In depth

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(updated January 12, 2023)

# FAQ on accounting in uncertain economic times

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## At a glance

Our most recent CFO Pulse Survey, conducted in January 2022, found that 71% of CFOs think a recession is likely to occur in the next 12 months. Since that time, the Federal Reserve has raised interest rates several times, the annual rate of inflation in the US through August was over 8% and GDP growth in the US was negative for the first two quarters. The war in Ukraine is now in its seventh month, continuing to disrupt global energy, agricultural, commodity markets, and supply chains that had not yet recovered from the challenges of the COVID-19 pandemic.

Depending on a company's industry, location, customer and supplier diversification, they may experience both direct and indirect impacts from these and other macroeconomic and geopolitical conditions. The severity and duration of any (or all) of these trends could have a significant impact on a number of assets and liabilities. This *In depth* answers questions about a range of accounting considerations that may be impacted by the current economic environment.

This *In depth* was updated on January 12, 2023 to add additional questions related to goodwill impairment assessments and restricted cash considerations.

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# Revenue and receivables

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## QUESTION 1.1

*How could revenue recognition be impacted by a customer's inability to make payments due to challenges arising from macroeconomic events?*

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### *PwC response*

ASC 606 requires that in order to have a "contract" and, therefore, to be able to recognize revenue, a company must conclude that it is probable it will collect substantially all of the consideration to which it will be entitled under the arrangement. If a company continues to sell products and services to a customer when it is uncertain whether collection is probable—due to the potential deterioration of its

customer's financial position or that customer's current inability to settle outstanding receivables—the question arises as to whether revenue can continue to be recognized on new transactions.

ASC 606 requires a company to first consider any potential price concessions that it expects to provide, which reduce the transaction price, before assessing collectibility. Additionally, a company should consider as part of the collectibility assessment whether it has the ability and intent to cease providing service if the customer fails to pay. In many cases it may be challenging to conclude that collection for new sales is probable when the customer has been unable to pay existing receivables. This type of situation requires judgment and is dependent upon facts and circumstances; however, if a company cannot conclude collection is probable at inception of an arrangement, it cannot recognize revenue from the arrangement.

If a company concludes collection is not probable at contract inception, it should continue to reassess this conclusion each reporting period as collection may become probable at a later date. Further, even for contracts that are currently in process, a significant change in facts and circumstances, such as a significant deterioration in a customer's ability to pay, would be an indicator that a company should also reassess whether it is probable that it will collect the remaining consideration under the contract for future goods and services.

**Excerpt from ASC 606-10-25-7**

If a company concludes collection is not probable, but the customer subsequently makes a payment, revenue can only be recognized when one or more of the following occurs:

a. The entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable.

b. The contract has been terminated, and the consideration received from the customer is nonrefundable.

c. The entity has transferred control of the goods or services to which the consideration that has been received relates, the entity has stopped transferring goods or services to the customer (if applicable) and has no obligation under the contract to transfer additional goods or services, and the consideration received from the customer is nonrefundable.

## QUESTION 1.2

*How should a company account for "customer goodwill" gestures, such as giving customers free or discounted goods or services, price concessions, or extended payment terms?*

### *PwC response*

A company that provides free or discounted goods to existing customers should first consider whether the transaction (a) should be combined with another revenue transaction entered into at or near the same time based on the criteria in ASC 606-10-25-9 or (b) changes the scope of an existing customer contract and should be accounted for as a modification.

An option to receive free or discounted goods or services that is combined with another revenue transaction may provide a material right to the customer. Material rights are a separate performance obligation in the contract and a portion of the transaction price (consideration) should be allocated to the right based on the relative standalone selling price allocation framework. However, if the company is offering the goods or services at the same price to similar customers on a standalone basis (i.e., without entering into a current revenue transaction), it would be considered a marketing offer rather than a material right and would have no accounting impact at the time it is offered.

If a company gives customers or potential customers free goods or services that are not provided in connection with another revenue transaction, it would likely conclude a contract does not exist because there are no enforceable rights and obligations. Accordingly, no revenue would be recognized as the free goods or services are transferred. Revenue would generally be recognized on a prospective basis if the customer subsequently commits to purchase additional goods or services from the company. That is, revenue would not be allocated to the goods or services that were transferred for no consideration before a contract existed in that circumstance.

As a result of current events, a company may decide to offer payment terms to customers that extend longer than typically offered. For a new contract, extended payment terms should be considered in the assessment of whether collection is probable and/or whether the company intends to provide a concession at contract inception. Extended payment terms may also indicate that the arrangement includes a significant financing component. Importantly, the mere existence of extended payment terms is not determinative when assessing whether collection is probable (for purposes of establishing the existence of a contract) and all facts and circumstances should be evaluated. Companies should also consider whether extended payment terms affect their assessment of the allowance for doubtful accounts or credit losses. If a company modifies an existing contract to extend payment terms (potentially changing the transaction price), it should consider whether the contract modification guidance applies, particularly if the change is made in conjunction with other changes to the scope of the contract.

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## QUESTION 1.3

*What should companies consider when modifying contracts or terminating relationships?*

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### *PwC response*

Contracts with customers may be modified or terminated as a result of a decision to exit operations in conflict areas. Similarly, entities may need to modify or terminate a contract in response to impacts from a broader economic recession. A modification is a change in the scope of the contract, the price of the contract, or both. A modification is accounted for as a separate contract only if distinct goods or services are added to the contract for a price equal to standalone selling price (adjusted for contract-specific circumstances).

The accounting for a modification that is not a separate contract depends on whether the remaining goods or services are distinct from the goods or services transferred before the modification:

- If the remaining goods or services are not distinct (e.g., a single performance obligation is being modified), the modification is accounted for on a cumulative catch-up basis. Estimates of the transaction price and measure of progress are updated and cumulative revenue recognized is adjusted (increased or decreased) accordingly.
- If the remaining goods or services are distinct (including goods or services that are part of a series), the modification is accounted for prospectively as if it were a termination of the existing contract and the creation of a new contract. The sum of: (a) unrecognized consideration from the original contract and (b) additional consideration promised as part of the modification is allocated to the remaining goods or services to be provided based on relative standalone selling prices as of the modification date.

The partial or complete termination of a contract will typically also be accounted for as a modification as it is a change to the scope and price of the contract. Companies should consider any penalties, refunds, or other payments it may be liable for upon contract termination, particularly if a company unilaterally ceases performing, which may constitute a breach of contract. This will often be a legal determination and require evaluation of contract termination rights, force majeure clauses, and contractual remedies upon breach of contract. Payments made to a customer are presented as a reduction of revenue in accordance with ASC 606-10-32-35 unless the payment is in exchange for a distinct good or service received from the customer. Companies should also evaluate in which period any contract liabilities (i.e., deferred revenue) related to a terminated contract have been satisfied through performance or otherwise extinguished. Judgment may be required to determine when such amounts can be recognized and whether they represent additional revenue from the contract or other income.

***Resources***

- PwC's *Revenue from contracts with customers* guide, *Section 2.6.1*, *Section 2.6.2*, *Section 2.6.3*, *Section 2.9*, and *Section 4.2*
- ASC 606, *Revenue from Contracts with Customers*

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## QUESTION 1.4

*How should companies consider economic uncertainty in developing their estimate of current expected credit losses (CECL) for customer receivables?*

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### *PwC response*

The CECL model requires companies to consider current conditions and reasonable and supportable forecasts in developing an estimate of expected credit losses. This estimate requires the use of judgment, especially in times of economic uncertainty. Given the economic downturn we are currently experiencing, and the broader macroeconomic challenges, we expect that many companies will recognize additional allowances for credit losses related to their trade receivables, loans, and other financial assets carried at amortized cost.

Companies should (1) update their models and estimates to reflect the revised economic outlook due to the the recent economic downturn as well as implications arising from implemented or announced sanctions against various jurisdictions in light of geopolitical conflict, (2) perform sensitivity analyses based on the new forecasts, (3) adjust probability weighting on alternative scenarios, and (4) consider qualitative adjustments.

Companies should also consider the impact of current conditions and economic forecasts relating to specific sectors, geographical areas, and borrower-specific exposures. Factors to consider include whether models reflect specific risks, whether data used in estimates (e.g., ratings or other indicators) reflect current conditions and reasonable and supportable forecasts, and changes in the value of any collateral.

In addition, if a company has not yet adopted ASU 2022-02, which eliminates the special accounting model for creditors in a troubled debt restructuring (TDR), the CECL model requires consideration of all of the effects of a TDR on estimated credit losses when it has a reasonable expectation at the reporting date that it will execute a TDR with the borrower.

For entities that have adopted the CECL guidance in ASU 2016-13, ASU 2022-02 is effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For entities that have not yet adopted ASU 2016-13, ASU 2022-02 is effective for the adoption of ASU 2016-13.

***Resources***

- PwC's *Loans and investments* guide, *Chapter 7*
- SEC Staff Accounting Bulletin No. 119 (Topic 6.M)

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# Investments

### *Financial asset impairments*

The impairment model for financial assets depends on the type of asset. The model for some assets was impacted by adoption of ASC 326, *Financial Instruments—Credit Losses*, which was effective for calendar year-end SEC filers (other than smaller reporting companies) on January 1, 2020.

| Type of asset | Model | Challenges due to current environment |
|---|---|---|
| Financial assets measured at amortized cost (including loans, held-to-maturity debt securities and trade receivables) and certain off-balance sheet items, such as loan commitments/credit guarantees | Current expected credit losses (CECL): estimate credit losses expected over the "life" of an asset (or pool of assets)<br>Consider:<br>• Historical & current information<br>• Reasonable and supportable forecasts of future events and | Determining impact of market events on reasonable and supportable forecast assumptions, including macroeconomic forecasts<br>Changes to collateral values/sector impacts, etc.<br>Changes to expected life of loans (e.g., prepayments) |

| Type of asset | Model | Challenges due to current environment |
|---|---|---|
| | circumstances<br>• Estimates of prepayments<br>• Certain contractually provided extension options | Model requires consideration of reasonably expected troubled debt restructurings<br>First period of required qualitative and quantitative disclosures, including a description of how the allowance was determined |
| Available-for-sale debt securities | Credit allowance may need to be established if the fair value of the debt security is less than its amortized cost basis<br>Allowance established at security level | First period of required disclosures<br>Requires discounted cash flow analysis to evaluate for credit loss when fair value is below amortized cost; many use qualitative filters that may not be designed for the current environment |
| Equity instruments at fair value | Measured at fair value each period with changes recorded in earnings | Determination of fair value may require additional judgment |
| Equity instruments under the measurement alternative | Remeasurement to fair value required when there is an impairment or there are observable price changes in orderly transactions for the identical or similar investment of the same issuer investment of the same issuer | Impairment model is qualitative; using indicators and determination of fair value upon impairment will require judgment<br>Market activity may result in additional observable transactions requiring remeasurement to fair value in additional observable transactions requiring remeasurement to fair value |
| Equity method investments | Impairment charge recognized in earnings when the decline in value below the carrying amount is determined to be other than temporary | Determination of whether the investment is other than temporarily impaired will require judgment given market decline<br>Considerations of (1) duration and severity of market value being less than cost, (2) financial condition and near-term prospects of the investee, and (3) the intent and ability to retain investment for a period of time sufficient to allow for any anticipated recovery in market value |

## QUESTION 2.1

*Many financial and nonfinancial markets have experienced disruption from geopolitical conflict and related economic sanctions as well as significant volatility. What are some of the implications of these events on the determination of fair value?*

### *PwC response*

ASC 820-10-20 defines fair value as: "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." Inherent in this definition are a number of inputs that may be affected by current events.

