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Contents



# Accounting and Financial Reporting in Uncertain Times: Considerations for Navigating Macroeconomic and Geopolitical Challenges

## Introduction

The convergence of various macroeconomic and geopolitical factors has created a volatile and uncertain environment in which a business's decision-making and accounting and financial reporting have become increasingly challenging. We see evidence of these challenges in the form of banks failing or being downgraded, businesses struggling to raise capital, and companies announcing layoffs, broader restructuring plans, and impairments. As business leaders struggle to deal with macroeconomic and geopolitical changes, both preparers and users of financial statements need to understand the impacts and potential impacts of those changes, which involve a myriad of factors. Some of the more prominent factors affecting businesses include:

- Risk of recession.
- Interest rate increases.
- Tightening of credit and concerns about the banking sector.
- Concerns about the real estate sector, both residential and commercial.
- Continuing inflation, including geographic- and sector-specific impacts.
- Tightened labor market.

- Changes in foreign currency exposure as a result of both the geopolitical environment and supply chain challenges.
- Climate risk.

While each factor on its own poses challenges in the application of accounting standards, the convergence of these factors significantly increases the level of complexity involved and, therefore, the amount of effort needed to develop significant accounting estimates, such as the valuation of receivables, inventory, investments, property and equipment, leased assets, goodwill, and intangibles. In addition to the many potential impacts on accounting estimates, the factors can also have more direct accounting implications. For example, as interest rates rise, debt covenant violations may increase, which could call for an evaluation of debt classification and going concern considerations, among others. Furthermore, given the current environment, companies may also need to reevaluate their foreign currency exposures, the effectiveness of hedging relationships, and — while generally considered rare — the potential need to change a foreign entity's functional currency as a result of significant changes in economic facts and circumstances.

In light of the changing macroeconomic and geopolitical environments, companies should also be mindful of the considerations below related to risk assessment, internal controls, and SEC disclosures.

## Risk Assessment

To address the complexity in the current environment, companies may need to revisit their historical risk assessments and revise their processes and controls to ensure that their accounting and reporting reflects the changing macroeconomic and geopolitical factors. SEC Chief Accountant Paul Munter recently released a statement reinforcing the importance of assessing risk comprehensively to ensure effective financial reporting and internal controls. He discussed risk assessment considerations for both management and auditors related to the changing economic conditions.

At the highest level, addressing this changing environment means revisiting risk assessments to ensure that management has identified new risks or changes in existing risks, including fraud risks, that are affecting the company. For example, management might consider the following:

- If management mitigated its exposure to foreign currency fluctuations by denominating more of its transactions in a particular currency, has it unwittingly changed the functional currency of the related business? Alternatively, if management mitigated its foreign currency exposure by expanding its hedging program, has it adequately considered counterparty risk, especially given the concerns about the banking sector?
- If management changed or diversified its suppliers in response to supply chain constraints or geopolitical concerns, has this supplier change increased the company's exposure to foreign currency fluctuations and, if so, is that appropriately disclosed in the company's financial statements and SEC filings?
- Which of the current macroeconomic and geopolitical factors, or combination of factors, affect the overall risk of fraud either at an entity level or with respect to specific risks within the entity's existing accounting and reporting structure?

In addition, organizations that use or are considering using generative artificial intelligence (GenAI) in accounting and financial reporting should carefully consider the potential risks associated with this technology. GenAI models can be biased and inaccurate, and they may not be able to capture all the nuances of the current business environment. Therefore, organizations may need to revise their processes and controls to mitigate these risks.

While many of the changes outlined above are one-off occurrences, others have a clear recurring impact. For instance, when the inflation rate was lower, companies may have been successful in passing on minor cost increases to their customers so that cost changes may not have had a substantial impact on margins. However, customers may now be more resistant to price increases and therefore companies may face difficulties in passing on significant cost increases to their customers. Pressure to increase margins may instead lead companies to explore cost-saving initiatives such as layoffs and restructuring activities, which can create new accounting, reporting, and fraud risks.

## Design and Operation of Internal Controls

Each new material risk identified by management is typically accompanied by a corresponding change in the design or operation of a company's internal control over financial reporting. From a design point of view, management may consider the need to challenge (1) how well the control addresses the risk, (2) the frequency with which the control is performed, (3) the competency and authority of those performing the control, and (4) the level of aggregation or disaggregation, predictability, and the criteria for investigation in a management review control. For example, management may consider the following:

- In a highly inflationary environment, does the existing fluctuation analysis, in which management reviews changes over an amount or percentage, continue to be effective as an internal control or should the criteria for investigation be changed? For example, in an inflationary environment, a decrease in costs as a percentage of sales may warrant investigation even if the decrease did not exceed a defined threshold for investigation. Conversely, in situations in which every cost has increased above management's threshold for investigation, should management consider whether that investigation has been diligent or whether it reflects a confirmation bias since management expected costs to increase?
- Do personnel reviewing the fluctuation analysis understand the business well enough to tell the difference between an unusual fluctuation and an expected fluctuation?
- As a result of the tight labor market, has the company experienced turnover and had challenges hiring qualified personnel? Management should also consider whether, as a result of these challenges in hiring qualified personnel, it takes more time to fill vacancies, which possibly puts stress on existing controls and processes and thereby increases the opportunity for fraud.

A common example of changing the frequency of when a control is performed is an interim goodwill impairment analysis in response to a triggering event. However, there are other circumstances in which the frequency of a control may need to be changed, even if it is not called for by accounting standards. For example, if an entity is experiencing significant cost increases, management should consider whether to only update the standard cost of inventory annually or to do it on a more frequent basis. If management instead relies on its process for capitalizing variances, it should assess whether (1) that process adequately considers the fact that some costs are relatively stable while others continue to undergo significant change and (2) the analysis should be disaggregated by product line, cost type, or other unit to ensure a reasonable allocation.

