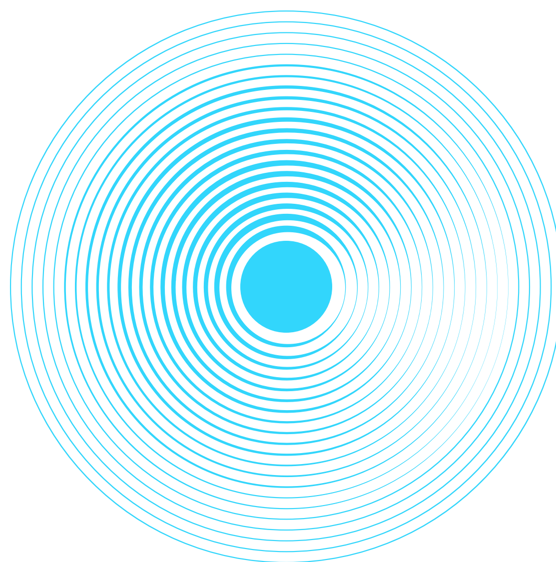
Financial Reporting Alert 22-5
December 1, 2022



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Accounting and Financial Reporting Considerations Related to the Current Macroeconomic and Geopolitical Environment

Introduction

Today's consumers and companies face numerous challenges associated with the current macroeconomic and geopolitical environment. Reports of continuing global supply-chain disruptions and labor shortages dominate the news and are top of mind for many financial executives.

On the basis of Deloitte's recent Q3 2022 *CFO Signals* survey, some of the most common issues affecting CFOs include internal matters, such as employee retention, employee working arrangements, and cost management, as well as external concerns such as inflation, stagflation, and geopolitical tensions.

Certain of these challenges started during the COVID-19 pandemic, which gave rise to new operational and financial difficulties, often with unique accounting and financial reporting implications (see Deloitte's *Financial Reporting Alert*, "Financial Reporting Considerations Related to COVID-19 and an Economic Downturn"). For example, as a result of significant global supply-chain disruptions and labor shortages brought on by the pandemic, many product and employment costs increased (see Figure 1 below). Global central banks have also been raising interest rates in an attempt to temper the impact of historically high inflation rates (see Figure 2 below).

Figure 1: U.S. CPI and Employment Cost Index

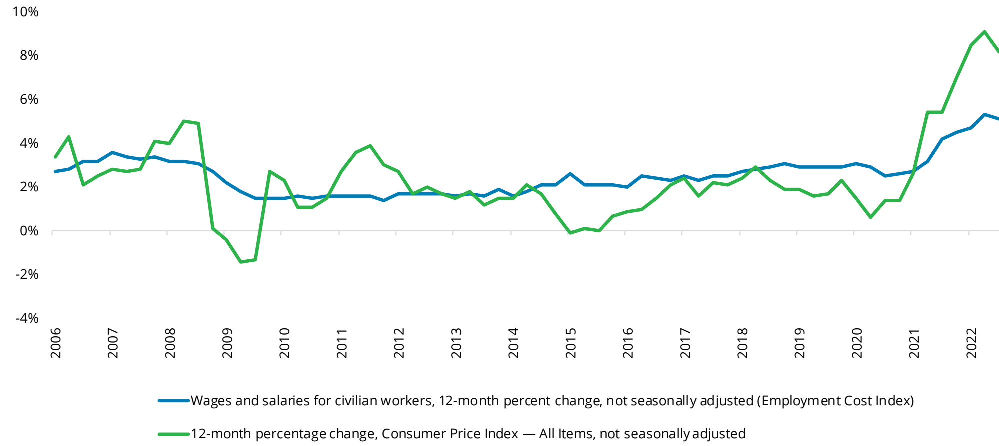
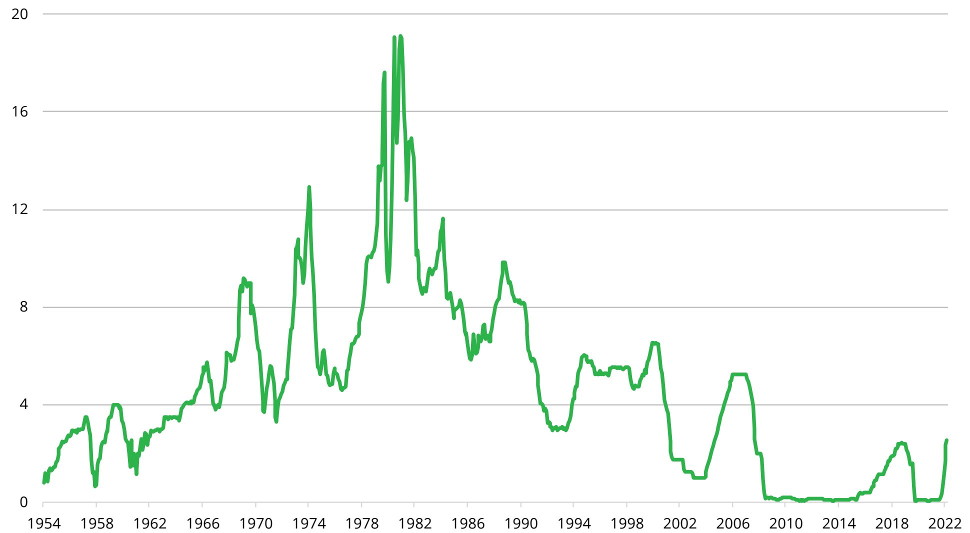