*Price*

Depending on the asset or liability in question, historically available market-based prices may no longer be available, because, for example, the respective markets are affected by global sanctions.

Information used in fair value models, other than market-observable prices, should consider all information that is known or knowable to market participants as of the measurement date, whether that information is obtained prior or subsequent to the balance sheet date. For events that occur after the measurement date that provide information about facts that were not in existence on the measurement date, including market price movements, the nature and significance of the event may warrant disclosure. This will require the use of professional judgment and should be based on the individual facts and circumstances related to the assessed asset or liability.

To the extent management is determining expected prices based on discounted cash flow analysis and similar valuation methodologies, they should document the significant judgments related to such cash flows and associated uncertainties, including the consideration of various scenarios and the applied valuation methodology. Management will also have to consider the significant uncertainties around inputs such as interest and foreign currency rates.

*Principal or most advantageous market*

ASC 820-10-35-5 through ASC 820-10-35-6C describe the principal market as the market with the greatest volume and level of activity for the asset or liability from the perspective of a market participant. In the absence of a principal market, the most advantageous market should be used. The most advantageous market is the market that maximizes the amount that would be received to sell the asset or minimizes the amount that would be paid to transfer the liability, after taking into account transaction costs and transportation costs. In evaluating the principal or most advantageous markets, ASC 820 restricts the eligible markets to only those that the company can access at the measurement date.

ASC 820-10-35-6C acknowledges that there may not always be an observable market: "Even where there is no observable market to provide pricing information about the sale of an asset or the transfer of a liability at the measurement date, a fair value measurement shall assume that a transaction takes place at that date, considered from the perspective of a market participant that holds the asset or owes the liability. That assumed transaction establishes a basis for estimating the price to sell the asset or to transfer the liability."

*Market participant*

The above definition of an assumed transaction, in the absence of market-based pricing, puts significant focus on the determination of the appropriate market participants with whom the company would transact. As a result of the geopolitical environment, the historically applied perspectives may no longer be valid and certain counterparties may not be available. As such, management will have to assess if historical assumptions are still sustainable or who presently would be a relevant market participant and how that may affect the price or other inputs when determining fair value.

When there is no market available to the company, it may have to determine the characteristics of a market participant to which it would hypothetically sell the asset if it were seeking to do so. Once the market participant characteristics have been determined, the company would identify the assumptions that those market participants would consider when pricing the asset. The company should construct a hypothetical or "most likely" market for the asset based on its own assumptions about what market participants would consider in negotiating a sale of the asset or transfer of the liability.

***Resources***

- PwC's Fair value measurements guide, *Chapter 4*
- ASC 820, *Fair Value Measurements*

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## QUESTION 2.2

*In determining the fair value of an investment or other financial instrument, can a company adjust or disregard a quoted price in an active market (that is, a level 1 input) in a period of significant market volatility?*

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### *PwC response*

The objective of "fair value" is to determine a price at which an orderly transaction would take place between market participants under conditions that existed at the measurement date. It would not be appropriate to adjust or disregard observable transactions unless those transactions are determined to not be orderly. Generally, there is a high bar to conclude that a transaction price is not orderly under ASC 820. Although ASC 820-10-35-54I provides a list of factors to consider that may indicate a transaction is not orderly, we believe there is an implicit rebuttable presumption that observable transactions between unrelated parties are orderly and therefore, evidence to the contrary should be incontrovertible. Accordingly, we would expect that the fair value of an investment in an active market would continue to be calculated as the product of the quoted price for the individual instrument times the quantity held (commonly referred to as "P times Q"), even in times of significant market volatility.

In a period of significant market volatility, investments that may have previously had an active market and quoted prices may be reduced to level 2 or level 3 inputs for valuation purposes.

**Resources**

- PwC's *Fair value* guide, Chapter 7

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## QUESTION 2.3

*How should a company determine whether a credit loss allowance is necessary for an available-for-sale debt security (after adoption of the CECL model codified in ASC 326)?*

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### PwC response

An available-for-sale debt security is considered impaired if the fair value of the security is less than its amortized cost basis.

If a company concludes that it does not intend to sell (and it is not more likely than not that it would be required to sell) an impaired security before recovery of its amortized cost basis, a company needs to determine whether any portion of the impairment relates to credit losses. If so, an allowance for credit losses is established through net income. This determination is based on an analysis of the present value of contractual cash flows expected to be collected as compared to the amortized cost basis. Any portion of the impairment not related to credit losses would continue to be recognized in other comprehensive income. The amount of any allowance for credit losses is limited to the amount by which fair value is less than amortized cost. In practice, many companies evaluate whether an allowance is necessary based upon qualitative filters (e.g., credit rating). Given the current environment, those filters alone may not be sufficient to identify credit losses.

If the security is impaired and the company intends to sell (or will more likely than not be required to sell) the security before recovering its amortized cost basis, a company should first write off any previously recognized allowance for credit losses with an offsetting entry to the security's amortized cost basis. If the allowance has been fully written off and fair value is less than amortized cost basis, a company should directly write down the amortized cost basis of the asset to its fair value with an offsetting entry to net income.

**Resources**

- PwC's *Loans and investments* guide, Chapter 8
- ASC 326, *Financial Instruments - Credit Losses*

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## QUESTION 2.4

*For held-to-maturity and available-for-sale debt securities, how should companies consider whether declines below carrying value are other than temporary, under the standards in effect prior to the adoption of the credit loss standard (ASC 326)?*

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### PwC response

An investment in a debt security is considered impaired if the security's fair value is less than its amortized cost at the balance sheet date. Prior to the adoption of ASU

2016-13, if impairment exists, the accounting and reporting model, including the determination of whether that impairment is "other than temporary," differs depending on the facts and circumstances.

- If a debt security is impaired, additional analysis is needed to determine whether the impairment is temporary or other than temporary (OTTI):
  - If an investor intends to sell an impaired debt security, the impairment is considered to be other than temporary. The impairment would be measured as the difference between fair value and amortized cost.
- If an investor does not intend to sell the impaired debt security, the investor must consider available evidence to assess whether it is more likely than not (MLTN) they will be required to sell the security before the recovery of its amortized cost basis (e.g., whether its cash or working capital requirements, or contractual or regulatory obligations, indicate the security will be required to be sold before a forecasted recovery occurs). If the investor will MLTN be required to sell the security before recovery of its amortized cost basis, the impairment is considered to be other than temporary. The impairment would be measured as the difference between fair value and amortized cost.

If the investor does not intend to sell the impaired security and it is not MLTN that the investor will be required to sell the impaired security, an analysis should be performed to determine whether a credit loss exists. In assessing whether a credit loss exists, an investor must compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If the present value of the cash flows expected to be collected is less than the amortized cost basis of the security, the entire amortized cost basis of the security will not be recovered (i.e., a credit loss exists), and an other-than-temporary impairment is considered to have occurred. The impairment recorded in earnings would be based on the difference between the amortized cost basis and present value of future cash flows. In practice, in applying the guidance, many companies may evaluate whether an impairment is necessary based upon qualitative filters (e.g., credit rating). Given current events, those filters may not be sufficient to identify credit losses.

***Resources***

- PwC's *Loans and investments* guide, *Chapter 8*

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## QUESTION 2.5

*Given the rapidly evolving nature of recent economic and market events, what should companies consider in developing their estimate of current expected credit losses for held-to-maturity debt securities?*

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### *PwC response*

CECL requires companies to consider current conditions and reasonable and supportable forecasts in developing an estimate of expected credit losses. This estimate requires the use of judgment, especially in times of economic uncertainty.

Companies should update their models and estimates to reflect the revised economic outlooks, perform sensitivity analyses based on the new forecasts, adjust probability weighting on alternative scenarios, consider qualitative adjustments, and/or provide additional disclosures. In addition, the CECL model requires consideration of all of

the effects of a troubled debt restructuring (TDR) on estimated credit losses when it has a reasonable expectation at the reporting date that it will execute a TDR with the borrower. Note that ASU 2022-02 has eliminated the accounting guidance for TDRs for creditors. For entities that have adopted ASU 2016-13, ASU 2022-02 is effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For entities that have not yet adopted ASU 2016-13, ASU 2022-02 is effective upon adoption of ASU 2016-13.

Companies should also consider the impact of current conditions and economic forecasts relating to specific sectors, geographical areas (particularly those impacted by geopolitical conflict or sanctions), and borrower-specific exposures. Factors to consider include whether models reflect specific risks, whether data used in estimates (e.g., ratings or other indicators) reflect current conditions and reasonable and supportable forecasts, and changes in the value of any collateral.

Following a systematic and well-documented process consistent with the guidance in SEC Staff Accounting Bulletin No. 119 will continue to be important in developing the estimate for credit losses. In addition, it will be important for companies to provide transparent disclosures on the impact of the current economic environment including assumptions used and their impact on the estimate for credit losses.

***Resources***

- PwC's *Loans and investments* guide
- PwC's *Financial statement presentation* guide, *Chapter 9* (pre-ASC 326)
- ASC 326, *Financial Instruments - Credit Losses*

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## QUESTION 2.6

*How does the market downturn impact the accounting for investments in equity securities when a company applies the measurement alternative under ASC 321?*

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### *PwC response*

When a company elects the measurement alternative in ASC 321, the equity interest is initially recorded at cost. The carrying amount should be subsequently remeasured to its fair value in accordance with the provisions of ASC 820 when either (a) there are observable price changes (i.e., observable prices in orderly transactions for an identical or similar investment of the same issuer) or (b) it is impaired. The fair value measurement in response to observable transactions would be as of the transaction date. If the fair value measurement is in response to impairment, the measurement date would be period end. Any adjustments to the carrying amount are recorded in net income.

In the current environment, investors may be adjusting their investment strategies, which may increase the likelihood of an observable transaction. In addition, increasing or decreasing an investment in a company should be assessed for whether it represents an observable transaction.

In the absence of any observable transactions, an investment in an equity security is impaired if based on a qualitative assessment of impairment indicators, the fair value of the equity interest is less than its carrying amount. If considered impaired, the difference between the carrying amount and fair value determined in accordance with

ASC 820 should be recognized immediately in net income., Declines in the market values of equity securities in a particular industry may be a qualitative indicator of impairment, even in the absence of observable transactions. Companies should consider whether the fair value of the equity instrument could be below its carrying amount.

In assessing an equity investment for impairment, the measurement alternative model does not include a significance threshold or the ability to avoid an impairment if a company believes the decline in fair value is temporary. ASC 321 does not include the concept of "other than temporary" as it relates to an impairment assessment. The impairment model under ASC 321 is a one-step impairment model under which a company should determine the fair value of an equity investment in accordance with ASC 820 if it has reason to believe the investment's fair value is below the carrying value. If the equity investment's fair value is below the carrying value, the company must record an impairment for the difference.

If there are no recent observable transactions, a company may be using a discounted cash flow model to estimate the fair value. Due to rising interest rates, there is likely an increase to the discount rate, which would reduce fair value and could lead to an impairment.

***Resources***

- ASC 321, *Investments - Equity Securities*
- ASC 820, *Fair Value Measurements*

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## QUESTION 2.7

*When should a company record and how should it measure an impairment of an equity method investment?*

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### *PwC response*

A company should record an impairment charge in earnings when there is a decline in the fair value of the investment below its carrying amount that is other than temporary. The unit of account for assessing whether there is an other-than-temporary impairment (OTTI) is the carrying value of the investment as a whole.

