., the projected interest payments) may be deemed probable of not occurring after the restructuring. Such circumstances result in the termination of hedge accounting, and any related amounts reported in accumulated other comprehensive income would be reclassed to earnings.

Certain debt arrangements require the debtor to obtain an interest rate cap, which requires the counterparty to the cap (in exchange for a premium) to make payments to the debtor if interest rates exceed a certain level. This reduces the debtor's cost of funds and mitigates the risk that the debtor will default on its obligations in a rising interest rate environment. The debtor may wish to reduce the cost of the cap by selling an interest rate floor for a premium. The combination of the interest rate cap and floor are commonly referred to as an interest rate collar. A debtor may wish to designate the interest rate collar as a hedging instrument in a cash flow hedge. However, because interest rate caps and floors are option contracts, the entity must follow the accounting guidance in ASC 815-20-25-87 to 25-99 (in ASC 815, *Derivatives and Hedging*) on hedging with options and combination of options, which makes achieving hedge accounting more challenging.

Share-based compensation

Performance conditions and forfeitures

Share-based payment arrangements may include performance targets tied to an entity's operations (e.g., customer sales, revenues, annual earnings before interest, taxes, depreciation and amortization). Under ASC 718, *Compensation—Stock Compensation*, entities are required to assess the outcome of the performance condition and update that assessment each reporting period. Compensation cost is recorded only if it is probable the performance condition will be achieved. Probable, as used in this assessment, means an event is likely to occur. The inflationary market may have resulted in a change to this probability assessment. Entities will need to carefully assess whether performance conditions are still probable of being achieved and adjust compensation cost accordingly. If performance conditions are no longer probable of being met, reversal of all or a portion of compensation cost related to unvested awards may be appropriate. Similar accounting would also result for an award with service conditions if an entity has elected to estimate forfeitures and is now expecting layoffs or restructurings resulting in forfeitures of unvested awards.

Modifications

As a consequence of inflation and its related impact on the market, entities may also be considering changing the terms of share-based payment arrangements to allow for continued vesting in awards with performance conditions or to lower the exercise price for out-of-the-money options. Any amendments that impact the vesting, value or classification of share-based payment awards must be accounted for as modifications and could result in changes in the amount of compensation cost to be recognized.

Measurement

Rising interest rates and market volatility may also impact the valuation of share-based payment awards. For example, changes in the risk-free rate, current share price, and expected volatility of the underlying share price as a result of inflation and other market pressures will impact the determination of fair value for stock options or similar instruments.

Pension and OPEB obligations

Rising interest rates may affect the measurement of pension and other postemployment benefit obligations (OPEB) obligations. An assumed discount rate is used to calculate the actuarial present value of accumulated, projected and vested benefit obligations. The discount rate used should reflect the rate at which the benefits could be settled currently and should be re-evaluated at each measurement date, especially in periods of changing interest rates.

Accounting for pension and OPEB obligations in a changing rate environment can be challenging. Increasing interest rates generally result in a decrease in the recognition of obligations under such arrangements. However, increasing interest rates also decrease the values of investments in fixed income securities, and that coupled with depressed equity valuations, including lowered expected growth rates, adversely impact the expected returns on investments, which generally increase an entity's projected pension obligations.

For postemployment benefit plans that provide health care benefits, assumptions about medical costs that will be paid by the plan in the future are key to the estimate of the obligation. As a result, higher inflation increases the expected annual rate of change in the cost of benefits currently provided by the plan, which in turn may result in an increase of the projected benefit obligation.

Disclosures

Public entity reporting considerations

Additional disclosures in management's discussion and analysis (MD&A) and other sections of an entity's SEC filings may be necessary to describe changes in the entity's operations that are materially affected by current macroeconomic conditions or events, including the following:

