No. 2022-12
Updated 31 March 2023

Technical Line

Effects of inflation and rising interest rates on financial reporting

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What you need to know

- Companies need to consider the effects of inflation, rising interest rates and other macroeconomic factors on their accounting and financial reporting. The effects may be direct or indirect, depending on the company and industry.
- This publication has been updated to address recent developments in the banking sector and the potential implications that companies need to consider.
- Management should carefully evaluate the implications for projections and other assumptions used in preparing the financial statements.
- Companies will need to closely monitor developments and assess the implications for their businesses and their internal control over financial reporting.

Overview (updated 31 March 2023)

Companies need to consider the effects of inflation, rising interest rates and other macroeconomic factors on their accounting and financial reporting. This includes determining how inflation and supply chain issues may be affecting cash flow projections used in prospective financial information and what discount rate is used to discount those cash flows. Public companies also need to make sure their risk factor disclosures and management's discussion and analysis (MD&A) are up to date.

The effects may be direct or indirect and may vary by company. Management will need to consider the company's facts and circumstances. Companies should consider any potential effects consistently when preparing their financial statements (e.g., consistently apply assumptions).

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Companies need to consider the implications of recent developments in the global banking sector, including the failures of Silicon Valley Bank and Signature Bank (the second and third largest bank failures in US banking history, respectively), the cash infusion at First Republic Bank and the Swiss government-aided acquisition of Credit Suisse by UBS.

In the US, regulators created a credit facility to backstop eligible depository institutions, guaranteeing their customer deposits. This action was intended to restore confidence in the US banking system, take stress out of the system and minimize the impact on businesses, households, taxpayers and the broader economy.

The credit facility established by the Federal Reserve, called the Bank Term Funding Program (BTFP), is designed to support depository institutions facing heightened liquidity risk due to significant unrealized losses in their portfolios of debt securities. It is intended to assure that these institutions have the ability to cover customer withdrawals without having to sell debt securities at a loss. More specifically, the BTFP offers loans of up to one year to eligible depository institutions that pledge as collateral high-quality securities, such as US Treasuries, US agency securities and US agency mortgage-backed securities.

Meanwhile, many regulators remain concerned about inflation, and central banks are continuing to raise interest rates. For example, the Federal Reserve raised interest rates by 25 basis points to 5% on 22 March 2023 in its ongoing effort to tame inflation in the US, marking the ninth consecutive rate hike since March 2022. The Bank of England's Monetary Policy Committee also raised the Bank Rate by 25 basis points to 4.25% as inflation remains elevated.

This publication, which addresses the implications for accounting and internal control over financial reporting (ICFR), has been updated to discuss considerations related to recent events in the banking sector. Appendix A lists EY publications that discuss these topics in more detail. Appendix B lists potential questions entities should consider.

Key considerations

Current-quarter financial reporting (added 31 March 2023)

For current reporting periods (both interim and year end for non-calendar-year companies), companies will need to determine how they have been impacted by the macroeconomic environment and ongoing market uncertainty and whether changes to their financial reporting and ICFR are required.

A starting point to determine whether changes in financial reporting are required is to evaluate whether an entity's operations have been directly or indirectly affected by the recent market changes and developments.

Reporting entities will need to comprehensively consider whether changes to their disclosures are required, including whether:

- Additional risks need to be disclosed in risk factors
- Changes to MD&A of financial condition and results of operations are required
- Updates to liquidity and capital resource disclosures are needed
- Revisions to disclosures about critical accounting policies are needed
- Material changes in ICFR have occurred that must be disclosed
- Additional disclosures in the reports for the current periods are needed

Financial reporting issues that entities may need to consider include:

- Changes to their estimates of credit losses and changes to the factors they consider in developing reasonable and supportable forecasts for financial assets measured at amortized cost under Accounting Standards Codification (ASC) 326
- Changes to the valuation of assets, including investments and deferred tax assets
- Impairments of held-to-maturity (HTM) investments and available-for-sale (AFS) debt securities
- "Tainting" of an entity's intent and ability to hold the remaining portfolio to maturity upon sales or transfers of HTM securities
- Changes to the fair value measurement of derivatives based on changes to counterparty risk and changes to the value of collateral
- Changes in the assessment of hedge effectiveness or the probability of a forecasted hedged transaction occurring
- Changes in the classification of debt and whether debt covenant violations exist
- Changes in agreements with customers or vendors (e.g., modifications to extend payment terms)
- New financing arrangements or modifications of existing credit agreements
- Changes in the assessment of goodwill impairment

Reporting entities need to consider whether disclosures need to be updated to comply with Regulation S-K.