All available evidence should be considered in assessing whether a decline in value is other than temporary. The relative importance placed on individual facts may vary depending on the situation. Factors to consider in assessing whether a decline in value is other than temporary include:

- The length of time (duration) and the extent (severity) to which the market value has been less than cost,
- The financial condition and near-term prospects of the investee, including any specific events that may influence the operations of the investee, such as changes in costs for raw materials for their product or decreases in demand for their products that may affect the future earnings potential, and
- The intent and ability of the investor to retain its investment in the investee for a period of time sufficient to allow for any anticipated recovery in market value.

Consideration should also be given to the reasons for the impairment and the period over which the investment is expected to recover. The longer the expected period of recovery, the stronger and more objective the positive evidence needs to be in order to overcome the presumption that the impairment is other than temporary.

Once a determination is made that an OTTI exists, the investment should be written down to its fair value in accordance with ASC 820, *Fair Value Measurements*, which establishes a new cost basis. Therefore, the use of an "undiscounted cash flow" approach is not an appropriate means of assessing the amount of an impairment charge. In addition, bifurcation of declines in value between "temporary" and "other than temporary" is not allowed.

*Timing of assessment*

Fair value is determined at the reporting date for the purposes of an impairment, regardless of whether the investor accounts for the investment on a lag. Therefore, subsequent declines or recoveries after the reporting date are not considered in the determination of fair value. A previously recognized OTTI cannot subsequently be reversed if fair value increases above the original carrying amount.

When an investor records an OTTI, the investor is required to attribute the impairment charge to the underlying equity method memo accounts of its investment. The attribution may create new basis differences, increase existing basis differences, or reduce existing basis differences. ASC 323, *Investments—Equity Method and Joint Ventures*, does not provide guidance on attributing the amount of an OTTI to the investor's equity method memo accounts. We believe there are several acceptable methods to attribute the charge; however, the method applied should be reasonable and applied consistently.

*Consideration of cumulative translation adjustment balances*

An investor may have an equity method investment in, or within, a foreign entity and a related cumulative translation adjustment balance. Unless an entity has committed to a plan to dispose of the equity method investment that would cause reclassification of some amount of CTA into earnings (i.e., the equity method investment is part of a disposal group held for sale), any accumulated foreign currency translation adjustments related to the equity method investment should be excluded from its carrying amount when assessing for impairment.

***Resources***

- PwC's *Foreign currency* guide, *Chapter 8*
- PwC's *Equity method investments and joint ventures* guide, *Chapter 4*
- ASC 323, *Investments - Equity Method and Joint Ventures*

# Inventory

## QUESTION 3.1

*A broader economic recession may affect customer demand or purchasing capabilities. In the current environment, how should a company think about the net realizable value (NRV) of inventory, including purchase commitments?*

### *PwC response*

For inventories measured using any method other than LIFO or the retail inventory method, ASC 330-10-35 establishes the lower of cost and net realizable value measurement principle for inventories. A different model (i.e., lower of cost or market) applies for inventories initially measured using LIFO or the retail inventory method (see ASC 330-10-35-1C through ASC 330-10-35-7).

ASC 330 defines "net realizable value" as the estimated selling price in the ordinary course of business less reasonably predictable costs of completion, disposal, and transportation. Additionally, ASC 330-10-35-4 states that no loss should be recognized on inventories unless it is clear that a loss has been sustained.

In applying the lower of cost and NRV principle to raw materials and work-in-progress inventories, it is necessary to estimate the costs to convert those items into saleable finished goods in order to determine NRV. In determining the net amount to be realized on subsequent sales, selling costs should include only direct items, such as shipping and commissions on sales.

Determining NRV at the balance sheet date requires the application of professional judgment, and all available data, including changes in product prices experienced or anticipated subsequent to the balance sheet date, should be considered. For example, a subsequent decrease in prices may indicate the need for an NRV adjustment for inventory on hand at the balance sheet date. Thus, a decrease in selling price subsequent to the balance sheet date that is not the result of unusual circumstances generally should be considered in determining NRV at the balance sheet date.

ASC 270-10-45-6 and ASC 330-10-55-2 require that inventories be written down during an interim period to the lower of cost and NRV unless substantial evidence exists that the net realizable value will recover before the inventory is sold in the fiscal year. Situations in which an interim write-down would not be necessary are generally limited to seasonal price fluctuations. Given the significant uncertainties associated with the current market conditions, we believe it would be challenging for a company to conclude that such substantial evidence exists. This would also likely be the case for inventory intended to be sold in markets impacted by geopolitical conflict or sanctions.

As detailed in ASC 270-10-45-6, inventory losses from declines in NRV should not be deferred beyond the interim period in which the declines occur if they are not expected to be restored in the same fiscal year. Recoveries of such losses on the same inventory in later interim periods of the same fiscal year should be recognized as gains in the later interim period. Such gains cannot exceed previously recognized losses.

As indicated in SAB Topic 5.BB, based on ASC 330-10-35-14, a write-down of inventory to the lower of cost and NRV at the close of a fiscal period creates a new cost basis that subsequently cannot be marked up based on changes in underlying circumstances after the company's fiscal year-end. Based on this guidance, lower of cost and NRV write-downs recorded during an interim period can be reversed (partially or fully) only in subsequent interim periods of the same fiscal year if NRV recovers.

Losses expected to arise from firm, non-cancelable and unhedged commitments for the future purchase of inventory items should be recognized unless the losses are recoverable through firm sales contracts or other means pursuant to ASC 330-10-35-17 through ASC 330-10-35-18.

***Resources***

- PwC's *Inventory* guide, *Chapter 1*
- PwC's *Accounting for inventory: 5 things you need to know* podcast

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## QUESTION 3.2

*How might idle capacity, decreased production, or increased costs associated with acquiring and moving goods through the supply chain impact inventory costing?*

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### *PwC response*

ASC 330-10-30-3 through ASC 330-10-30-4 indicates that variable production overhead costs should be allocated to each unit of production on the basis of the actual use of the production facilities. The allocation of fixed production overhead costs, however, is required to be based on the "normal capacity" of the production facilities, which is defined as the production expected to be achieved over a number of periods under normal circumstances, taking into consideration loss of capacity resulting from planned maintenance. Judgment is required to determine what represents an abnormally low production level and the range of normal capacity will vary based on business and industry factors.

While production from some operations may have been reduced or others may have been temporarily idled due to supply chain challenges, the amount of fixed overhead costs allocated to each unit of production should not be increased as a consequence of such abnormally low production. Unabsorbed fixed overhead costs should be expensed in the period in which they are incurred.

In addition, ASC 330-10-30-7 requires that abnormal amounts of freight, handling costs, and wasted material (spoilage) be recognized as current period charges and not included in the cost of inventory. Higher than normal or higher than anticipated costs for otherwise routine activities are not "abnormal costs" in this context. In addition, the concept of spoilage refers specifically to goods that are damaged, destroyed, or lost during the production process. Merely incurring higher costs when acquiring inventory from third parties is not considered "wasted materials." Those higher costs should be capitalized, subject to lower of cost and net realizable value considerations. Also, companies should consider additional disclosures around the current and expected impact of increased costs on their financial results, particularly those entities that use the last-in, first out (LIFO) inventory cost flow assumption. Based on SEC guidance, disclosures might include any material adverse impacts on

the supply chain or the methods used to distribute products or services and any material changes in the relationship between costs and revenues.

***Resources***

- PwC's *Inventory* guide, *Chapter 1*
- ASC 330, *Inventory*

# Property, plant and equipment

## QUESTION 4.1

*What events may indicate the need to perform an impairment test of long-lived property, plant and equipment?*

### *PwC response*

The nature and need for an impairment test will vary depending on the type of asset. The following chart summarizes the requirements for impairment testing under ASC 360, *Property, Plant, and Equipment*, which includes long-lived assets and amortizable intangible assets.

| | |
|---|---|
| Frequency | Trigger based |
| Methodology | Two step |
| Focus | Recoverability of asset carrying amount |
| Additional guidance | PPE 5 |

Long-lived assets and intangible assets subject to amortization should be tested for recoverability when events or changes in circumstances indicate that their carrying amount may not be recoverable. ASC 360-10-35-21 includes the following examples of such events or changes in circumstances:

**Excerpt from ASC 360-10-35-21**

a. A significant decrease in the market price of a long-lived asset (asset group)

b. A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition

c. A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator

d. An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)

e. A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)

f. A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

## QUESTION 4.2

*If production facilities are idle, should a company consider changes in depreciation?*

### *PwC response*

Facilities that are temporarily vacant or idle should continue to be depreciated. However, extended inactivity due to supply chain challenges, lack of raw materials, or other factors may demonstrate the need to reassess the useful life of the long-lived asset. Plans to abandon the asset before the end of its previously estimated useful life, which may also be a decision based on higher total life cycle costs of the asset driven by other macroeconomic factors like inflation and rising interest rates, would also require shortening its useful life.

***Resources***

- PwC's *Property, plant, equipment and other assets* guide

# Intangibles and Goodwill

## QUESTION 5.1

*What events may indicate the need to perform an impairment test of intangible assets and/or goodwill?*

### *PwC response*

The nature and need for an impairment test will vary depending on the type of asset. The following chart summarizes the requirements for impairment testing under ASC 350, *Intangibles - Goodwill and Other*.

| | Indefinite-lived intangible assets | Goodwill |
|---|---|---|
| Frequency | Annual/trigger based | Annual/trigger based |
| Methodology | One step | One step* |
| Focus | Fair value of the individual asset | Fair value of the reporting unit* |
| Additional guidance | BCG 8.3 | BCG 9.5 |

*Assumes adoption of ASU 2017-04, *Simplifying the Test for Goodwill Impairment*

According to ASC 350-30-35-18, "An intangible asset not subject to amortization shall be tested for impairment annually or more frequently if events or changes in circumstances indicate that it is more likely than not that the asset is impaired." ASC 350-30-35-18B provides the following examples of events that could affect the significant inputs used to determine the fair value of an indefinite-lived intangible asset.

**Excerpt from ASC 350-30-35-18B**

a. Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on future expected earnings and cash flows that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset
b. Financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset
c. Legal, regulatory, contractual, political, business, or other factors, including asset-specific factors that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset
d. Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset
e. Industry and market considerations such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (in both absolute terms and relative to peers), or a change in the market for an entity's products or services due to the effects of obsolescence, demand, competition, or other economic factors (such as the stability of the industry, known technological advances, legislative action that results in an uncertain or changing business environment, and expected changes in distribution channels) that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset
f. Macroeconomic conditions such as deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset.

ASC 350-20-35-3C lists the following examples of indicators for when an interim impairment test of goodwill may be required:

**Excerpt from ASC 350-20-35-3C**

a. Macroeconomic conditions, such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates, or other developments in equity and credit markets

b. Industry and market considerations, such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (consider in both absolute terms and relative to peers), a change in the market for an entity's products or services, or a regulatory or political development

c. Cost factors such as increases in raw materials, labor, or other costs that have a negative effect on earnings and cash flows

d. Overall financial performance, such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods

e. Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation

f. Events affecting a reporting unit such as a change in the composition or carrying amount of its net assets, a more-likely-than-not expectation of selling or disposing of all, or a portion, of a reporting unit, the testing for recoverability of a significant asset group within a reporting unit, or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit

g. If applicable, a sustained decrease in share price (consider in both absolute terms and relative to peers).