- Risk disclosures – A registrant is required to disclose in its quarterly report on Form 10-Q any material new risks or changes in risk factors previously disclosed in its annual report on Form 10-K. In its next quarterly (or annual) report, a registrant should consider whether there have been material changes in its previously disclosed risk factors or whether the entity is exposed to any new risk factors. These disclosures should be tailored to the registrant's facts and circumstances, including discussing specific effects on its operations, liquidity and financial condition. In addition, disclosures required under Item 305 of Regulation S-K[3] may be necessary to help users of the financial statements understand material changes in market risk exposures that affect the quantitative and qualitative disclosures presented as of the end of the preceding fiscal year.
- Known trends or uncertainties – A registrant is required to provide forward-looking information about known trends and uncertainties that have had, or are reasonably likely to have, a material effect on the registrant's revenues or income from continuing operations, liquidity or capital resources.[4] The effects of declines in market prices or foreign-currency exchange rates should be clearly disclosed in MD&A. Further, if the registrant cannot determine whether a material trend or uncertainty is reasonably likely to occur, it must assume that the uncertainty will occur and disclose that item in MD&A. Examples may include unusual or infrequent events such as effects from natural disasters, continuing effects of COVID-19, or ongoing staff shortages that may affect income from continuing operations.
- Critical accounting estimates - Registrants should consider whether additional quantitative and qualitative information is appropriate to describe uncertainty associated with fair value estimates. The SEC staff recently commented that this should include disclosures about why the estimate is critical in addition to enhanced disclosure about the potential effects that the current macroeconomic environment has had or is reasonably likely to have on an entity's financial condition.
- Non-GAAP reporting – The current macroeconomic environment may have entities determining whether non-GAAP measures would be useful to their investors. The SEC recently updated its Compliance and Disclosure Interpretation on Non-GAAP Financial Measures. Entities should review their non-GAAP reporting to ensure it is not affected by the updates. For example, when evaluating non-GAAP adjustments, the updated guidance clarifies that "occasional" expenses that occur irregularly may constitute recurring expenses. Restructuring, which may be prevalent in the current macroeconomic environment, is generally viewed as an appropriate non-GAAP adjustment, though entities should exercise judgment depending on their facts and circumstances.
- Segment Reporting – Entities should assess whether the current macroeconomic conditions have caused a change in the entity's operations, future financial projections, or how information is regularly provided and reviewed by the entity's chief operating decision maker (CODM). These changes could affect the identification of operating segments, aggregation of operating segments, or required disclosures within reported segments as required by ASC 280, *Segment Reporting*.

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[3] Smaller reporting entities are not required to provide the disclosures specified in Item 305 of Regulation S-K. However, if a smaller reporting company chooses to voluntarily provide this information, it must comply with all of the disclosure requirements of Item 305.

[4] Item 303 of Regulation S-K.

- Given the 40-year high inflationary pressures currently being experienced in the U.S., SEC staff are reminding registrants about ASC 255, *Changing Prices,* which provides guidance for making voluntary disclosures about the effects of changing prices (or inflation) on an entity's financial statements. Although the SEC may not be able to force registrants to provide the voluntary disclosures under ASC 255, there are other reporting and disclosure requirements that public companies need to comply with that the SEC can challenge. Given the lingering inflation and possibility that interest rates may continue to rise, entities need to continuously evaluate the impact of these factors on their business and financial reporting and provide disclosures on the impact.

Other reporting considerations

- Entities should revisit their risks and uncertainties disclosures under ASC 275 about matters existing as of the date of the financial statements that could significantly affect the reported amounts in the near term. For example, entities whose operations are affected by the current economic environment may be required to disclose certain significant estimates and concentrations (such as concentration of business volume with a particular customer or supplier or in a market or geographic area) that make an entity vulnerable to the risk of a near-term severe impact. These disclosures may be necessary for entities directly or indirectly affected by the current economic environment. Any lingering supply chain disruptions may also warrant disclosure.
- Subsequent events that require either recognition or disclosure under ASC 855, *Subsequent Events*, may be more prevalent this year end than they were in the recent past due to the current economic environment. Examples of unrecognized subsequent events that would require disclosure, that are more likely to occur in the current environment, include changes in the fair value of assets or liabilities or foreign exchange rates after the balance sheet date but before the financial statements are issued or available to be issued.
- New risks identified or material processes changed to attempt to alleviate the effects of inflation or rising interest rates, such as entering into transactions to hedge risks such as interest rate or foreign currency movements, may lead to new or different critical accounting policies and estimates that should be disclosed.