Reporting entities will need to consider whether their going concern evaluation requires more robust analysis. They also will need to consider whether disclosures need to be updated to comply with Regulation S-K (e.g., MD&A). Certain of these items are discussed in more detail below.

Internal control over financial reporting (added 31 March 2023)

The effects of recent developments in the banking sector on businesses can extend beyond a reporting entity's relationships with financial institutions. A reporting entity's customers and suppliers may also be affected by heightened liquidity risks. Some companies are reconsidering their strategies for managing cash and interest rate risk and making changes to their operations and processes to mitigate bank failure risk.

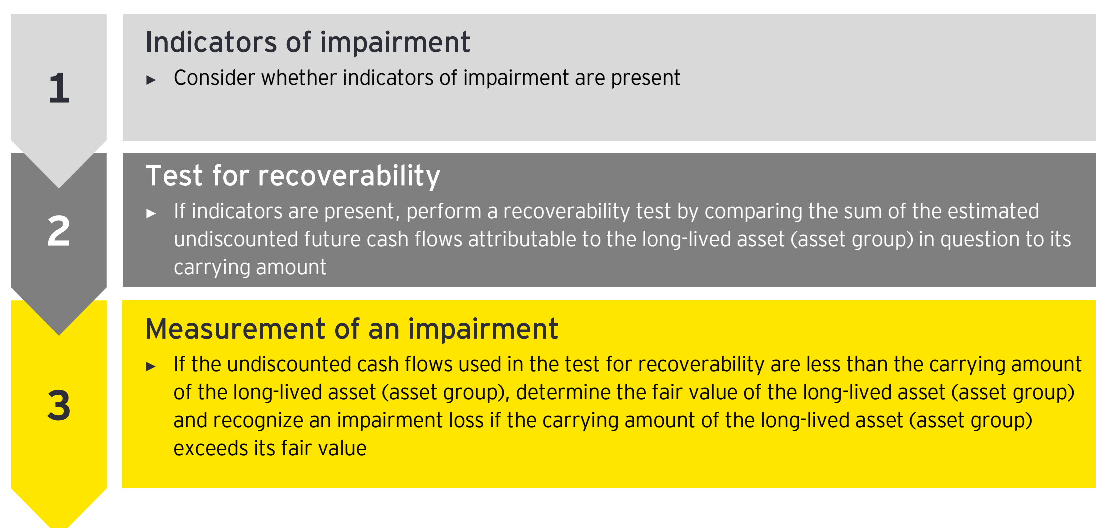
Reporting entities should revisit their ICFR risk assessments, including analyses of any operational changes (e.g., increases in the number of financial institutions in which they have deposits, modifications of governance policies) or other significant changes to processes and procedures. Entities also should consider whether any changes to their ICFR are material and, therefore, are required to be disclosed.

Some entities may need to expend more effort than usual this quarter to assess risks, including risks that may be heightened due to the banking sector developments and macroeconomic events.

Asset impairments

Impairment of long-lived assets to be held and used

The following are the required steps to identify, recognize and measure the impairment of a long-lived asset or an asset group (asset group) to be held and used:



Entities will need to consider the effect of higher interest rates on significant assumptions when determining the fair value of the asset group.

Companies that determine impairment indicators exist will need to consider the effects of inflation on their projections of undiscounted cash flows for the asset group being evaluated for recoverability (Step 2 recoverability test). If an entity is unable to pass rising costs on to customers, this may result in the carrying amount of an asset group not being recoverable (i.e., the carrying amount of the asset group exceeds the estimated undiscounted cash flows).

Entities that determine that the carrying amount is not recoverable are required to determine the fair value of the asset group (Step 3 impairment test). Entities will need to consider the effect of higher interest rates on significant assumptions (e.g., discount rates) used to determine the fair value of the asset group. Higher discount rates could result in a lower fair value of an asset group that may lead entities to recognize impairment losses (i.e., the carrying amount of the long-lived asset or asset group exceeds its fair value).

Refer to our Financial reporting developments (FRD) publication, ***Impairment or disposal of long-lived assets***, for additional information.

Goodwill and other indefinite-lived intangible assets

Goodwill and indefinite-lived intangible assets are tested for impairment at least annually and more frequently if events or changes in circumstances indicate that it is more likely than not that goodwill or the indefinite-lived intangible asset is impaired. Entities will need to consider the effects of inflation on their cash flow projections and the effects of higher interest rates on discount rates, in addition to other market conditions and external factors that could affect fair value.