***Resources***

- ASC 350, *Intangibles - Goodwill and Other*

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## QUESTION 5.2

*Company management has considered the events and circumstances that could require an interim goodwill impairment assessment described in ASC 350-20-35-3C and does not believe an interim triggering event has occurred. On that basis, is management required to perform an interim impairment test for goodwill?*

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### *PwC response*

The interim impairment indicators listed in ASC 350-20-35-3C are only examples, and are not an exhaustive list. Ultimately, the threshold is whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount. ASC 350-20-35-3F indicates that an entity should consider other relevant events and circumstances that affect the fair value or carrying amount of a reporting unit.

Additional examples of events or circumstances that may indicate that an interim impairment test is necessary include:

- Impairments of other assets or the establishment of a valuation allowance on deferred tax assets
- Negative operating cash flows or operating losses at the reporting unit level (the greater the significance and duration of losses, the more likely it is that a triggering event has occurred)
- Negative current events or longer-term outlooks for specific industries impacting the company as a whole or specific reporting units
- Failure to meet analyst expectations or internal forecasts in consecutive reporting periods, or downward adjustments to future forecasts
- Planned or announced plant closures, layoffs, or asset dispositions
- Market capitalization of the company below its book value

Therefore, management must consider all relevant facts and circumstances in order to conclude that it does not have a requirement to perform an interim impairment test for goodwill.

***Resources***

- ASC 350, *Intangibles - Goodwill and Other*

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## QUESTION 5.3

*If a company's market capitalization is below its book value, is this a triggering event to perform an interim goodwill impairment analysis?*

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### *PwC response*

Not necessarily. While market capitalization generally reflects the market's expectations of future cash flows of a company, the goodwill impairment assessment is performed at the reporting unit level. An impairment assessment is performed if a company determines that it is "more likely than not" that the fair value of a reporting unit is less than its carrying amount. When a substantial decline in market capitalization occurs, a company may need to consider whether its projections reflect current expectations of recent economic conditions.

A decline in market capitalization that is severe, even if it is recent, as a result of an event that is expected to continue to affect the company (e.g., reduction in customer demand) may trigger the need for a test.

***Resources***

- PwC's *Business combinations* guide, *Section 9.5*
- ASC 350, *Intangibles - Goodwill and Other*

## QUESTION 5.4

*If a company experiences a decline in market capitalization that is consistent with declines experienced by others within its industry, is it reasonable for the company to assert that a triggering event has not occurred?*

### *PwC response*

There are times when a distressed transaction may be put aside. However, a distressed market cannot be ignored. A decline in a company's market capitalization consistent with declines experienced by others within its industry may be reflective of the underlying value of the company in a distressed market. Entities should distinguish between a distressed market, in which prices decline yet liquidity exists with sufficient volume, and a forced or distressed transaction. Transactions at depressed prices in a distressed market would not typically be distressed transactions.

**Resources**

- PwC's *Business combinations* guide, *Section 9.5*
- ASC 350, *Intangibles - Goodwill and Other*

## QUESTION 5.5

*When calculating a goodwill impairment, how are deferred tax assets considered?*

### *PwC response*

Taxable business combinations can generate goodwill that is deductible for tax purposes. When such goodwill is impaired for financial reporting purposes, there may be an impact on deferred taxes. If that is the case, the amount of the goodwill impairment may not simply equal the difference between the fair value of the reporting unit and its carrying amount because the goodwill impairment may affect the deferred tax asset or liability associated with goodwill. In these cases, the guidance in ASC 350-20-55-23A through ASC 350-20-55-23D should be followed, which illustrates a simultaneous equation method to determine the amount of the goodwill impairment and the associated deferred income tax benefit.

**Resources**

- PwC's *Business combinations* guide, *Section 9.9*
- ASC 350, *Intangibles - Goodwill and Other*

## QUESTION 5.6

*Does it matter in which order a company performs its impairment testing of goodwill and other long-lived assets?*

### *PwC response*

Yes. If goodwill and long-lived assets of a reporting unit that are held and used (as opposed to held for sale) are tested for impairment at the same time, the impairment testing should be performed in the following order:

1. Assets and liabilities not covered by ASC 360, including indefinite-lived intangible assets (other than goodwill in the scope of ASC 350)
2. Long-lived assets in the scope of ASC 360, including right-of-use assets under leases
3. Goodwill

The carrying values of assets other than goodwill are adjusted, if necessary, for the result of each test prior to performing the next test. If an asset group is held for sale, goodwill should be tested in accordance with ASC 350 before performing the impairment test of the long-lived asset disposal group covered by ASC 360.

**Resources**

- PwC's *Property, plant, equipment and other assets* guide, *Section 5.2.2*

## QUESTION 5.7

*If management believes that the current trading price of its stock is not representative of fair value, can a company assert that the market data is not relevant when determining the fair value of a reporting unit?*

### *PwC response*

A company's market capitalization and other market data should be considered when assessing the fair value of a company's reporting units. In a depressed economy, declines in market capitalization could represent factors that should be considered in determining fair value, such as an overall re-pricing of the risk associated with the company. However, in inactive markets, market capitalization may not be representative of fair value, and other valuation methods may be required to measure the fair value of a company comprised of a single reporting unit. Determining the factors affecting market capitalization and their impact on fair value requires the application of judgment.

**Resources**

- PwC's *Business combinations* guide, *Section 9.7*

## QUESTION 5.8

*Could a company reflect the uncertainty of future projections by modeling multiple scenarios, rather than modeling a single scenario that reflects only its best estimate?*

### *PwC response*

Yes. Changing from modeling one scenario to using multiple scenarios is considered a change in valuation technique. ASC 820-10-35-25 indicates that a change in valuation technique is appropriate if it is equally or more representative of fair value in the circumstances. In situations when a company faces a wide range of possible scenarios, it can be difficult to come up with a single cash flow forecast and an appropriate discount rate. For example, a company may determine that financial projections will vary greatly depending on the effectiveness of any measures taken to address relevant issues or constraints to the various inputs to the company's cash flow models.

Additionally, under the single cash flow forecast model, the discount rate reflects the riskiness of the cash flows. That is, the cash flows are discounted to present value using a risk-adjusted rate of return. It is often difficult to establish the company's specific premium that captures this risk. Accordingly, to determine the fair value of a reporting unit, companies may find it easier to capture increased risk and uncertainty with an expected cash flow approach. This involves modeling a range of potential outcomes and probability-weighting each of them.

**Resources**

- PwC's *Fair value measurements* guide, *Chapter 4*
- ASC 820, *Fair Value Measurements*

## QUESTION 5.9

*How should a company derive the appropriate control premium?*

### *PwC response*

The price paid for a controlling interest in a company often exceeds the market capitalization of a company based on the trading price of its shares. This premium often reflects the ability of a controlling investor to achieve a greater economic benefit than a noncontrolling shareholder.

Control premiums can vary considerably depending on the nature of the business, industry, and other market conditions. Accordingly, determining a reasonable control premium will be a matter of judgment. Generally, when assessing the reasonableness of a control premium, companies should consider the current market conditions with respect to recent trends in their market capitalization, comparable transactions within their industry, the number of potential buyers, and the availability of financing. A well-reasoned and thoroughly documented assessment of the control premium is necessary and the level of supporting evidence in making this assessment would be expected to increase as the implied control premium increases from past norms. Further, in light of recent market events, consideration should be given as to whether

prior market transactions used to evaluate control premiums would be indicative of future transactions. The use of arbitrary percentages or rules of thumb would not be appropriate.

A control premium is often largely a function of synergies that a market participant would expect to realize by gaining control of the business. Therefore, one way to evaluate the reasonableness of a control premium is to perform a bottom's up approach by identifying areas where market participants could extract savings or synergies by obtaining control. In Valuations in Financial Reporting Valuation Advisory 3: The Measurement and Application of Market Participant Acquisition Premiums, the Appraisal Foundation provides a number of examples, including the ability to eliminate duplicative costs, diversify products, grow revenue in new markets, improve distribution channels, and lower risk due to diversification.

When deriving a control premium, it is important to note that the definition of a market participant in ASC 820, *Fair Value Measurement*, refers to one who has a reasonable understanding of the company "using all available information, including information that might be obtained through due diligence efforts that are usual and customary." Therefore, a control premium may reflect this knowledge.

In certain circumstances, it may not be appropriate to compute a control premium based on the average percentage premium of recent transactions within the company's sector, as the value that can be achieved with control may vary by company, even within the same industry sector. Similarly, while it is possible that certain companies may observe a higher control premium in an economic downturn, that determination would be specific to a company's particular facts and circumstances.

Accordingly, increased control premiums in the current market should be carefully evaluated. A larger control premium must be adequately supported and consider the synergies inherent in a market participant's perspective of the fair value of a reporting unit. Only in those instances when a reporting unit could command a higher price in the current market can management consider applying a high control premium. This assessment should be based on all facts and circumstances.

***Resources***

- Valuations in Financial Reporting Valuation Advisory 3: The Measurement and Application of Market Participant Acquisition Premiums
- ASC 820, *Fair Value Measurement*

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## QUESTION 5.10

*What is the impact of the current economic environment on the discount rate when using a discounted cash flow valuation technique?*

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### *PwC response*

The discount rate used in a discounted cash flow valuation technique includes a number of market inputs, including a risk-free rate and a cost of capital. With central banks increasing interest rates and, in turn, significantly higher interest rates in the market, the value of both of these inputs to developing a discount rate assumption has increased for reporting entities across a broad spectrum of industries. Thus, the

discount rate used in many discounted cash flow valuations is expected to increase. It is important to remember, though, that different valuation techniques capture risks through different inputs. The discount rate needs to be calibrated to the risks in the cash flow forecast, including the long-term growth rate, as well as volatility in the market that increases its risk profile.

In situations when a reporting entity faces a wide range of possible scenarios, it can be difficult to come up with a single cash flow forecast and appropriate discount rate combination. In these cases, it may be better to employ an expected cash flow approach (multiple probability-weighted cash flow scenarios) to appropriately capture the uncertainty associated with the cash flow forecasts. There might be a range of potential outcomes considering different scenarios, depending on which inputs are most significant to the calculation.

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## QUESTION 5.11

*What are common reconciling items between the aggregate fair values of a company's reporting units and its market capitalization?*

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### *PwC response*

When a difference exists between a company's market capitalization and the aggregate fair values of a company's reporting units, the reasons for the difference should be understood. A common reason for the aggregate fair values of the reporting units to exceed the company's market capitalization is that the control premium associated with each reporting unit is not reflected in the quoted market price of a single share of stock.

Other differences may be linked to external events or conditions, such as broad market reaction to circumstances associated with one or a few reporting companies. For example, the deteriorating financial condition of one company in a particular market sector could cause temporary market declines for other companies in the same sector. Short-term fluctuations in volatile markets may not necessarily reflect underlying fair values. It is therefore important to be able to explain the market fluctuations as part of the reconciliation of market capitalization to the estimated fair values of reporting units. The AICPA Goodwill Guide indicates it is a best practice to identify and document the reasons for differences between the aggregate fair value of reporting units and the observable market capitalization. Factors identified include control synergies, data about the reporting unit's cash flow forecasts that may not be available to a market participant, tax consequences, company-specific versus market participant capital structures, excessive short positions against the stock, and controlling or large block interests.

