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Financial Reporting Considerations Related to Inflation, Supply Chain Disruptions, and Labor Shortages

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Introduction

Since early 2020, companies have had to grapple with unprecedented operational and financial challenges. Now, as companies look to navigate the "new normal" while the economy emerges from COVID-19, additional uncertainties cloud not only the overall economic picture but also the outlook for individual companies.

Inflation, supply chain disruptions, and labor shortages are all affecting an increasingly large number of companies in different industries to varying degrees. If a company's business model and operations are affected, its accounting and financial reporting are likely to be as well.

This publication takes a strategic look at financial reporting and accounting challenges related to inflation, supply chain disruptions, and labor shortages that companies may face both individually and collectively as the economy emerges from the COVID-19 pandemic.

Forecasting

Throughout the COVID-19 pandemic, many companies have faced significant challenges related to forecasting as a result of the ongoing uncertainties associated with the pandemic. Even as the pandemic diminishes in intensity, it is causing what some consider to be lingering ill effects,[1] such as inflation, supply chain disruptions, and labor shortages. These effects continue to make forecasting particularly challenging in the current environment.

[1] Patti Domm, "Labor Shortage, Supply Constraints and Inflation Hold Back Economy Trying to Emerge From Pandemic," CNBC.com, October 29, 2021.

One of the many consequences of COVID-19 has been pent-up demand for a variety of goods and services. However, many companies are having difficulty satisfying the demand because of labor shortages and a disrupted supply chain — with goods in transit stuck on boats either at ports or out at sea (if they have even been able to make it that far in the supply chain). For some industries, supply chain disruptions may also involve the shortage of key components needed for production, such as microchips for auto manufacturers. Faced with the additional challenge of inflation trends unlike any witnessed in the past 25 years, companies are trying once again to develop forecasts amid a number of uncertainties.

As cost structures change with higher inventory and freight costs and pressure to increase employee compensation, companies should (1) consider how they expect the altered cost structures to continue into the future and (2) evaluate whether they will be able to offset any increased costs with pricing adjustments. Companies may see a significant decline in revenues if they are unable to procure resources needed to produce and deliver goods and services.

Inflation, supply chain constraints, and labor shortages all affect a company's forecasts. Such forecasts are used in a variety of accounting estimates, including, but not limited to, those related to the assessment of (1) goodwill or other long-lived assets for impairment, (2) whether valuation allowances related to the recovery of deferred tax asset balances are needed, and (3) liquidity and the appropriateness of the going-concern presumption. In developing forecasts and assessing the related accounting implications, companies should consider whether the effects of the uncertainties are short-term or long-term and how that determination will affect various accounting estimates.

Inflation

Although the effects of inflation vary by company, there are some common topics that companies should evaluate when considering how recent inflationary trends may affect their accounting and financial reporting.

Because inflation is most likely driving up costs of acquiring goods/inventory and related packaging materials, as well as employee wages, companies should consider whether they can pass along those increased costs to their customers. See the Supply Chain Disruptions section for considerations related to costs capitalized as part of inventory.

Companies may also have increased costs associated with long-term revenue contracts that they may or may not be able to pass along to their customers. If a company is unable to raise its prices under a revenue contract, the company's estimated profitability on the contract may decline or result in a loss on the contract. Companies should consider the potential accounting implications of reduced or negative profitability on a revenue contract, including the period in which to record a loss if applicable.

Inflation may result in renegotiating long-term contracts, such as leases or long-term supply agreements, which in turn may have potential accounting implications. For example, depending on the terms, a modification to a lease contract may require a company to reassess the classification and measurement of the lease.

In addition, inflation may lead to an increase in interest rates and corresponding declines in the value of fixed-rate financial assets. Companies should also consider potential impacts on estimated credit and loan loss reserves.

As companies review their investment strategies in light of recent inflation, they may consider making different types of investments or moving away from holding excess cash on hand. For example, a company may consider investing in gold, digital assets (such as cryptocurrencies), or Treasury Inflation-Protected Securities as a hedge against inflation. Companies contemplating such investments should consider the complex accounting and financial reporting that may result from holding them. For example, inflation-indexed debt

securities are subject to specific interest recognition guidance under U.S. GAAP and should be evaluated to determine whether they contain any derivative that is required to be accounted for separately for accounting purposes.

Further, certain companies should monitor the appropriateness of the discount rate used to measure any pension-related liabilities, particularly since even a seemingly small change in the discount rate can affect a company's pension liability significantly. For example, higher interest rates may lead to decreases in pension liabilities and required employer contributions. However, such decreases may be offset by higher employee wages, which are further discussed in the Labor Shortages section.