A company that performs the optional qualitative assessment as part of the annual test under ASC 350, Intangibles — Goodwill and Other, may determine that inflation, higher interest rates, declining share prices and other economic factors make it more likely than not that the fair value of a reporting unit (or an indefinite-lived intangible asset) is less than its carrying amount, thus requiring a quantitative impairment test. These same factors may trigger the requirement for a company to perform an interim impairment analysis for indefinite-lived intangible assets and/or goodwill.

ASC 350 provides examples of events and circumstances that should be considered in performing a qualitative assessment or evaluating whether an interim impairment test is required for both goodwill and indefinite-lived intangible assets. The examples are not meant to be all inclusive, and it is likely that none of these events or circumstances by itself indicates that it is more likely than not that an indefinite-lived intangible asset or goodwill assigned to a reporting unit is impaired. Instead, a company also weighs any positive or mitigating factors and holistically evaluates all events since the most recent quantitative impairment test to determine whether it is more likely than not that the indefinite-lived intangible asset or reporting unit is impaired. More weight should be placed on those events and circumstances that most affect a reporting unit's fair value or the carrying amount of its net assets.

A publicly traded company should also reconcile the fair value of its reporting unit(s) to its stock price and market capitalization to corroborate its fair value estimates. Although this isn't required under US GAAP, the Securities and Exchange Commission (SEC) staff has requested that registrants provide support for the implied control premium (i.e., the additional value that an investor is willing to pay to receive the benefits of control).

Refer to our FRD, ***Intangibles — goodwill and other***, for additional information.

Equity method investments

Entities should consider whether current conditions and the current economic environment, including inflation and rising interest rates, represent changes in circumstances that indicate that the carrying amount of an equity method investment (including investments in joint ventures) might not be recoverable and, therefore, require an impairment analysis. If the equity method investment is impaired (i.e., fair value is less than the carrying amount of the investment), an investor would need to use judgment to determine whether the impairment is other than temporary. If the impairment is other than temporary, an impairment loss would be recognized.

Refer to our FRD, ***Equity method investments and joint ventures***, for additional information.

Inventory

Net realizability

The increases in oil and gas prices and supply chain disruptions for certain raw materials and component parts, which are contributing to inflation, could result in higher costs that may be capitalized into inventory (e.g., costs of raw materials, shipping, fuel, labor). If an entity is unable to pass higher costs on to customers, the carrying amount of the inventory may not be recoverable, and the entity may be required to assess inventory realizability as a result.

Equity securities measured using the measurement alternative

For equity securities measured using the measurement alternative in ASC 321, *Investments — Equity Securities*, entities are required to perform a qualitative impairment assessment at each reporting date. Impairment indicators that an entity considers include:

- Significant deterioration in earnings
- Significant adverse change in the economic environment of the investee
- Significant adverse change in the general market condition of the geographical area or industry in which the investee operates
- Negative cash flows from operations, working capital deficiencies or noncompliance with debt covenants

If the qualitative assessment indicates that the investment is impaired, and the investment's fair value is less than its carrying value, the excess of the carrying value over fair value is recognized as an impairment loss.

Refer to our FRD, ***Certain investments in debt and equity securities***, for additional information.

Financing receivables, contracts assets, available-for-sale debt securities and held-to-maturity debt securities

Allowance for credit losses under ASC 326

Companies will need to consider the current economic conditions in their assessment of the allowance for credit losses under ASC 326, *Financial Instruments — Credit Losses*, for various assets, including loans, trade receivables, contract assets and debt securities that are classified as available for sale and held to maturity. Inflation and rising interest rates may adversely impact the ability of borrowers to repay their debts and, therefore, could trigger impairment losses.

Current economic conditions and uncertainty may cause financial assets previously pooled under ASC 326 to no longer exhibit similar risk characteristics. For these assets, companies need to assess whether the assets continue to display similar risk characteristics or whether they have to revise their pools or perform an individual assessment of expected credit losses. Companies should consider highlighting these risks in their qualitative and quantitative disclosures about credit risk and the allowance for credit losses. They should also consider the disclosures related to the basis of inputs and assumptions and estimation techniques used, and how forward-looking information has been incorporated.

Available-for-sale debt securities (added 31 March 2023)

Whether an entity establishes an allowance for credit losses on an AFS debt security depends on whether it expects to realize the total value of the security by collecting the contractual cash flows rather than by selling the security. Therefore, if an entity intends to sell a debt security (or believes it will more likely than not be required to sell a debt security before it recovers its amortized cost basis), using an allowance to account for credit losses is not appropriate.