### *Resources*

- PwC's *Business combinations* guide, *Section 9.7*

## QUESTION 5.12

*When preparing a company's reconciliation of market capitalization to the sum of the reporting units' fair values, can a company use an average of market prices over a short period of time leading up to the date of impairment testing rather than a single day's market price?*

### *PwC response*

Given recent market volatility, it may be appropriate for a company to consider recent trends in its trading price instead of just a single day's trading price when determining the market capitalization that it should reconcile to the aggregate fair value of its reporting units. In some cases, share prices may have moved dramatically over a short period of time or there may be a specific event that may impact market prices. Frequently, companies use averages over relatively short periods to determine representative market values. However, companies must carefully evaluate all relevant facts and circumstances. For example, an average may not be appropriate if a company's share price had a steady downward decline. On the other hand, an average may be a reasonable proxy for fair value when share prices experience significant volatility.

**Resources**

- Robert G. Fox III, Professional Accounting Fellow, Office of the Chief Accountant. SEC, Remarks before the 2008 AICPA National Conference on Current SEC and PCAOB Developments

## QUESTION 5.13

*What are some of the disclosures a company may be required to include in its footnotes related to the impairment analyses for goodwill, indefinite-lived intangibles, and long-lived assets?*

### *PwC response*

There are a number of different disclosure requirements that a company should consider related to an impairment or potential impairment in the context of the current environment.

**Significant estimates**: As discussed in ASC 275-10-50-4 through ASC 275-10-50-8, a company should disclose their use of estimates when the resolution of matters could differ significantly from what is currently expected, and if it is reasonably possible that the estimates will change in the near term and the effect of the change will be material. Rising interest rates and inflation, volatile markets, and exacerbated supply chain challenges, among other macroeconomic trends, should all be continuously monitored by reporting entities to ensure its disclosures are appropriate. Given the uncertainty of financial markets driven by inflation and recession concerns, goodwill and other assets may or may not currently be impaired, though significant estimates used to make these assessments may change in the near term. If such change could be material, disclosure should be included in the footnotes.

**Change in methodology:** As discussed in ASC 820-10-50-2bbb, a change in a valuation approach or a valuation technique requires disclosure of the change and the reason such change was made. However, for this type of change, the disclosures required by ASC 250 for a change in accounting estimate are not required.

**Recognized impairments**: Recording an impairment results in an asset reported at fair value. This nonrecurring fair value measurement results in certain required disclosures under ASC 820. For example, ASC 820-10-50-1a requires a company to disclose the valuation techniques and inputs used to determine the fair value. See Refer to PwC's *Financial statement presentation* (FSP) guide, Section 20.3.1 for a complete listing of disclosure requirements.

When a long-lived asset is impaired, the company should include the nonrecurring measurement disclosures in (1) the quarter in which the impairment was recorded, (2) its subsequent quarterly filings for the year in which the impairment is recorded, and (3) the annual filings that include the quarter in which the charge was recognized. We believe the approach to include the disclosure in subsequent quarterly filings is consistent with the interim disclosure requirements in Rule 10-01 of Regulation S-X. The primary principle in S-X 10-01 is that the financial statement user will have read the prior year's annual financial statements and the quarterly financial statements should include disclosures for significant events that occurred during the current year, such as impairments. Also, because the year-to-date information is included in each quarterly report, an impairment in one quarter would be recognized in any following quarter's year-to-date information, and thus disclosure when material would be required.

For each long-lived asset, indefinite-lived intangible or goodwill impairment loss recognized, a company must disclose a description of the facts and circumstances that led to the impairment, the amount of the impairment loss, and the method of determining the fair value along with additional disclosures. See FSP Sections 8.6.1, 8.9.2, and 8.10.2 for a complete listing of these disclosures.

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## QUESTION 5.14 (added January 2023)

*How may increasing interest rates impact goodwill impairment assessments?*

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### *PwC response*

As discussed in Question 5.10, the discount rate used in many discounted cash flow valuation techniques is expected to increase during periods of increasing interest rates, which produces a lower present value of future cash flows. This, in turn, results in a lower fair value of a reporting unit used in a goodwill impairment test.

As a reminder, the guidance within ASC 350-30-35-18 notes that a reporting entity is required to assess goodwill or an indefinite-lived intangible asset for impairment as of a date other than its annual test date when events or changes in circumstances indicate that such impairment is more likely than not. Accordingly, each time interest rates increase, a reporting entity will need to consider whether to perform another impairment assessment, particularly when it has recently recorded an impairment charge. Assuming all other inputs in determining a reporting unit's fair value have not changed, further increases in the discount rate due to increases in interest rates will result in a further reduction in the fair value of the reporting unit, which will result in an incremental impairment charge. Recurring goodwill impairment charges would not be considered unusual in an environment of rising interest rates.

A reporting entity should carefully consider all inputs when determining the discount rate and estimating future cash flows for purposes of determining a reporting unit's fair value, which should also take into account the uncertainty associated with the future projections as discussed in Question 5.8.

***Resources***

- PwC's *Business combinations* guide, *Section 9.5*

# Debt

## QUESTION 6.1

*What should a company consider if it expects a debt covenant violation on or after the balance sheet date due to unfavorable market conditions?*

### *PwC response*

Debt is classified as current if the debt is puttable at the balance sheet date due to the covenant violation. If a lender waives its right to put the debt based on that particular covenant violation for at least one year from the balance sheet date, the debt will not automatically be classified as noncurrent. A company that has to meet the same or more restrictive covenant going forward must determine if it is probable that it will fail those covenants within one year from the balance sheet date. If it is probable, the debt must be classified as current despite the waiver.

The same assessment must be done if debt is modified to avoid a covenant violation at the balance sheet date. If a violation happened after the balance sheet date or is anticipated in the future, the debt would generally be classified as noncurrent, but transparent disclosure of the violation or potential violation is required.

***Resources***

- PwC's *Financial statement presentation* guide, *Section 12.3.3*
- PwC's *Accounting for debt in uncertain times: 5 things to know* podcast

## QUESTION 6.2

*What should a company consider if it restructures its debt?*

### *PwC response*

Anytime debt is restructured with the same lender, a company should first consider if the event constitutes a troubled debt restructuring. This is important because, in some cases, the accounting for a troubled debt restructuring can be significantly different from the accounting for a non-troubled debt restructuring. In order for a debt restructuring to be considered troubled, a company must be experiencing financial difficulties and the lender must grant a concession. ASC 470-60 provides indicators

to determine if a company is experiencing financial difficulties and guidance on how to determine if a concession was granted. If the transaction is not considered troubled, a company should consider whether the restructuring is a modification or extinguishment based on the guidance in ASC 470-50 (see Question 6.3).

***Resources***

- PwC's *Accounting for debt in uncertain times: 5 things to know* podcast
- PwC's *Borrower's accounting for debt restructurings: 5 things to know* podcast

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## QUESTION 6.3

*How does a company determine if a non-troubled term debt restructuring is a modification or extinguishment?*

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### *PwC response*

During uncertain economic times, a company may need to restructure its debt to extend the maturity date, change the timing of payments, change covenants, etc. Often, the lender will charge a fee or increase the interest rate in order to be compensated for these changes. While a company may be experiencing financial difficulties, the additional fee or interest may lead to a conclusion that no concession was granted, so the transaction is not considered troubled. Therefore, it needs to assess the transaction to determine if it is a modification or extinguishment based on the guidance in ASC 470-50.

In order to do this assessment, a company must determine if the new terms of the arrangement have substantially changed from the original debt. This analysis requires a present value calculation to determine if the change in contractual cash flow between the original debt and the restructured debt is greater than 10%. This assessment has some particular nuances that can often be overlooked. These nuances are covered in detail in the podcast and video included in the additional resources below.

If the change in cash flows is greater than 10%, the restructuring is accounted for as an extinguishment; otherwise, it is a modification. The difference between the two outcomes is summarized as follows:

| Type of transaction | Debt | New lender fees | New third-party fees |
|---|---|---|---|
| Extinguishment | A gain or loss is recorded for the difference between the net carrying value of the original debt and the fair value of the restructured debt. | Expense | Capitalize |
| Modification | No gain or loss is recorded. A new effective interest rate is established based on the carrying value of the debt and the restructured cash flows. | Capitalize | Expense |

***Resources***

- PwC's *Financing transactions* guide, *Chapter 3*

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## QUESTION 6.4

*What is the impact of liquidity risks, including substantial doubt about an entity's ability to continue as a going concern, on debt classification?*

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### *PwC response*

Debt agreements may contain a subjective acceleration clause (SAC) in which the lender can accelerate repayment if the borrower experiences an adverse change. These covenants are typically referred to as material adverse change (MAC) or material adverse effect (MAE) clauses. The likelihood of payment being accelerated impacts the classification of debt with a SAC. If acceleration of the due date is probable based on facts and circumstances at the balance sheet date, debt subject to a SAC should be classified as current. The accounting guidance indicates that liquidity issues and recurring losses are examples of instances that may make acceleration of debt probable.

A conclusion by the auditor that its report will need to contain an additional paragraph related to liquidity risks and uncertainties may indicate it is probable that the SAC will be exercised. Although the audit report is issued after the balance sheet date, the liquidity issues resulting in the additional paragraph in the auditor's report may have existed at the balance sheet date. Even with no additional paragraph, management's disclosure of liquidity issues may also indicate it is probable that the SAC will be exercised.

***Resources***

- PwC's *Accounting for debt in uncertain times: 5 things to know* podcast

# Derivatives and hedging

## QUESTION 7.1

*Companies that have designated forecasted transactions in cash flow hedging relationships, such as inventory purchases, sales or revenues, debt issuances, or interest payments, may have decreased their forecasts of transaction volume due to the current economic environment. How may the change in the probability of a hedged forecasted transaction impact the financial statements?*

### *PwC response*

The accounting impact will depend on the likelihood of the forecasted transaction occurring within two months of the originally specified time period:

- Transaction is still probable of occurring - If the forecasted transaction is probable of occurring by the end of the originally specified time period, hedge accounting should still be permissible and deferred derivative gains or losses should continue to be reported in accumulated other comprehensive income.
- Transaction is no longer probable of occurring - If at any time the likelihood of the hedged forecasted transaction ceases to be probable of occurring, hedge accounting will cease prospectively and all future changes in the fair value of the derivative would be recognized directly in earnings. Any derivative gains or losses deferred in AOCI prior to the change in likelihood will remain in AOCI until the forecasted transaction impacts earnings (or until the forecasted transaction becomes probable of not occurring).
- Transaction is probable of not occurring - If a company determines that the hedged forecasted transaction is probable of not occurring by the end of the originally specified time period (or within an additional two-month period), amounts deferred in AOCI are required to be recognized in earnings immediately.

Additionally, companies are required to disclose the amount of gains and losses reclassified from AOCI into earnings as a result of the discontinuance of hedge accounting.

As discussed in ASC 815-30-40-5, a pattern of missed forecasted transactions would call into question its ability to accurately predict forecasted transactions and the propriety of using cash flow hedge accounting in the future for similar transactions and thus companies should consider the impact of any missed forecasted transactions on other cash flow hedging relationships.

***Resources***

- PwC's *Derivatives and hedging* guide
- PwC's podcast: *Derivative toolkit: Hedging Debt with Derivatives*

- PwC's podcast: *Derivative toolkit: Do I have a derivative?*
- PwC's podcast: *Derivative toolkit: Deciphering foreign currency hedges*

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## QUESTION 7.2

*What is the potential impact of the current economic environment on a company's ability to continue designated transactions as hedges or to establish new hedges?*

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### *PwC response*

To qualify for hedge accounting, the relationship between a hedging instrument and a hedged item, both at inception and on an ongoing basis, must be highly effective in achieving offsetting changes in fair value or cash flows. Volatility in markets caused by current events may cause a company's existing hedges to no longer be effective, resulting in the need to discontinue hedge accounting, and may also make it difficult to assert that new hedges will be effective.