Figure 2: U.S. Federal Funds Effective Rate



Inflation remains high, notwithstanding tightening monetary policies by global central banks. Further, while current unemployment levels have reached historical lows, relative employee productivity has decreased. Many companies also continue to struggle domestically with labor shortages and have been focusing on the importance of employee talent acquisition and retention.

While companies must deal with the impact of inflation and scarce labor markets, there have been signs of improvement. As noted in Deloitte's "United States Economic Forecast," certain prices (notably of oil, gas, and food) are beginning to decline, consumer spending remains high, and companies do not generally appear to be affected by rising interest rates (which, as noted in the above chart, are still historically low) given the amount of cash they accumulated during the pandemic. Further, even as equity prices have cooled off from the surge in 2021, public companies may continue to regard equity financing as an attractive source of capital.

Companies may also want to focus on preparing for the recovery that will follow a recession or downturn, which many economists believe will come sooner than expected. Even if the U.S. economy is not (and may never be) in a recession given the definitions of that term in the United States, the impacts of the downturn are clear, and U.S. companies may need to deal with the challenging accounting and financial reporting implications of both the macroeconomic conditions and the actions they take to combat those conditions and prepare for a recovery.

Such implications may also be challenging for U.S. companies with global operations in countries whose macroeconomic conditions are more or less severe than those in the United States.

Further, U.S. companies may be affected by geopolitical crises occurring abroad, such as the continuing Russia-Ukraine war and associated trade restrictions (see Deloitte's *Financial Reporting Alert*, "Financial Reporting Considerations Arising From the Russia-Ukraine War," for more information), as well as the strained relationship between China and the West. These situations may lead to continued changes in foreign investment, the shifting of supply chains, and disruptions in the availability of resources. Furthermore, companies with operations in the European Union that are in energy-intensive industries are likely to have experienced significant cost increases in gas prices, partly because European Union countries have faced a cutoff of gas from Russia. Meanwhile, they continue to seek alternative sources from other countries.

Although other Deloitte publications have addressed various impacts of the macroeconomic downturn and the geopolitical situation, the discussion below provides current guidance on key financial reporting, accounting, and internal control matters for companies to consider.

SEC Reporting and Disclosure Considerations

Registrants must consider the impacts of the current macroeconomic and geopolitical conditions on their required disclosures and public filings. Recent guidance issued by the SEC has included CF Disclosure Guidance (DG) Topic 9 and DG Topic 9A (in response to the pandemic) and a sample letter discussing disclosure considerations (in response to the Russia-Ukraine War). While the guidance in those documents was prompted by specific events, it continues to apply in today's economic and geopolitical environment. It also provides a framework for registrants to use in thinking through their disclosures. Such framework emphasizes the need for companies to provide information about their financial and operating status, as well as their expectations for the future, in a timely manner. That need was reiterated by the International Organization of Securities Commissions in a November 14, 2022, public statement, which also includes considerations for a registrant's auditors and audit committees.

Management's Discussion and Analysis

The Management's Discussion and Analysis (MD&A) section of a registrant's filing supplements the financial statements by providing information about the registrant's financial condition, results of operations, and liquidity. A registrant should discuss in MD&A the economic and geopolitical environment and the material quantitative and qualitative impact it may have on its business. For example, the discussion could address potential issues such as changes in consumer behavior, including an unusual increase or decrease in demand, store or facility closures, changes in customer traffic, increased competition for raw materials, higher costs due to inflation, labor shortages, supply-chain disruptions, production delays or limitations, risk of loss on significant contracts, liquidity challenges or debt covenant issues, increasing interest rates, regulatory risks, the impact of foreign currency, or the impact on human capital.