In these situations, any existing allowance is written off against the security's amortized cost basis, with any remaining difference between the debt security's amortized cost basis and fair value recognized as an impairment loss in earnings.

Financial assets purchased with credit deterioration

Changes in broad market conditions or the economic outlook may result in the widening of credit spreads, which could be an indicator of a deterioration in credit quality before more objective indicators (e.g., delinquency) are observed.

Companies contemplating or completing acquisitions during periods of inflation and rising interest rates should carefully consider their conclusions on whether the acquired assets are purchased credit deteriorated (PCD) and, if so, should follow the initial recognition and measurement requirements for PCD assets in ASC 326.

Refer to our FRD, ***Credit impairment under ASC 326***, for more information on measuring credit impairment after the adoption of ASC 326. Refer to our To the Point publication, ***FASB eliminates TDR guidance for creditors and requires enhanced vintage disclosures***, for more information on Accounting Standards Update (ASU) 2022-02.

Business combinations

Assets acquired or liabilities assumed in a business combination are generally measured at their acquisition date fair values in accordance with the principles of ASC 820, *Fair Value Measurement*. Fair value means the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Accordingly, fair value is determined considering the perspective of market participants, and therefore, it is not an entity-specific value.

Inflation and rising interest rates may cause volatility in the market and affect significant assumptions used to determine fair value. For example, higher interest rates generally result in higher discount rates, and inflation could affect projected cash flows, all of which may affect the fair value of assets and liabilities.

Additional guidance about accounting for business combinations and measuring fair value is included in our FRD, ***Business combinations***, and our FRD, ***Fair value measurement***, respectively.

Revenue recognition

The effects of the current economic environment may impact various aspects of an entity's revenue recognition under ASC 606, *Revenue from Contracts with Customers.* The following table highlights certain topics that entities may need to consider.

Contract modification	Cost-to-cost measure of progress	Loss contracts
Consider how inflation and rising interest rates may lead to contract modifications or terminations. A contract modification is a change in the scope or price (or both) of a contract. Examples include revising payment terms, providing discounts or introducing variable consideration in a previously fixed-price contract. A contract termination may also be considered a contract modification. Contract modifications may change the timing or amount of revenue recognized for a contract. For example, some modifications are accounted for on a prospective basis and others on a cumulative catch-up basis.	Consider how rising inflation may affect the measure of progress for contracts under which an input method (e.g., costs incurred relative to total expected costs) is applied to measure progress toward completion to recognize revenue over time. For example, increasing total expected costs due to inflation may affect the percentage of completion of a long-term construction contract. Companies will need to monitor their contract costs and timely update their progress in completing the performance obligation.	For contracts subject to the loss contract guidance (e.g., contracts in the scope of ASC 605-35, separately priced extended warranty and product maintenance contracts in the scope of ASC 605-20), consider when losses on onerous contracts should be recognized, and, if a loss needs to be recognized, consider how to measure it in light of the potential for increasing costs.

Refer to our FRD, ***Revenue from contracts with customers (ASC 606)***, for additional information.

Debt covenant violations and debt modifications

The effects of inflation and rising interest rates may lead to liquidity issues for borrowers and debt covenant violations. An increase in interest rates may lead to the need for borrowers to amend the terms of existing debt agreements or obtain waivers if they no longer satisfy debt covenants.

Borrowers need to consider the guidance in ASC 470-50, *Debt — Modifications and Extinguishments*, and ASC 470-60, *Debt — Troubled Debt Restructurings by Debtors*, to determine whether a change to an existing debt arrangement represents a troubled debt

restructuring, a debt modification or a debt extinguishment, each of which would have different accounting implications. In addition, borrowers need to consider the guidance in ASC 470-10 on the classification of debt when there has been a covenant violation or other default at the balance sheet date (or prior to the issuance of financial statements).

Refer to our FRD, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***, or our FRD, ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***, for additional information.

Supplier finance programs

Companies may use supplier finance programs to manage their liquidity and working capital in a rising interest rate environment. A company that uses these programs needs to evaluate whether it can continue to classify payables subject to a supplier finance program as trade payables or whether it has to reclassify them to debt.