***Resources***

- PwC's *Derivatives and hedging* guide
- PwC's podcast: *Derivative toolkit: Hedging Debt with Derivatives*

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## QUESTION 7.3

*How may supply chain disruptions or changes in sales forecasts impact the ability for purchases and sales contracts to qualify for the normal purchases and normal sales derivative scope exception?*

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### *PwC response*

Companies with derivative contracts that qualify for the normal purchases and normal sales (NPNS) derivative scope exception should consider the impact of lower sales or purchase volumes on the assertion that physical delivery is probable. Under the NPNS exception, a company must conclude that it is probable — at inception and throughout the term of the contract — that physical delivery will occur.

If a reporting entity determines that it is no longer probable that a contract will result in physical delivery, it may need to discontinue its application of the NPNS exception. Whether and when a reporting entity should discontinue application of the normal purchases and normal sales scope exception partially depends on the form of net settlement applicable to the contract.

| Method of net settlement | Timing of changes in designation |
|---|---|
| Net settlement under contract terms (ASC 815-10-15-99a)<br>Net settlement through a market mechanism (ASC 815-10-15-99b) | The normal purchases and normal sales scope exception will cease to apply when physical delivery is no longer probable; this could occur prior to the actual net settlement. |
| Net settlement by delivery of asset that is readily convertible to cash (ASC 815-10-15-99c) | The normal purchases and normal sales scope exception will continue to apply until the contract is financially settled, even if management intends or otherwise knows that physical delivery is no longer probable. |

If a reporting entity determines that one contract no longer qualifies for the normal purchases and normal sales scope exception, this may call into question its ability to assert probable physical delivery for other similar contracts or contracts within a group.

***Resources***

- PwC's *Derivatives and hedging* guide

# Stock compensation

## QUESTION 8.1

*What is the impact if a company modifies performance targets of stock compensation awards to "rebalance" the targets in light of the impact of macroeconomic trends on the business, or allow grantees to earn awards that would not otherwise be earned based on actual results?*

### *PwC response*

In these situations, it is important to first remember the distinction between performance conditions, which would typically be company-specific targets, such as revenue or earnings, and market conditions, such as achieving a target stock price or total shareholder return. While both affect whether an employee actually earns an award, performance conditions affect how much (if any) compensation cost is recorded whereas market conditions only affect the grant date fair value of an award.

*Performance conditions*

If a company changes the performance targets (such as revenue or earnings) required to earn a stock compensation award, this would be considered a modification of the award. On the modification date of an equity-classified award, management should assess the probability of both the original and modified vesting conditions being satisfied.

If the award was probable of vesting before the modification and probable of vesting

after the modification, the cumulative amount of compensation cost that should be recognized over the requisite service period of the award is the original grant-date fair value of the award plus any incremental fair value resulting from the modification itself. For example, if the new performance targets will result in a higher number of awards that are probable of vesting than under the original terms, the fair value of those additional shares at the modification date would be considered the incremental fair value arising from the modification.

If the award was not probable of vesting before the modification, but the performance conditions are changed such that it is now probable of vesting after the modification, the cumulative compensation cost recognized for the original award would be zero immediately prior to the modification (as none of the awards were expected to vest). The "incremental" fair value is therefore equal to the fair value of the modified award on that date. This incremental compensation cost would be recognized over the remaining requisite service period, if any. This is considered a "Type III" (improbable-to-probable) modification under ASC 718-20-55-116 to ASC 718-20-55-117. In this situation, the amount of total compensation cost could be more or less than the original award's grant-date fair value.

*Market conditions*

Equity-classified awards with market conditions (such as a target stock price or total shareholder return) are measured and accounted for differently than awards with performance or service conditions. At the grant date, the effect of the market condition is reflected in the fair value of the award and the recognition of compensation cost is solely dependent upon the recipient completing the requisite service, regardless of whether the condition is actually achieved. If the grantee is expected to complete the requisite service at the time of the modification, a company would recognize compensation cost equal to the unrecognized grant-date fair value of the original award plus any incremental fair value of the modified award over the remaining requisite service period.

*Liability-classified awards*

The general principle of exchanging the original award for a new award also applies to a modification of a liability-classified award. Unlike an equity-classified award, however, a liability-classified award is remeasured at fair value at the end of each reporting period. Therefore, a company would simply recognize the fair value of the modified award by using the modified terms at the modification date. There is no "floor" or requirement to recognize at least as much as the grant-date fair value of a liability-classified award as the ultimate compensation expense will equal the fair value on the settlement date.

*All awards*

Modifications of stock compensation awards can only be reflected in the period that the modification actually occurs. Future modifications cannot be anticipated at the balance sheet date, and those that occur after the balance sheet but before the issuance of the financial statements are nonrecognized subsequent events. The accounting at the balance sheet date must reflect the terms as they existed at that date.

***Resources***

- PwC's *Stock-based compensation* guide, *Chapter 2*, *Chapter 4*, and *Chapter 9*
- PwC's *A refresh on stock comp basics before you modify your stock options* podcast

## QUESTION 8.2

*What is the impact if a company grants new performance-based stock compensation awards but wishes to delay setting the performance targets until there is greater clarity on the impact of macroeconomic trends on the company's business and forecasts?*

### *PwC response*

If a company issues a new share-based award that vests upon achieving a performance target, but delays setting the performance targets, management needs to consider whether a grant date has been established. A grant date is established and compensation cost becomes fixed based on the grant-date fair value of an equity-classified award when all of the following criteria are met:

- The company and the grantees have reached a mutual understanding of the award's key terms and conditions.
- The company is contingently obligated to issue shares or transfer assets to grantees who fulfill vesting conditions.
- The grantees begin to benefit from, or be adversely affected by, subsequent changes in the company's stock price (e.g., the exercise price for an option is known).
- Awards are approved by the board of directors, management, or both if such approvals are required, unless approval by one or more parties is considered perfunctory.
- The recipient is an employee (i.e., grant date cannot be established prior to the first day of employment) if the award is for employee service.

One of the key terms of an award is the vesting criteria: what the recipient must do in order to earn the award. For an award with a performance condition, the performance condition is part of the vesting criteria. If the performance target has not yet been defined and communicated, then a mutual understanding of the key terms and conditions of the award would not exist (ASC 718-10-55-95).

To establish a grant date, performance targets should be objectively determinable and measurable. However, this determination might not always be straightforward. For example, the company might issue an award with an initial performance target, but the compensation committee has the ability to adjust, at its discretion, the target itself or how performance against the target will be measured. When assessing whether the discretion by the compensation committee (or others with authority over the compensation arrangement) to make adjustments to performance targets related to a particular issue (or otherwise) impacts the timing of when a grant date has been achieved, a company should consider whether there are objective criteria for making adjustments to an award and whether the holders of the award have an understanding of when and how the terms of the award will be adjusted. As the impacts of recent macroeconomic trends likely remain subject to significant uncertainty, companies may find it challenging to assert that award holders would have a clear understanding of when and how the terms of the award will be adjusted.

If the company determines that a grant date has not been established, then it should also consider whether there is a "service inception date" prior to grant date. This is discussed in ASC 718-10-55-108. One of the key considerations in these

circumstances would likely be whether the award's terms include a substantive future requisite service condition that exists at the grant date (ASC 718-10-55-108(c)1). If the award will be fully vested by the time the performance condition is established, then it is likely that the service inception date precedes the grant date. In that case, a company should recognize compensation cost over the requisite service period beginning on the service inception date, and should remeasure the fair value of the award each period until the grant date.

If the service inception date does not precede the grant date, then no accounting is required (or appropriate) for the award until the grant date. No compensation cost would be recognized until that time, and the fair value of the award on the ultimate grant date would be recognized prospectively over the service period.

***Resources***

- PwC's *Stock-based compensation* guide, *Chapter 2*

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## QUESTION 8.3

*Can a company exclude recent stock price volatility when incorporating historical volatility into the determination of the expected volatility assumption needed to value stock options?*

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### *PwC response*

One of the inputs into determining the fair value of a stock option or related share-based payment award is the expected volatility of the company's stock price over the expected term of the option. All other things being equal, a higher volatility of the stock price results in a higher fair value of the award.

Volatility may be derived from historical stock price movements over time, implied from the market price of traded options or convertible securities (if the company has any), or inferred from the volatility of similar (peer) companies for non-public companies or those that have not been public for a long enough period of time to accumulate sufficient historical stock price activity. While typically a company would start with historical information, a company should also consider, based on available information, how the expected volatility of its share price may differ from historical volatility to estimate how a marketplace participant would value the award.

ASC 718-10-55-37(a) observes that in certain circumstances, an entity might disregard an identifiable period of time in which its share price was extraordinarily volatile because of a failed takeover bid if a similar event is not expected to recur during the expected term of the award. However, in order to exclude the historical data from the volatility calculations, such events should be specific to the company, under management's control, and not expected to recur during the expected term of the award. In SEC Staff Accounting Bulletin Topic 14, the SEC staff indicates that such exclusions are expected to be rare.

Based on the narrow company-specific example in ASC 718 and the guidance in the SAB Topic, we believe that volatility data that reflects the broader market, even if significantly different than historical experience, should not be excluded from a company's estimate of volatility.

**Resources**

- PwC's *Stock-based compensation* guide, Chapter 9
- SAB Topic 14 D.1 Question #2(5)

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## QUESTION 8.4

*Can a company use an average stock price over a period of time to measure the fair value of a stock compensation award?*

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### PwC response

No. ASC 718 requires the measurement of share-based awards to be based on their fair value on the measurement date. This applies to newly granted equity-classified awards, which would be measured at their grant-date fair value, as well as to new or existing liability-classified awards that are required to be remeasured to fair value at each period-end reporting date. The fair value of an award is measured based on the fair value of the underlying stock and any other relevant assumptions based on the nature of the award as of the applicable measurement date. Thus, using an average stock price over some other period would not be consistent with the measurement objective. The only exception to this requirement is if, pursuant to Staff Accounting Bulletin No. 120, management concludes that they have granted a "spring-loaded award," in which case an adjustment to the observable market price on the date of grant would likely be necessary.

**Resources**

- PwC's *Fair value measurements* guide, Chapter 4
- ASC 820, *Fair Value Measurements*
- PwC's *Stock-based compensation* guide, Chapter 2

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# Income taxes

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## QUESTION 9.1

*What should a company consider when assessing the need for a valuation allowance in the current environment?*

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### PwC response

Companies must reassess the need for a valuation allowance on deferred tax assets at each reporting date.

ASC 740-10-30-17 indicates that all available evidence should be considered when assessing the need for a valuation allowance. "All available evidence" includes historical information supplemented by all currently available information about future years. Events occurring subsequent to a company's period-end, but before the

financial statements are released, that provide additional evidence regarding the likelihood of realization of existing deferred tax assets should also be considered when determining whether a valuation allowance is needed.

ASC 740-10-30-21 indicates that it is difficult to avoid a valuation allowance when there is negative evidence such as cumulative losses in recent years. Losses expected in early future years and uncertainties whose unfavorable resolution would adversely affect future results are also negative evidence to be considered. Even if there has been income in recent years, companies need to consider projections of near-term future losses, including if they will result in a cumulative loss position.