In addition to discussing the impact on historical results, registrants are also expected to disclose any known trends, events, or uncertainties that have had or that are reasonably likely to have a material impact on their financial condition, results of operations, or liquidity. These forward-looking disclosures are especially critical in connection with the current conditions and associated economic uncertainty. Such disclosures can give investors an "early warning" about risks such as (1) when and under what conditions charges may be incurred in the future and the potential magnitude of such charges, (2) when revenue growth or profit margins may not be sustainable because of underlying economic conditions, or (3) when the registrant may be unable to comply with debt covenants or have other liquidity issues. Further, a registrant's liquidity may be significantly affected because its access to cash through debt or equity markets could prove challenging in light of the recent volatility in the capital markets and

the rising interest rate environment. In MD&A disclosures about liquidity, registrants should discuss their working capital or other cash flow needs, anticipated changes in the amount and timing of cash generated from operations, the availability of other sources of cash along with potential limitations associated with accessing such sources, and the possible ramifications of their inability to meet their short- or long-term liquidity needs.

Management should also consider providing early-warning disclosures in connection with accounting areas in which significant judgment is required, such as contingencies, valuation allowances, or potential impairments. These account-specific disclosures are frequently included as part of the critical accounting estimates section of MD&A. Given the economic and geopolitical conditions and uncertainty associated with them, there is likely to be an increase in the level of judgment entities need to apply in estimating future results and the potential range of reasonably likely outcomes. Registrants should therefore consider expanding their disclosures about (1) the key assumptions used in their most significant estimates and (2) the sensitivity of such estimates to changes that could reasonably occur as events continue to develop. Such disclosures should be continually evaluated and updated, particularly if material changes have been made to key assumptions and estimates.

Risk Factors

Registrants must disclose information about the most significant risks that apply to their company or its securities. In light of the evolving macroeconomic and geopolitical environment, registrants should continually evaluate whether they need to update their risk factor disclosures to add specificity about the direct and indirect impacts such conditions may have on their business. If the conditions are framed in an existing risk factor disclosure as a potential or hypothetical condition, registrants should update the disclosure to clarify that the risk is no longer hypothetical and provide more specificity about the actual and potential impacts of the conditions. In addition, registrants should consider (1) adding or updating risk factors to address the heightened risk of cybersecurity attacks resulting from geopolitical conditions and (2) describing the steps they have taken to mitigate those risks.

Note that on March 9, 2022, the SEC issued a proposed rule on cybersecurity disclosures that would require registrants to provide enhanced disclosures about "cybersecurity incidents and cybersecurity risk management, strategy, and governance." See Deloitte's March 16, 2022, *Heads Up* for more information.

Form 8-K Considerations

A registrant commonly uses Form 8-K to give investors more timely information about its financial and operating status. The form can also be used to provide updates to investors on the current and potential future impact that the economic and geopolitical environment may have on the registrant's business. Further, a registrant may have to file a Form 8-K to disclose material dispositions of assets and any related pro forma information (Item 2.01), liquidity events that result in the violation of debt covenants or that accelerate or increase any obligations (Item 2.04), costs to be incurred in connection with any exit or disposal activities (Item 2.05), or material impairment charges (Item 2.06).

Non-GAAP Measures, Metrics, and KPIs

Registrants may also consider reflecting various impacts of the economic and geopolitical conditions in their non-GAAP measures, metrics, and key performance indicators (KPIs). The primary requirements for disclosing non-GAAP information are related to prominence, reconciliation, clear labeling, and usefulness and purpose. In addition, registrants' disclosures about metrics and KPIs may need to include (1) a clear definition of the metric and how it is calculated, (2) a statement indicating the reasons why the metric provides useful information to investors, (3) a statement indicating how management uses the metric in managing

or monitoring the performance of the business, (4) a description of any key estimates, assumptions, and limitations (e.g., whether the metric is a "hard" amount or an estimate), and (5) presentation of the metric within a balanced discussion.