After the adoption of ASU 2022-04, *Liabilities — Supplier Finance Programs (Subtopic 405-50): Disclosure of Supplier Finance Program Obligations*, a company that uses supplier finance programs in connection with the purchase of goods and services will need to determine whether its programs are subject to the disclosure requirements in the ASU, including disclosures about the key terms of the programs and information about the company's obligations under these programs, as well as a rollforward of those obligations.

The ASU is effective for all entities for fiscal years beginning after 15 December 2022, including interim periods within those fiscal years, except for the rollforward requirement, which is effective for fiscal years beginning after 15 December 2023. Early adoption is permitted.

Refer to our FRD, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***, our FRD, ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***, and our To the Point publication, ***FASB requires disclosures about supplier finance program obligations***, for additional information.

Derivatives and hedge accounting

Fair value measurement of derivatives

Entities that hold interest rate derivative instruments may experience substantial gains or losses, which could affect collateral requirements and liquidity. In addition, changes in a derivative counterparty's credit risk or an entity's own nonperformance risk could affect fair value estimates of derivatives, as well as hedge effectiveness assessments for interest rate derivatives that are designated as hedging instruments.

Hedge accounting activity

Entities looking to protect themselves from rising interest rates may enter into interest rate derivatives to hedge interest rate risk related to forecasted debt issuances or existing variable-rate debt. Entities that seek to apply hedge accounting for these transactions need to consider the requirements of ASC 815 to support the hedge accounting.

Refer to our FRD, ***Derivatives and hedging (after the adoption of ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities)***, for additional information.

Held-to-maturity debt securities (added 31 March 2023)

Transfer and sales activity

Liquidity issues may lead a company to consider sales or transfers of debt securities from its HTM portfolio.

Transfers from the HTM category should be rare. When a security is transferred from the HTM category to the AFS category, the security's amortized cost basis carries over to the AFS category for the following purposes:

- Subsequent amortization of the historical premium or discount
- Comparisons of fair value and amortized cost for the purpose of determining unrealized holding gains and losses
- Required disclosures of amortized cost

The difference between the security's amortized cost and fair value at the date of transfer should be recognized as an unrealized gain or loss recorded in other comprehensive income (OCI). An entity would also cease accreting any other-than-temporary impairment of the HTM security previously recognized in OCI. Transferring a security out of the HTM category is inconsistent with an expressed intent to hold similar debt securities to maturity and would call into question (i.e., "taint") the entity's assertion that it has the intent and ability to hold the remaining portfolio to maturity. This could necessitate the transfer of all remaining HTM securities to AFS. The FASB originally discussed the idea of permitting entities to sell or transfer a small percentage of securities from the held-to-maturity category without "tainting" the classification of the remaining securities in this category. However, the FASB decided not to allow this because it would contradict the premise underlying the use of amortized cost. That is, management intends to hold each security classified as held to maturity until maturity.

ASC 320-10-25-6(a) through (f) describes a number of circumstances where an entity's change in intent to hold a security to maturity would not call into question its intent to hold other debt securities to maturity currently or in the future.

The SEC staff strictly interprets the requirements in ASC 320 for HTM securities. Any sales or transfers of securities from the HTM portfolio, other than in the limited circumstances described in ASC 320-10-25-6, will lead to a presumption by the SEC staff that the entire portfolio of HTM securities should be reevaluated for reclassification to the AFS or trading portfolios.

Although that presumption may be overcome in rare situations, each additional sale or transfer from the HTM portfolio strengthens the presumption that the entire portfolio should be reclassified.

Disclosures about transfers are required under ASC 320-10-50-9 and 320-10-50-10. In addition to the disclosures of transfers described in ASC 320, transfers involving trading securities may represent a noncash investing activity for purposes of the statement of cash flows. ASC 230 requires disclosure of amounts and information about noncash investing and financing activities.

Refer to our FRD, ***Certain investments in debt and equity securities***, for additional information.

Foreign currency matters

Highly inflationary economies

Given the upward trend in inflation rates globally, entities with foreign operations should monitor inflation rates in the foreign countries where they operate. If a foreign entity's local economy becomes highly inflationary, the entity may need to change its functional currency as of the beginning of the reporting period following the period in which that economy becomes highly inflationary.

Refer to our FRD, ***Foreign currency matters***, for more information.

Asset retirement obligations

Companies may need to consider the effects of inflation and rising interest rates on asset retirement obligations. Rising costs may indicate that expected cash flows underlying the asset retirement obligations have changed materially, which may require companies to make changes to the amount or timing of the expected cash flows required to settle asset retirement obligations that already have been recognized.