Generally, a company's most recent results are the most objectively verifiable indicator of its future performance. This is why a cumulative loss is such a significant piece of negative evidence to overcome. Many companies rely on forecasts of taxable income exclusive of reversing temporary differences to support realization of some or all their deferred tax assets. Forecasts are inherently less objective than prior results, so if a company has a cumulative loss, then its forecast must reach the level of objectively verifiable in order to overcome the historical results. Often companies may use their most recent year's results as a baseline for its forecast of taxable income, adjusting it for items that are objectively verifiable (e.g., items that have already occurred, like the pay down of debt or the acquisition of a business late in the prior year). However, in the current environment, it may be harder to gauge whether the most recent results are indicative of future performance given the impact of the macroeconomic environment (negative or positive) on prior year results. This area will require significant judgment, and consideration of all available evidence given the current economic environment.

***Resources***

- PwC's *Income taxes* guide
- PwC's *Valuation allowance for deferred tax assets – the basics* podcast
- PwC's *Income tax accounting year-end reminders* podcast

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## QUESTION 9.2

*For purposes of interim reporting, how should a company estimate its annual effective tax rate if it is unsure how the current economic environment will impact operations?*

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### *PwC response*

At each interim period, a company is required to estimate its forecasted full-year annual effective tax rate (AETR). That rate is applied to year-to-date ordinary income or loss in order to compute the year-to-date income tax provision. In order to compute the AETR, a company needs to estimate its full year ordinary income and its total tax provision, including both current and deferred taxes. When a company is subject to tax in multiple jurisdictions, one overall (i.e., worldwide) estimated AETR is developed and applied to consolidated ordinary income (loss) for the year-to-date period.

Given the financial impact of recent events, it may be relevant for companies to consider ASC 740-270-30-18, which indicates that if a reliable estimate cannot be made, the actual effective tax rate for the year-to-date period may be the best estimate of the annual effective tax rate. Two additional exceptions may also be relevant:

- When a company operates in a jurisdiction that has generated ordinary losses on a year-to-date basis, or anticipates an ordinary loss for the full fiscal year, and no benefit can be recognized on those losses, the company should exclude that jurisdiction's income (or loss) from the overall estimate of the AETR. In effect, any jurisdictions with losses for which no benefit can be recognized are removed from the base calculation of the AETR and a separate AETR is calculated for that jurisdiction.
- When a company cannot make a reliable estimate of ordinary income for a particular jurisdiction, that jurisdiction should be excluded from the overall computation of the estimated AETR and a separate discrete calculation of its tax provision should be made. Determining whether an estimate is reliable requires the use of professional judgment. For example, in some cases, a small change in a company's estimated ordinary income could produce a significant change in the AETR. This might occur when a company that is anticipating only marginal pre-tax book profitability for the year has significant permanent differences that could result in wide variability in the tax expense (benefit) and, in turn, the AETR. In such cases, an estimate of the AETR would not be reliable if a small change in ordinary income were likely to occur. While there is a general presumption that companies will be able to make a reliable estimate of ordinary income, exceptional circumstances can exist in which a genuine inability to make a reliable estimate justifies exclusion of a jurisdiction from the worldwide effective tax rate. A company's assertion that it cannot develop a reliable estimate should be consistent with its other disclosures and communications to its investors, creditors, and other financial statement users.

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## QUESTION 9.3

*What other potential tax accounting implications may companies encounter due to pre-tax impacts from the current economic environment?*

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### *PwC response*

The current macroeconomic environment creates a number of pre-tax impacts that companies will need to assess for related tax accounting consequences. For example, the impairment of tangible and intangible assets may have an impact on a company's deferred taxes. The deferred tax accounting in connection with goodwill impairments can be particularly complex in certain instances.

In addition to the related tax accounting impacts of pre-tax items, companies may also have to consider any impact to their assertions with regard to deferred taxes on the outside basis difference in foreign subsidiaries in impacted territories. Currently, foreign investors and companies alike may be faced with not only restrictions on the ability to extract cash, but also decisions of whether to exit business operations in certain markets. As prescribed in ASC 740-30-25-17, the presumption that all undistributed earnings will be transferred to the parent entity may be overcome and no income taxes accrued by the parent for entities that can evidence that a subsidiary has invested or will invest undistributed earnings indefinitely or that the subsidiary's

earnings will be remitted in a tax-free liquidation. This non-recognition of a deferred tax liability for outside basis differences is an exception to ASC 740's model for the comprehensive recognition of deferred taxes for temporary differences. Therefore, an enterprise availing itself of that exception must continuously assert its intent to indefinitely reinvest its outside basis difference. Given various geopolitical conflicts and trade sanctions, management should consider whether there are any changes to their assertions concerning their ability and intent to indefinitely prevent the outside basis difference of a foreign subsidiary from reversing with a tax consequence. Entities that are unable to assert indefinite reinvestment must record a deferred tax liability for any taxable temporary differences that would be incurred when the outside basis difference reverses. It is important to remember that the indefinite reversal exception only applies to the transfer of unremitted earnings across national boundaries, and not for transfers of unremitted earnings between entities within the same foreign country (or consolidated/group tax return). As a result, management needs to consider book-over-tax outside basis differences within each legal entity in its organization. US GAAP also prohibits a company from recording a deferred tax asset on its outside basis differences under ASC 740-30-25-9 unless the deferred tax asset will reverse in the foreseeable future. Generally, the "foreseeable future" is considered to be one year. In the case of a sale of a subsidiary, we believe that in most cases, such a deferred tax asset should be recognized when the held-for-sale conditions of ASC 360-10-45-9 are met.

Consideration should be given to the company's ability to manage its borrowing needs, including access to existing credit facilities. A question may arise as to whether a "one-time" repatriation of cash in response to current economic conditions would "taint" a company's indefinite reinvestment assertion. The answer depends on the specific facts and circumstances of each company. Considerations may include which earnings are being repatriated (i.e., current earnings vs. historical earnings), from which subsidiaries, the tax law applicable to the repatriation, and the business rationale for the change, among others.

***Resources***

- PwC's *Income taxes* guide, *Chapter 5*, *Chapter 10*, *Chapter 11*, and *Chapter 16*
- ASC 740, *Income Taxes*
- *PwC's Business combinations* guide, *Chapter 9*

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## QUESTION 9.4

*What are some of the tax implications to consider when a company concludes that an event is unusual or infrequent?*

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### *PwC response*

ASC 220-20-45-1 provides guidance for reporting events that are unusual and infrequent. If a company concludes that a material event is of an unusual nature and/or occurs infrequently, it should be reported as a separate component of income from continuing operations in the income statement or disclosed in the notes to the financial statements. This guidance also prohibits net-of-tax reporting (including per-share effects) of such items on the face of the income statement. For these purposes, unusual nature is defined as possessing a high degree of abnormality and clearly unrelated to, or only incidentally related to, the ordinary and typical activities of

the company. Infrequent means that the event should not be reasonably expected to recur in the foreseeable future. Both of those characteristics are, therefore, highly dependent on the environment in which a company operates. While the scope and severity of the economic impacts of certain events may be significant to some entities, it is important to consider whether those impacts are a function of inherent economic uncertainty that is present in all circumstances (e.g., demand risk, geopolitical influences on sources of supply). ASC 220-20 does not provide guidance on how to quantify the impact of a material event that is of an unusual nature and/or infrequent, and, thus, determining the incremental amount is a matter of significant judgment. We believe that a reasonable approach would be to identify those impacts that are direct and incremental related to the event. Judgment will be required to determine what is incremental. ASC 740 provides that the AETR only applies to the tax effect of ordinary income. ASC 740-270 provides that the tax related to significant unusual or infrequently occurring items that will be separately reported should not be included in the AETR. Companies will need to analyze the financial effects of current events in order to determine if they represent unusual items to the company. They will then need to determine which losses and costs are attributable to the unusual event and consider whether there are related impacts to the calculation of the estimated AETR.

***Resources***

- PwC's *Income taxes* guide, *Chapter 16*
- ASC 220, *Comprehensive Income*

# Consolidation

## QUESTION 10.1

*How should a reporting entity consider conflicts, sanctions, and other geopolitical issues as it relates to whether or not to consolidate an entity?*

### *PwC response*

Pursuant to ASC 810, *Consolidation*, a reporting entity consolidates another entity if it has a financial interest and ability to exert control over such entity. Geopolitical conflict and related sanctions may affect the assessment of whether a reporting entity continues to have control over entities in the conflict region.

Evidence of a lack of control, in spite of the legal ownership of a subsidiary's outstanding equity, includes a parent's inability to repatriate funds of a subsidiary because of long-term exchange restrictions, political uncertainties, threats of expropriation of a subsidiary's assets, and other similar situations. In the case of the Russian government's invasion of Ukraine, as one example, while sanctions around Russian financial institutions continue to rise, the Russian government has maintained a regime of strict currency controls. Multinational companies should expect to face significant difficulties in repatriating earnings from Russian entities as there continues to be significant uncertainty about exchange rates, the amount that can be repatriated at a given exchange rate, and the timing of repatriation as inflation rises within Russia. These difficulties should be considered when assessing whether

there continues to be a controlling financial interest in subsidiaries in any conflict region in which similar issues may exist.

In the past, for example in respect to the currency crisis in Venezuela, the International Practices Task Force of the SEC Regulations Committee of the Center for Audit Quality (IPTF) and its discussions with the SEC staff have provided valuable insights on the regulator's perspective regarding consolidation. While private entities are not subject to the SEC's regulations and interpretations, the IPTF deliberations may still provide valuable insights. The IPTF has not yet addressed the Russia-Ukraine conflict specifically.

We generally believe that short-term disruptions to the ability to repatriate funds or communicate with local management would by themselves not be expected to result in deconsolidation in situations involving political and economic instability. However, depending on how a situation evolves, there may be a de facto loss of ability to make significant decisions by the parent and hence deconsolidation may be appropriate.

We expect that a reporting entity's decision to deconsolidate its operations would, at a minimum, be supported by considering the following:

- The inability to access various exchange mechanisms at the level required by the scope and size of its operations
- The demonstrated impact of government regulations on the reporting entity's decision-making authority, including its ability to manage the capital structure, product development, purchasing, production scheduling, product pricing, and labor relations
- An evaluation of the current political and economic situation

Furthermore, companies may experience such significant financial difficulties from the conflict that they are forced to enter into the local equivalent of a bankruptcy process. In such a case, management will have to assess the applicable legal framework and if the parent still maintains control over the bankrupt entity or if deconsolidation is appropriate at that point.

If deconsolidation is deemed appropriate within a foreign entity (i.e., a portion of a foreign entity), the parent would not release any of its cumulative translation adjustment (CTA) from AOCI into earnings unless such deconsolidation represents a complete or substantially complete liquidation of the foreign entity. In contrast, if it is deemed a deconsolidation event of a foreign entity, the parent would release all of its CTAs related to the derecognized foreign entity, even when a noncontrolling investment is retained. See Chapter 8 in PwC's *Foreign currency* guide for additional information regarding this determination.

***Resources***

- PwC's *Foreign currency* guide, *Chapter 8*
- PwC's *Consolidation* guide
- PwC's *Bankruptcy and liquidations* guide, *Section 3.18*
- ASC 810, *Consolidation*
- ASC 830, *Foreign Currency*

## QUESTION 10.2

*How should call options and other contractual arrangements to reacquire a disposed business be considered in a reporting entity's deconsolidation assessment?*

### *PwC response*

In connection with the disposal of its operations due to a geopolitical situation, a reporting entity may negotiate terms that allow it to reacquire such operations if the situation changes. These repurchase rights may be structured as call options or rights of first refusal and may specify a repurchase price at fair value, a fixed price, or based on a formula.