Supply Chain Disruptions

Supply chain disruptions have been well publicized of late. For example, it has been reported[2] that since the manufacturers, suppliers, and distributors in a supply chain are interconnected, "disruption in one part of the chain [has] a ripple-down effect on all parts of the chain" and "ultimately [affects] consumers and economic growth."

For many companies, such disruption is significantly increasing the costs associated with moving goods through the supply chain. If the higher costs are included in inventory, companies should consider whether these costs drive up the cost of the inventory in such a way that adjustments based on the expected net realizable value of the inventory are warranted. This determination is likely to vary by industry and by company given (1) the use of different types of materials, (2) diversity in suppliers, and (3) a company's ability to transfer cost increases to its customers through higher selling prices.

While the goods are making their way through the disrupted supply chain, companies should consider the point in time at which the buyer actually assumes ownership of the goods to ensure appropriate reporting of raw materials, finished goods, and supplies on their balance sheets. Companies that may have had only immaterial amounts of goods in transit because of historically short transit times may find it necessary to implement more robust accounting processes and internal controls to appropriately capture their inventories (some of which may be physically held by third parties). Likewise, companies should ensure that suitable cutoff procedures result in revenue recognition in the appropriate period.

In addition, companies struggling to obtain certain products that are inputs to finished goods, such as microchips, may consider adjusting their manufacturing processes to use different inputs or manufacture the products differently. Companies should consider whether the need to use alternate raw materials or processes affects the warranties offered and the accounting for those warranties. Changes to the terms and conditions of warranties, the expected life of the product, or expected warranty claims may differ by product type; such differences, combined with increased material and labor costs, could affect the related warranty accounting.

Labor Shortages

Labor shortages may manifest themselves in the form of employee turnover, departures, and demands for higher wages at all levels of the organization. As costs of retaining labor increase in a production environment, companies should consider how these increased labor costs affect the cost of inventory and whether these higher costs can be offset by price increases as companies sell these goods to their customers. Companies should also consider the potential accounting implications of including increased costs in inventory, as discussed in the Supply Chain Disruptions section.

[2] Holly Ellyatt, "Supply Chain Chaos Is Already Hitting Global Growth. And It's About to Get Worse," CNBC.com, October 18, 2021.

To address the employee demands for increased compensation, many companies are revisiting their compensation structures. Adjustments may take the form of increased hourly wages, retention bonuses, improved incentive compensation or stock compensation, or other benefits. Companies should consider the accounting implications of these changes in compensation structure. For example, if a company provides retention bonuses to employees, the company should consider the contractual terms of those arrangements and assess during what period those bonuses should be recognized. In addition, certain companies may need to consider changes in their workforce and the related compensation structure when evaluating assumptions used to measure their pension liability.

In response to a shortage in labor, some companies may be forced to operate at a reduced capacity. In such a case, companies should consider whether there are costs that have been capitalized into inventory historically but should be expensed currently because of abnormal production levels (e.g., indirect costs such as rent and depreciation).

Further, with federal vaccine mandates issued and scheduled to go into effect in January 2022, certain companies should consider what actions they will (or may) be required to take because of the mandates and whether the mandates will exacerbate the labor shortage and affect the considerations discussed above. Any departure of employees as a result of the mandates may put a strain on production and delivery forecasts and could pose additional challenges related to employee compensation, including termination benefits.

Increased turnover and the shortage of employees may also put stress on a company's internal control environments. As employee responsibilities shift, companies should assess whether the appropriately skilled and trained individuals are in place to effectively design, implement, operate, and monitor controls, including controls related to information technology.

Communication With Stakeholders

In addition to considering potential accounting-related impacts of inflation, supply chain disruptions, and labor shortages, companies will need to evaluate their communication strategies related to such risks and uncertainties. While private and public companies alike will need to comply with the disclosure requirements under U.S. GAAP, public companies will also need to consider the SEC's reporting requirements, including required disclosures about trends and uncertainties in the business, risk factors, and MD&A sections of filings. For many companies, these issues may require disclosure in MD&A of known trends or uncertainties that could affect sales, net income, or liquidity. For example, supply chain disruptions may result in lower sales, increased costs, or increased working capital requirements, all of which may warrant disclosure in MD&A. Companies should consider disclosing the current effects of these matters on the business, expected future impacts, and how management is responding. Further, companies should tailor these disclosures to their specific circumstances and avoid generic boilerplate descriptions of inflation, supply chain disruptions, and labor shortages.

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