Upward revisions to the amount of undiscounted cash flows (incremental cash flows over the initial projection) should be discounted using the credit-adjusted risk-free rate in effect at the time of change in estimate.

Refer to our FRD, ***Asset retirement obligations***, for additional information.

Entities with foreign operations should monitor inflation rates in the foreign countries where they operate.

Income taxes

The effects of inflation and rising interest rates may impact a company's income tax accounting in several ways, including with respect to the indefinite reinvestment assertion, tax deductible interest expense and judgments made about the realizability of deferred tax assets.

Our FRD, ***Income taxes***, provides further discussion on the topics highlighted below.

Indefinite reinvestment

Companies that assert their intent and ability to indefinitely reinvest foreign earnings should challenge whether they can continue doing so in their operations that have been affected by inflation and rising interest rates.

The assertion that earnings from foreign operations will be indefinitely reinvested should be supported by projected working capital and long-term capital needs in the locations in which those earnings are generated (or other foreign locations) and by an analysis of why those funds are not needed upstream.

Tax deductible interest expense

Rising interest rates may increase interest expense for entities in some jurisdictions. This could cause the deductibility of interest expense to be either limited for the first time or limited further. The expectation of higher interest costs in the future may result in changes to realizability assessments of existing interest deduction carryforwards.

Realizability of deferred tax assets

Companies may need to challenge their conclusions about the realizability of their existing deferred tax assets and deferred tax assets that are being created due to the current economic conditions. Future realization of deferred tax assets ultimately depends on the existence of sufficient taxable income of the appropriate character in either the carryback or carryforward period under the tax law. Determining whether a valuation allowance for deferred tax assets is necessary often requires an extensive analysis of positive and negative evidence regarding the realization of the deferred tax assets, including an assessment of the likelihood of sufficient future taxable income.

Many companies have seen a decline in the value of their equity and debt securities that may generate unrealized losses and result in new or increasing deferred tax assets. Companies should evaluate whether a valuation allowance is necessary for the deferred tax assets and the effect to the estimated annual effective tax rate, if it is recorded in an interim period.

Projections of future taxable income to support the realizability of deferred tax assets should be consistent with projections used for other purposes (e.g., long-lived asset impairment tests, interim goodwill impairment tests) and should reflect the direct and indirect effects of the current economic environment, including rising interest rates, higher inflation and the decline in the value of securities.

Companies that change their assertion about indefinite reinvestment or change their valuation allowance during an interim period should consider ASC 740-270 for guidance on whether to include the effects of the change in the estimated annual effective tax rate or recognize the effects as a discrete item in the interim period.

Leases

Rising interest rates also affect lease accounting because they increase a lessee's incremental borrowing rate (IBR), which is used to measure the lease liability for new leases, certain lease modifications and when other events require remeasurement. An increase in a lessee's IBR would result in the recognition of a lower lease liability, if all other variables are constant (e.g., lease payments). Since the IBR is entity specific and considers variables included in a lease (e.g., lease term), each lease and lessee may be impacted by rising interest rates differently.

Higher bond yields used to determine discount rates may result in a decrease in postretirement benefit obligations.

Refer to our FRD, ***Lease accounting — Accounting Standards Codification 842, Leases***, or our FRD, ***Lease accounting — Accounting Standards Codification 840, Leases***, for more information.

Share-based payment awards

Award modifications

The significant uncertainty in the current environment may prompt companies to amend the terms or conditions of share-based payment awards to keep employees incentivized. If such amendments change an award's fair value, vesting conditions or classification, the company has to apply modification accounting. When calculating the compensation cost to recognize for a modification, a company generally has to determine on the date of the modification whether, based on current circumstances, it is probable that the awards would vest under either the original vesting conditions or the new vesting conditions, or both.

Modifying share-based payments can have tax consequences; therefore, companies should consult with their tax advisers before doing so.

Forfeitures

Forfeitures generally result from the failure to satisfy service or performance conditions. Entities that estimate forfeitures related to service conditions may need to consider how the economic environment will impact forfeiture activity.

Measurement of share-based awards

Inflation and rising interest rates may affect inputs used to determine the fair of value of share-based payment awards (e.g., risk-free rate, volatility, current share price).

Refer to our FRD, ***Share-based payment***, for more information.

Postretirement benefits

The effects of inflation and rising interest rates may also impact the measurement of postretirement obligations. For example, higher bond yields used to determine discount rates may result in a decrease in postretirement benefit obligations.