Beyond the design of a control, it is also important to think about how controls operate in a changing environment. Processes such as developing a forecast for use in an impairment analysis and reviewing that forecast may need to be modified when many of the factors discussed above come together. For example, a global entity may encounter very different economic circumstances in different geographies, with some countries experiencing deflation and others experiencing significant inflation. The company's consideration of inflation will necessarily be affected by the degree of inflation in the geographies in which the company operates, and a one-size-fits-all approach will not fit every company. In addition, since interest rate changes will affect the weighted-average cost of capital used in a discounted cash flow analysis, management should consider whether tightening credit has had an impact on debt-to-equity ratios. Even if a company is projecting solid profitable growth, its ability to grow could be challenged by labor availability in a tight labor market.

Management should consider the above factors, among others, in the preparation and review of forecasts and should challenge whether historical results and relationships continue to be indicative of future projected results. It should also consider potential fraud risks and schemes related to pressures resulting from interest rate changes, since such pressures could affect the company's forecasts and ability to meet targets for key performance indicators.

## SEC Disclosures

Because it is important for investors and other users of the financial statements to understand how companies are affected by changes in the factors discussed above, companies must give careful attention to disclosures of the impacts of these factors, both inside and outside of the financial statements. We have observed that the SEC has increased its focus on macroeconomic factors, primarily those related to risk factors and MD&A. For further information, see the sample SEC comments below as well as the "Dear Issuer" Letters section of Deloitte's December 18, 2022, *Heads Up*, which covers topics such as climate risk and the Russia-Ukraine war.

**Examples of SEC Comments on MD&A[1]**

**Results of Operations**

- You disclose you have been impacted by negative macroeconomic trends, including a condensed labor market, wage inflation, global supply chain issues and inflation affecting your revenues and underwriting. **Please expand your disclosure to identify the principal factors contributing to these issues and clarify the resulting impact on you.** Additionally, **disclose any known trends or uncertainties regarding these issues that are reasonably likely to have a material impact** on your cash flows, liquidity, capital resources, cash requirements, financial position, or results of operations. [Emphasis added]
- There have been significant developments in federal and state legislation and regulation and international accords regarding climate change that you have not discussed in your filing. **Please revise your disclosure to identify material pending or existing climate change-related legislation, regulations, and international accords and describe any material effect on your business, financial condition, and results of operations**. [Emphasis added]
- **Revise your disclosure to identify any material past and/or future capital expenditures for climate-related projects.** If material, please quantify these expenditures. [Emphasis added]

**Critical Accounting Estimates**

- Your response to comment 7 indicates that given recent central bank-led interest rate hikes and the overall macroeconomic environment, you elected to perform a quantitative impairment test . . . at your annual testing date of October 31, 2022. **Please tell us why these two factors did not result in you performing quantitative assessments for any of your other reporting units** as of October 31, 2022. **Address the need to expand your disclosures to address this apparent inconsistency**. [Emphasis added]

The MD&A section of an SEC registrant's filing supplements the financial statements by providing information about the registrant's financial condition, results of operations, liquidity, and critical accounting estimates, including:

- Material quantitative and qualitative impacts on the registrant's historical results of operations, financial condition, and liquidity.
- Material known trends, events, or uncertainties that have had or are reasonably likely to have a material impact on the registrant's financial condition, results of operations, or liquidity. Such disclosures can give investors an "early warning" about risks such

[1] See Deloitte's Roadmap SEC Comment Letter Considerations, Including Industry Insights for further information.

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 may have other liquidity issues.

- Material impacts on liquidity, including a discussion of a registrant's 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 the registrant's inability to meet their short- or long-term liquidity needs.
- Material critical accounting estimates, which may include early-warning disclosures to highlight the uncertainty associated with material estimates including (1) the key assumptions used in the registrant's most significant estimates and (2) the sensitivity of such estimates to changes that could reasonably occur as events continue to develop.

The SEC also expects registrants to continually evaluate whether they need to update their risk factor disclosures and to explain their disclosures about key assumptions used in significant estimates and the sensitivity of such assumptions. Registrants may need to scrutinize their disclosure of risk factors, results of operations, liquidity and capital resources, and critical accounting policies to ensure that such disclosures reflect the challenges the company may face in the current macroeconomic and geopolitical environment.

In summary, a registrant should discuss in its MD&A all relevant material quantitative and qualitative impacts of the current environment on its business. MD&A disclosures are typically included in a Form 10-K or Form 10-Q; however, because of the rapidly evolving current environment, registrants sometimes may also file current reports on Form 8-K to update investors on the current and potential future impact of such events on their business.

## Conclusion

In the face of converging macroeconomic and geopolitical challenges, businesses are grappling with a volatile and uncertain environment that complicates financial accounting and reporting. Given these complexities, companies may need to revisit their historical risk assessments, including fraud risks, and revise their processes and controls. As they navigate these challenges, companies need to pay close attention to the design and operation of internal controls to ensure their effectiveness in the current environment. Registrants should also note that the SEC is emphasizing the importance of clearly communicating the impacts of these factors to investors and other stakeholders.

## Resources

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

*Financial Reporting Alert — Financial Reporting and Accounting Considerations Related to the Current Commercial Real Estate Macroeconomic Environment*

*Financial Reporting Alert — Accounting and Financial Reporting Considerations Related to Recent Banking-Sector Developments*

*Heads Up — Highlights of the 2022 AICPA & CIMA Conference on Current SEC and PCAOB Developments*

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