Further, when evaluating whether an adjustment related to certain economic and geopolitical conditions is appropriate in a non-GAAP measure, a registrant should consider several factors including, but not limited to, whether the adjustment is:

- Directly related to such conditions or to the associated economic uncertainty.
- Incremental to normal operations and nonrecurring (i.e., it is not expected to become the "new normal").
- Objectively quantifiable, as opposed to an estimate or projection.

A registrant must use judgment when evaluating whether an adjustment is consistent with these factors. However, we believe that a non-GAAP measure of performance that eliminates normal recurring cash operating expenses would generally not be appropriate.

Any new adjustments or changes to non-GAAP measures related to the current economic environment should be clearly labeled, and changes to such measures should be transparently disclosed. In addition, if new adjustments to non-GAAP measures are added as a result of the current environment, an entity should ensure that its disclosure controls and procedures address the assessment and approval of the revised non-GAAP measures, including the consistency of presentation between periods and transparent disclosures about any changes. Similar considerations apply to changes to, or newly introduced, metrics and KPIs.

See Deloitte's Roadmap *Non-GAAP Financial Measures and Metrics* for more information about SEC requirements and interpretations related to such measures and metrics. In addition, see Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights* for current trends in SEC comments.

Financial Reporting, Accounting, and Internal Control Considerations

An economic downturn may have a broad impact on an entity's financial reporting or it may be limited to certain accounts, transactions, or disclosures. As a result of current conditions, future uncertainty, or both, entities may also face significant challenges associated with forecasting. Such challenges may be compounded by historically high inflation and global supply-chain issues.

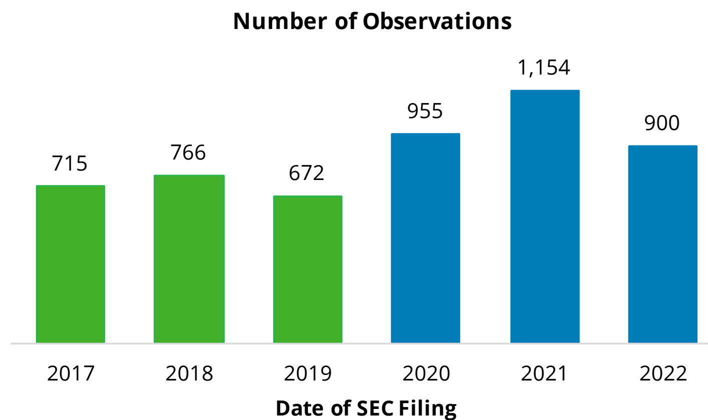
Specific accounts that may be affected by forecasting are addressed in the discussion below, along with other relevant considerations. Companies should also review Deloitte's *Financial Reporting Alert*, "Financial Reporting Considerations Related to Inflation, Supply Chain Disruptions, and Labor Shortages," for additional details associated with these challenges.

Impairment of Nonfinancial Assets (Including Goodwill)

Overview

Historically, as economic conditions deteriorate, the chance of events that trigger impairments (e.g., a worsening market for an asset, a change in the way an entity uses an asset, operating losses, or excessive costs) increases accordingly. This correlation was recently evidenced by the uptick in impairments attributable to the pandemic starting in 2020 and has continued throughout the downturn, as represented in blue in Figure 3.

Figure 3: Impairments of Nonfinancial Assets of Registrants With Market Capitalizations Over $1 Billion



Entities should carefully assess the impairment considerations outlined below. Specifically, the current economic environment or changes in an entity's business or legal environment (such as a deterioration in general economic conditions, fluctuations in foreign exchange rates, or increases in operating costs that have a negative effect on earnings and cash flows) may lead to "triggering events" that result in a requirement to test for impairment on an interim basis or may significantly affect the measurement of an asset's value. Further, central banks are increasing interest rates, which may result in higher discount rates and, in turn, lower fair values and more impairments when entities use the discounted cash flows valuation method. Even if nonfinancial assets are not impaired, an entity should also consider the need to provide financial statement disclosures about the risks and uncertainties associated with its operations and how such risks and uncertainties may affect its accounting estimates.

Inventory

Under U.S. GAAP, most inventory must be measured at the lower of its cost or (1) market value (for inventory measured by using the last in, first out method or the retail inventory method) or (2) net realizable value (for all other inventory). In a volatile economic environment, it may be particularly important for entities to determine whether the utility of their inventory on hand has been impaired as a result of their inability to transfer those price increases to customers. Also, entities with noncancelable, unhedged firm purchase commitments for inventory should recognize expected net losses to the extent that they are unable to recover such cost through sales.