For other postretirement benefit plans that provide health care benefits, economic assumptions about future levels of medical costs that will be paid by the plan are critical to the estimate of the obligation. Therefore, inflation would increase the expected annual rate of change in the cost of benefits currently provided by the plan (i.e., the health care cost trend rate), which may result in an increase of the other postemployment benefit obligation.

Refer to our FRD, ***Postretirement benefits***, for more information.

Financial statement disclosures

The financial statement disclosures for companies directly or indirectly affected by the current economic environment will vary depending on the magnitude, duration and nature of the effects on their businesses and the availability of information. Companies will need to closely monitor developments and assess the implications for their financial reporting.

Risks and uncertainties

ASC 275, *Risks and Uncertainties*, requires disclosures about certain risks and uncertainties, including qualitative disclosures about risks and uncertainties that in the near term (i.e., within one year from the date of the financial statements) could significantly affect the amounts reported in the financial statements or the functioning of the reporting entity.

Companies whose operations are affected by the current economic environment may be required under ASC 275 to disclose certain significant estimates and concentrations (e.g., 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 companies directly or indirectly affected by the current economic environment (e.g., a company that has material operating costs sensitive to fuel prices). Potential supply chain disruptions may also warrant disclosure.

SEC reporting and disclosures

Domestic and foreign companies that file with the SEC need to consider a number of SEC reporting and disclosure requirements. Companies should carefully evaluate how economic conditions may affect their business and provide disclosures on the effects in sufficient detail.

In its reviews of filings, the SEC staff has been asking about the effects of macroeconomic factors and that is likely to continue. For example, the staff has requested that registrants discuss whether recent inflationary pressures have materially impacted their operations and identify the types of inflationary pressure they are facing (e.g., price increases in materials, commodities and/or services; impacts on borrowing costs) and how their business has been affected. Further, the staff has asked that registrants identify any actions planned or taken to mitigate inflationary pressure. The SEC staff has also asked registrants to discuss in detail whether inflation has materially affected their outlook or business goals.

Companies also need to make sure their disclosure controls and procedures are operating effectively so they can produce the necessary robust disclosures in a timely manner.

MD&A

Companies are required to disclose any unusual or infrequent events, transactions or significant economic changes that materially affected income from continuing operations (such as lost revenue or costs attributable to current economic environment) in MD&A. They are also required to disclose known trends or uncertainties that have had, or are reasonably expected to have, a material effect on their revenue or income from continuing operations, liquidity or capital resources.[1] Known trends or uncertainties may include supply chain disruptions that affect the relationship of costs to revenues, for example.

Companies may need to consider the effects on their capital resources and liquidity, including situations in which the sources and uses of cash could be materially affected and potentially lead to uncertainty about a company's ability to continue to meet covenants of credit agreements. A company that is having liquidity issues should evaluate the adequacy of its disclosures related to potential capital needs and alternative sources of capital to fund those needs. If a material liquidity deficiency has been identified, disclosures may need to include the course of action the company has taken or proposed to take to remedy the deficiency.

It may also be appropriate for companies to include disclosures related to any heightened uncertainty or changes in key assumptions underlying critical accounting estimates.

Form 8-K

Affected companies should have robust disclosure controls and procedures in place so they can timely disclose material information related to macroeconomic events and identify any triggering events that may warrant the filing of a Form 8-K. For example, a company will need to consider whether the effects of macroeconomic factors, such as inflation or a decline in economic activity, trigger a material impairment charge, which generally would be required to be reported within four business days under Item 2.06 of Form 8-K, unless the conclusion is made in connection with the preparation, review or audit of financial statements required to be included in a timely filing and such disclosure is included in the timely filed report.

Risk factor disclosures

Since companies are required to disclose in each 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, they should consider the need to update their risk factor disclosures to reflect the direct and indirect effects of inflation, rising interest rates and other macroeconomic factors. Accordingly, risk factors that were added or revised in the first quarter would need to be disclosed and updated as appropriate in each subsequent quarterly report if they are still applicable.

Other disclosure considerations

Companies may need to consider adjusting disclosures in other areas of their annual reports and registration statements to reflect the direct and indirect effects of inflation, rising interest rates and other macroeconomic factors, including the description of their business, properties and human capital under Items 101 and 102 of Regulation S-K.

How we see it

Given the persistence of inflation, the expectation that interest rates will continue to rise and the recent developments in the global banking sector, companies need to continuously evaluate the impact on their business and financial reporting and provide disclosures on the impact, if material.

Endnote:

[1] Item 303 of Regulation S-K.

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SCORE No. 17945-221US
(Updated 31 March 2023)

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Appendix A

This appendix provides links to FRDs referenced throughout this Technical Line and other relevant publications. See below for the breakout by section.

Asset impairments

- Financial reporting developments, ***Impairment or disposal of long-lived assets***
- Financial reporting developments, ***Intangibles — Goodwill and other***
- Financial reporting developments, ***Equity method investments and joint ventures***
- Financial reporting developments, ***Certain investments in debt and equity securities***
- Financial reporting developments, ***Credit impairment under ASC 326***
- Financial reporting developments, ***Credit impairment for short-term receivables under ASC 326***
- To the Point, ***FASB eliminates TDR guidance for creditors and requires enhanced vintage disclosures***

Debt covenant violations and debt modifications

- Financial reporting developments, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***
- Financial reporting developments, ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***

Supplier financial programs

- Financial reporting developments, ***Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***
- Financial reporting developments, ***Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***
- To the Point, ***FASB requires disclosures about supplier finance program obligations***

Derivatives and hedge accounting

- Financial reporting developments, ***Derivatives and hedging (after the adoption of ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities)***

Foreign currency matters

- Financial reporting developments, ***Foreign currency matters***

Asset retirement obligations

- Financial reporting developments, ***Asset retirement obligations***

Business combinations

- Financial reporting developments, ***Business combinations***

Revenue recognition

- Financial reporting developments, ***Revenue from contracts with customers (ASC 606)***

Income taxes

- Financial reporting developments, ***Income taxes***

Leases

- Financial reporting developments, ***Lease accounting — Accounting Standards Codification 842, Leases***
- Financial reporting developments, ***Lease accounting — Accounting Standards Codification 840, Leases***

Share-based payment awards

- Financial reporting developments, ***Share-based payment***

Postretirement benefits

- Financial reporting developments, ***Postretirement benefits***

SEC reporting and disclosures

- SEC Financial Reporting Series, ***2022 SEC annual reports — Form 10-K***
- SEC Financial Reporting Series, ***2022 SEC quarterly reports — Form 10-Q***

Appendix B: Questions to consider in connection with current period financial reporting (added 31 March 2023)

The following is a non-exhaustive list of potential questions entities should consider.

Operations

- Have the current macroeconomic conditions led to changes in operations, performance trends or the outlook that affect financial reporting or ICFR?
- Have recent developments in the banking sector affected the entity? What was the response? Does the response affect financial reporting or ICFR?
- Has the entity made any changes to governance this quarter?
- Has the entity established new or expanded relationships with financial institutions, including new depository or lending relationships?
- Have the entity's customers, vendors or suppliers been impacted by the current macroeconomic conditions or banking sector events? Is there a knock-on effect to be considered by the reporting entity?
- Have contractual relationships changed?
- Has the outlook for the entity's ability to continue as a going concern changed, including whether a more robust analysis than usual is required?

ICFR

- Is an update to the entity's ICFR risk assessment required following operational changes?
- Have there been any material changes to ICFR that require reporting?

Accounting issues

- Do credit loss assumptions require updating?
- Do possible impairments of investments, goodwill and other assets exist?
- Have there been sales or transfers of HTM securities that would "taint" the reporting entity's intent and ability to hold the remaining portfolio to maturity?
- Is more robust analysis needed relating to the valuation of assets, including investments and deferred tax assets?
- Have there been any modifications to financing arrangements?
- Do assumptions used in the fair value measurement of derivatives, in particular those relating to changes in counterparty risk or collateral value, need to be updated?
- Is there any change to a hedging instrument and/or hedged item that may require the de-designation of a hedging relationship?
- Are forecasted hedge transactions in cash flow hedges still "probable" of occurring?
- Has there been a covenant violation or other default that may trigger a change in debt classification?

- Have the accounting implications of any contractual and/operational changes been analyzed, and do any effects need to be reported?
- Have there been any modifications to lease and/or revenue arrangements that need to be accounted for?
- Do assumptions related to variable consideration continue to be appropriate?
- Do possible knock-on effects impacting customers or vendors in an entity's supply chain have accounting implications (e.g., credit losses, inventory impairments, ability to fulfill performance obligations)?

Disclosures in the financial statements

- Does the disclosure of risks and uncertainties require updating?
- Do the fair value hierarchy disclosures remain appropriate?
- Do the going concern disclosures require updating?

Other disclosures

- Are the entity's communications outside of the financial statements consistent with the financial statement disclosures and assumptions?
- Have all matters related to current conditions, trends and the outlook been considered?