Further, if supply-chain disruptions affect an entity's ability to operate its manufacturing facilities at normal capacity, the entity should consider the accounting guidance on inventory to determine which costs may be capitalized. For example, certain manufacturers with facilities that may be operating at abnormally low production levels would be required to expense abnormal overhead costs as incurred rather than capitalize them into inventory.

Indefinite-Lived Intangible Assets Other Than Goodwill

Indefinite-lived intangibles other than goodwill (such as trade names) should be tested for impairment at least annually or more frequently if events or changes in circumstances indicate that it is more likely than not that the asset is impaired (i.e., a "triggering event" has occurred). In addition to evaluating the need for an interim impairment test, an entity should consider whether events and circumstances continue to support its conclusion that an asset has an indefinite useful life, which might occur if the entity's expected use of the asset changes in response to certain conditions.

Long-Lived Assets

Long-lived assets such as property, equipment, finite-lived intangibles, or right-of-use (ROU) assets arising from leases are tested for impairment when triggering events occur. An entity may need to consider whether factors such as rising costs due to spikes in energy prices (such as in the European Union) or higher labor costs have resulted in an impairment trigger. If a triggering event has occurred, the entity first assesses whether the asset is recoverable on an undiscounted cash flow basis. If the entity determines that the carrying amount of the assets is not recoverable, it then performs a valuation to calculate the fair value and to measure any subsequent impairment of the assets' carrying value. Regardless of whether the entity recognizes an impairment loss, it should still consider whether there has been a change in the remaining useful life or salvage value because of the triggering event that occurred.

Also, an entity may choose to abandon assets, whether because of geopolitical crises abroad or decisions to shift supply chains. If so, the entity should test the assets for impairment and consider the need for revised depreciation estimates.

For additional considerations related to impairment and abandonment of long-lived assets, see Chapters 2 and 4, respectively, of Deloitte's Roadmap *Impairments and Disposals of Long-Lived Assets and Discontinued Operations*.

Goodwill

Under U.S. GAAP, an entity must test goodwill for impairment at the reporting-unit level at least annually or more frequently if triggering events occur. An entity should pay particular attention to goodwill impairment when there have been significant declines in market capitalization, particularly as the entity's market capitalization approaches or declines below its carrying value.

Impairment and Valuation of Financial Assets

Overview

When measuring a financial asset's fair value (either on a recurring basis or to determine whether an impairment has occurred), an entity should be aware that fair value measurements are market-based and represent an exit price; thus, they are not entity-specific. An entity should maximize the use of observable inputs, except in certain times of significant volatility when it may be able to ignore observable inputs if a transaction is not orderly. Further, an entity should consider (1) the inputs used in a valuation technique and whether credit risk or liquidity risk should be included, (2) whether a valuation technique is appropriate in the circumstances, and (3) whether information obtained from brokers or pricing services is reliable given the current uncertainty, especially in specific geographies. See Chapter 10 of Deloitte's Roadmap *Fair Value Measurements and Disclosures (Including the Fair Value Option)* for more information.

The impairment model used for financial assets will depend on the type of investments, some of which will not require fair value measurements. In the discussions below, it is assumed that an entity has adopted the current expected credit losses (CECL) accounting standard.

Investments in Equity Securities Without Readily Determinable Fair Values

If an entity holds investments in equity securities without readily determinable fair values and elects not to remeasure those securities at fair value in each reporting period, it should remeasure the investments to fair value if either (1) there is an observable transaction in the same or similar security of the same issuer or (2) on the basis of a qualitative assessment (performed in each reporting period), the investment is impaired and the fair value of the investment is less than its carrying value. Entities that are invested in certain types of equity

securities such as an investment in the equity of a startup or of a foreign operation may want to focus in particular on the qualitative assessments and fair value considerations discussed above.

Investments in Equity Method Investments and Joint Ventures

Entities with equity method investments may need to evaluate whether decreases in an investment's value are other than temporary. See Section 5.5 of Deloitte's Roadmap *Equity Method Investments and Joint Ventures* for further discussion of the assessment of equity method investments for other-than-temporary impairments.

Financial Assets Measured at Amortized Costs (Such as Held-to-Maturity Debt Securities, Loans, and Trade Receivables)

Entities should apply the CECL impairment model, which is based on expected losses rather than historical incurred losses, when recognizing credit losses on financial assets that are carried at amortized cost. The allowance for credit losses takes into account historical loss experience, current conditions, and reasonable and supportable forecasts. Given the current macroeconomic environment, entities may experience an increase in recognized allowances for credit losses on these types of investments.

Available-for-Sale Debt Securities

An investment in an available-for-sale (AFS) debt security is impaired if the fair value of the investment is less than its amortized cost basis. An entity must assess impairment at the individual security level. Subsequent accounting for an AFS debt security also depends on the investor's intention to sell the security or whether it is more likely than not (MLTN) that it would be required to sell it. If the investor intends to sell the security or it is MLTN that it would be required to sell it, the investor must write down the security's amortized cost basis to its fair value, write off any existing allowance for credit losses, and recognize in earnings any incremental impairment. An entity that does not intend to sell an impaired security, or for which it is not MLTN that it would be required to sell the security, must determine whether a decline in fair value below the amortized cost basis resulted from a credit loss or from other factors. Any portion of the impairment attributable to credit losses is recognized through net income, with the remainder recorded through other comprehensive income. See Chapter 7 of Deloitte's Roadmap *Current Expected Credit Losses* for further discussion of AFS debt securities.

Consolidation

A reporting entity consolidates another entity (a legal entity) if it has a controlling financial interest in that entity. The reporting entity's consolidation determination may be affected by factors such as geopolitical conditions, sanctions, and the impact of current economic conditions on a legal entity that is currently a variable interest entity (VIE). In addition, reporting entities may need to reconsider whether a legal entity is a VIE if certain VIE "reconsideration events" occur. They should also continually reassess whether they are the primary beneficiary of a VIE throughout the entire period in which they are involved with the VIE. See Chapter 9 (on VIE reconsideration events) and Chapter 7 (on determining the primary beneficiary) of Deloitte's Roadmap *Consolidation — Identifying a Controlling Financial Interest* for further information.

Revenue

In addition to issues related to customer collectibility for which CECL allowances may be required, an entity may need to consider whether the inability of a customer to pay affects the entity's conclusion that a revenue contract exists. In such a case, revenue recognition may be precluded. Further, many entities may renegotiate contracts, grant concessions, or cancel

contracts and may need to consider the accounting requirements for contract modifications and price concessions. See Chapter 4 (on identifying a contract), Chapter 6 (on determining the transaction price), and Chapter 9 (on contract modifications) of Deloitte's Roadmap *Revenue Recognition* for additional information about these matters.

Stock-Based Compensation Arrangements

As a result of the decline in equity markets, an entity may have determined that a significant portion of its employees' outstanding stock options are "underwater" or "out-of-the-money." In such a case, the entity may reprice the options, may issue modified awards, or may allow employees to participate in stock option exchange programs. An entity that employs these measures as a means of talent retention should be aware of the potential one-time impacts to earnings. See Chapter 6 of Deloitte's Roadmap *Share-Based Payment Awards* for more information about modifications of share-based payment awards.

Leasing Arrangements

In addition to the impairment considerations described in the Long-Lived Assets section, lessors and lessees should be aware that any rent concessions granted in a leasing arrangement outside the original lease are likely to be accounted for as a lease modification. See Chapter 8 (on lessees) and Chapter 9 (on lessors) of Deloitte's Roadmap *Leases* for more information about lease modifications. Lessors should also be aware that net investments in leases (other than operating leases) are subject to the CECL impairment model described in the Impairment and Valuation of Financial Assets section. For information about the application of the leasing guidance to lessors with outstanding operating lease receivables, see Deloitte's *Financial Reporting Alert*, "Assessing the Collectibility of Operating Lease Receivables."

Foreign Currency Matters

While inflation in the United States has increased significantly, certain countries such as Turkey and Argentina have been experiencing hyperinflation. Under U.S. GAAP, entities must assess whether they are operating in an economy that has become highly inflationary. If so, they are required to remeasure financial statements in the reporting currency. See Chapter 7 of Deloitte's Roadmap *Foreign Currency Matters* for more information about highly inflationary economies.

Hedge Accounting

The current economic conditions may affect an entity's ability to apply hedge accounting. For example, it may be challenging for entities with certain cash flow hedges (such as interest rate swaps with current maturities extending beyond current debt obligations) to roll over their debt obligations. Such a challenge may be an indicator that it is no longer probable that forecasted transactions will occur and an entity therefore may be required to discontinue hedge accounting. Also, an entity whose derivative and hedging portfolios are at an increased risk of counterparty default may have to discontinue hedge accounting. See Deloitte's Roadmap *Hedge Accounting* for more information.

Income Taxes

An entity may have more difficulty developing forecasts as a result of the current macroeconomic conditions, which may affect different aspects of its income tax accounting. Even if the entity has generated income recently, it will need to consider the current economic environment and whether future losses are projected, which may indicate that a valuation allowance on deferred tax assets is required. In addition, for interim reporting purposes, adjustments to forecasted income (such as those assumed for other impairment analyses) will also need to be factored into the entity's estimated annual effective tax rate (AETR). In

other, more extreme, instances, an overall reduction in an entity's forecasted income due to changing economic conditions might make the entity's AETR highly sensitive to changes in estimated ordinary income for the year (and the entity may not be able to make a reliable estimate of the AETR). In those cases, the actual effective tax rate for the year to date may be the best estimate of the AETR. See Chapter 5 (on valuation allowances) and Chapter 7 (on interim reporting) of Deloitte's Roadmap *Income Taxes* for more information.

Presentation and Disclosure Considerations

Classification

Entities operating in geographies in which the United States and other countries have imposed sanctions may need to consider whether it remains appropriate to classify certain assets as current or certain liabilities as long-term on the statement of financial position. For example, cash and cash equivalents may be restricted, and entities affected by the economic environment may be at increased risk of breaching financial covenants. If such a breach occurs on or before the end of the reporting period and gives the lender the right to demand repayment within 12 months of the end of the reporting period, the liability would generally be classified as current in the borrower's financial statements.

Further, if an entity concludes that a material event is of an unusual nature or occurs infrequently (or both), the entity may need to report the nature and financial effects of the event as a component of income separately from continuing operations or provide a footnote disclosure.

Risks and Uncertainties

Estimates in financial statements are made on the basis of current events and transactions, the effects of which may not be precisely determinable until some future period. Uncertainty about the outcome of future events should be disclosed in the financial statements. For significant accounting estimates, financial statement disclosure is required when it is reasonably possible that an estimate will change in the near term and the effect of the change will be material. Further, entities are required under U.S. GAAP to disclose their concentrations if certain criteria are met. Entities with material exposures in specific regions or economies will need to consider whether to disclose concentrations, particularly if such concentrations makes them vulnerable to the risk of a near-term severe impact.

Going-Concern Considerations

An entity will need to consider whether current macroeconomic or geopolitical conditions give rise to substantial doubt about whether the entity may be able to continue as a going concern and, if so, whether it should continue to prepare its financial statements on a going-concern basis. Specifically, management must determine whether (1) there are conditions and events that, when considered in the aggregate, raise substantial doubt about the entity's ability to continue as a going concern within one year after the date on which the financial statements are issued and, if so, (2) management's plans are able to mitigate these conditions. An entity should also consider the disclosure requirements even if management's plans alleviate doubt about the entity's ability to continue as a going concern.

Subsequent Events

In an environment in which changes may occur rapidly or unexpectedly (and especially in areas affected by geopolitical crises), entities should carefully evaluate information that becomes available after the balance sheet date but before the issuance of the financial statements. Under U.S. GAAP, entities must recognize the effects of all subsequent events that provide additional evidence about conditions that existed as of the balance sheet date (including estimates) in the financial statements. Even if they are not required to recognize

subsequent events, entities should evaluate whether they must provide disclosures and whether omitting them would cause the financial statements to be misleading.

Internal Controls Over Financial Reporting

Entities may be required to either identify new controls or modify existing ones in response to new or modified financial reporting risks that have emerged as a result of the current macroeconomic or geopolitical environment. They must also consider the operating effectiveness of existing controls, especially if shortages in labor or changes in ownership have caused a change or breakdown in review-type controls.

Importantly, SEC registrants must disclose in their quarterly or annual filings any changes in internal controls that have materially affected, or are reasonably likely to materially affect, their internal control over financial reporting in Item 4 of Form 10-Q or in Item 9A of Form 10-K (or in Item 15 of Form 20-F for foreign private issuers).

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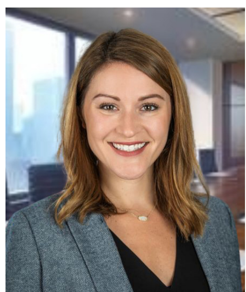

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