Upon disposal of such operations, a reporting entity will need to assess if it lost control and hence should derecognize the related assets and liabilities from its balance sheet. The existence of call options could affect that assessment and should be considered in several steps of the de-consolidation assessment:

- Variable interest: A call option at other than fair value written by the new owner of the disposed business may represent a variable interest retained by the reporting entity.
- Determining if the disposed entity is a variable interest entity (VIE): A call option at other than fair value would limit the new equity holder's participation in the economics of the disposed business (i.e., because the new equity holders may be required to sell their investment in the future at less than fair value). The call option would need to be considered in the determination of whether the disposed business is a VIE pursuant to ASC 810-10-15-14(b)(3).
- Determination of the primary beneficiary: If the disposed entity is a VIE, the reporting entity would need to determine the primary beneficiary, which includes determining whether the call option conveys the power to direct the activities that most significantly impact the economic performance of the VIE to the holder. When making this assessment, the holder should consider the voting rights exercisable through the shares underlying the option, as well as any other rights that may transfer to the holder upon exercising the option. As further described in Section 5.3.5 of the *Consolidation* guide, we believe that the following factors should be considered in making this evaluation:
  - Whether the option is currently exercisable
  - The strike price and other key terms of the call option
  - The substance of the call option
  - The overall level of control held by the holder of the option
  - Barriers to exercise the option
  - Conditions that make exercise not prudent, feasible, or substantially within the control of the holder
- The determination of the primary beneficiary is a continuous assessment and hence many of the factors noted above require continuous monitoring by a reporting entity.

To the extent the disposed business is not a VIE, the reporting entity's loss of control should be evaluated under the voting interest model. A call option or similar

contractual terms would typically not impact this assessment as the voting interest entity model is not an effective control model. However, in certain limited circumstances, the terms and conditions of a repurchase option may make them so highly likely of exercise that a reporting entity may be deemed to have a controlling financial interest in the entity even though the instruments have not been exercised. In making this assessment, a reporting entity should consider all facts and circumstances, including its relationships with the entity and other investors.

***Resources***

- PwC's *Consolidation* guide, *Section 3.3.3*, *Chapter 4*, *Section 5.3.5*, and *Section 7.2.3*

# Leases

## QUESTION 11.1

*How should lessees and lessors evaluate rent concessions?*

### *PwC response*

If a rent concession is not based on an existing contractual right, lease modification accounting would apply. In most cases, this would require determining if the arrangement meets the definition of a lease, remeasuring and reallocating contract consideration based on revised payment terms to components based on their then-current relative standalone selling price, and reassessing the lease term, discount rate and lease classification at the modification date. A full update of all the assumptions used in accounting for the lease may be challenging for lessors and lessees that have a large population of leases.

***Resources***

- PwC's *Leases* guide

## QUESTION 11.2

*Given changes in interest rates, should a company continue to evaluate lease classification and measure the lease liability using the incremental borrowing rate at the lease commencement date?*

### *PwC response*

Yes. ASC 842-20-30-1 requires the use of the incremental borrowing rate at lease commencement date. Recent increases in interest rates should not be disregarded even though future rate changes may be uncertain.

***Resources***

- PwC's *Leases* guide

## QUESTION 11.3

*What is the accounting impact if a right-of-use asset is impaired because it is in an asset group that is impaired?*

### *PwC response*

Once a right-of-use (ROU) asset for an operating lease is impaired, lease expense will no longer be recognized on a straight-line basis. ASC 842-20-35-10 requires delinking the amortization of the ROU asset and lease liability. A lessee should continue to amortize the lease liability using the same effective interest method as before the impairment charge. The ROU asset, on the other hand, should be subsequently amortized on a straight-line basis. The resulting accounting is similar to the accounting a lessee would apply to a finance lease, however, the lease is still classified as an operating lease, and a lessee should continue to follow operating lease presentation and disclosure guidance.

***Resources***

- PwC's *Leases* guide
- PwC's *Lessee right-of-use assets: 5 things you need to know* podcast

## QUESTION 11.4

*When a lessee decides to cease use of leased space, either immediately or at some point in the future, it will need to consider whether the associated right-of-use asset is or will be abandoned. For purposes of that assessment, what factors should a lessee consider in determining its intent and practical ability to sublease the space?*

### *PwC response*

A lessee's right-of-use asset is subject to the impairment guidance in ASC 360 applicable to long-lived assets. The determination of whether a right-of-use asset is or will be abandoned under ASC 360-10 is an entity-specific evaluation. When a lessee decides to cease using leased space either immediately or in the future, it will need to consider whether the right-of-use asset is or will be abandoned. Temporarily idling a right-of-use asset (e.g., leaving leased space unoccupied with plans to return at a future date) is not considered an abandonment. Similarly, vacating leased space with plans to sublease the space in the future does not constitute an abandonment of the right-of-use asset because the lessee could potentially economically benefit from the right-of-use asset in the future.

In certain situations, such as when there is a saturation of supply in the real estate market, a lessee may not be able to sublease the vacated leased space despite having the contractual ability to do so. In this scenario, judgment is required to support an abandonment conclusion. For example, when a lessee has a significant remaining lease term, it may be difficult to support abandonment, especially when a

reasonable party would likely attempt to economically benefit from the leased space at some point in the future, such as through subleasing or another alternative use. On the other hand, when there is an insignificant remaining lease term and the lessee can support that the leased space will not be used, or there is no reasonable possibility of subleasing at any point for the remainder of the lease term, abandonment accounting may be appropriate.

***Resources***

- PwC's *Leases* guide
- PwC's *Lessee right-of-use assets: 5 things you need to know* podcast

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## QUESTION 11.5

*When a company has committed to abandon a right-of-use asset, should the remaining useful life of the right-of-use asset be reconsidered?*

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### *PwC response*

Yes. Adjustment of the useful life of the to-be-abandoned asset may be necessary in accordance with ASC 360-10-35-47. The useful life assessment of a long-lived asset is based on the lessee's assumption of the length over which it intends to use the asset. Refer to Section 4.2.1 in PwC's *Property, plant, equipment and other assets* (PPE) guide for more information.

If a right-of-use asset has not been impaired but its useful life has been shortened, one acceptable approach to subsequently account for the lease is to follow the accounting for a right-of-use asset that has been impaired. Under this approach, amortization of the right-of-use asset and lease liability would be delinked in the subsequent accounting. Refer to Example PPE 6-12 in our *Property, plant, equipment and other assets* guide for an illustration of this delinked approach.

Another acceptable approach to subsequently account for the lease is to retain the linkage between the right-of-use asset amortization and the lease liability. In this case, the straight-line lease expense would be remeasured over the shortened useful life, which is consistent with the guidance in ASC 842-20-25-6(a). Refer to Example PPE 6-13 in our *Property, plant, equipment and other assets* guide for an illustration of this linked approach.

***Resources***

- PwC's *Leases* guide
- PwC's *Lessee right-of-use assets: 5 things you need to know* podcast

# Going concern

## QUESTION 12.1

*What are examples of risk indicators or scenarios to consider when performing an assessment of liquidity or a company's ability to continue as a going concern?*

### *PwC response*

Considerations will vary by company but may include, among other matters:

Changes in management's forecasted operating results and/or cash flow projections due to the following:

- A reduction in revenues and impact on costs due to a decline in customer demand
- Disruption to the supply chain that could impact product costs, cause delays/inability to source product, or result in increased product liability risks or costs
- Impact of increased inflation on costs
- Provisions in critical customer or supply agreements that could trigger penalties or the loss of significant customers
- Increased interest expense due to higher debt levels or incremental borrowings at higher interest rates
- Longer collection cycles due to customer cash retention programs or inability of customers to pay
- Significant workforce disruptions and related implications
- Charges or costs resulting from accounting for impairments, including those arising from changes in long-term growth or discount rate assumptions used in discounted cash flow modeling
- Charges or costs resulting from reserves, restructuring plans, or other impacts

Changes in management's assessment of its short- and medium-term liquidity or the company's ability to access capital or obtain funding, considering the following:

- The ability to fund operations for at least twelve months from the date the financial statements are issued, considering current cash on hand, current and projected net cash flows from operations, maturities of debt and other commitments, and available sources of funding
- The likelihood of non-compliance with financial and/or nonfinancial debt covenants that could result in an acceleration of debt, increased borrowing costs, or restrictions on future borrowings
- Increasing interest rates on variable rate debt and the potential impact on liquidity or financial covenants
- Any reductions in asset-backed lending capacity due to reductions in the company's borrowing base

- Potential or known credit downgrades that could result from reduced company profitability
- Tightening of credit within the financial markets, which could impact the company's ability to refinance debt or otherwise result in reduced borrowing availability
- Stock market volatility, including overall declines in market capitalization, which could impact the ability or cost of issuing securities
- The inability to meet margin calls from financing counterparties, which could result in an event of default

The impact of external conditions, such as measures taken by governments and banks to provide relief to affected entities or other matters, such as work stoppages or other labor difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, or a need to significantly revise operations

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## QUESTION 12.2

*What should a company's management consider in evaluating the adequacy of financial statement disclosures when conditions or events raise substantial doubt about the company's ability to continue as a going concern?*

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### *PwC response*

If conditions or events raise substantial doubt about a company's ability to continue as a going concern, the company should disclose information that enables users of the financial statements to understand (a) the principal conditions or events that raised substantial doubt about the company's ability to continue as a going concern (before consideration of management's mitigation plans), (b) management's evaluation of the significance of those conditions or events in relation to the company's ability to meet its obligations, and (c) management's plans that alleviated/are intended to mitigate the conditions or events that raise substantial doubt about the company's ability to continue as a going concern. If substantial doubt is not alleviated after consideration of management's plans, management must also include a statement that there is substantial doubt about the company's ability to continue as a going concern within one year after the date that the financial statements are issued (or available to be issued).

Companies should also disclose any risks and uncertainties that could significantly affect financial statement amounts in the near term.

Management is expected to determine whether disclosures are merited in both interim and annual financial statements. The extent of disclosure of the factors impacting liquidity should consider the severity of the conditions or events, and should be company specific. It is important to recognize that timely company-specific disclosure is essential, even though it may be difficult to assess or predict the effects of the market conditions. Disclosures about the risks, including how the company is responding to them, are expected to be specific to a company's situation as seen through the eyes of management.

Company-specific disclosure within the financial statements, risk factors, MD&A, and/or liquidity may include:

- Detailed discussion of the company's ability to generate sufficient cash to fund

operations

- Expected courses of action that bear on the company's financial flexibility, including planned cost reductions

The impact on capital and financial resources, including overall liquidity position and outlook, such as:

- If a material liquidity deficiency was identified, what course of action the company has taken or proposes to take to address the deficiency
- Material uncertainties about the ongoing ability to meet debt covenants and the existence and nature of subjective acceleration clauses
- Whether the cost of, or access to, capital and funding sources, such as revolving credit facilities, has changed or is reasonably likely to change
- New borrowings or new capital
- Whether current or anticipated sources or uses of cash will be materially impacted

Impairments that have had or are reasonably likely to have a material impact on the company's financial statements

It is important to note that management first determines the nature and extent of its disclosures. Auditors then have a professional responsibility to assess whether the annual and interim financial statement disclosures are adequate. Accordingly, this is another area where timely, ongoing, and transparent communications between management, those charged with governance, and the auditor is important.

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## QUESTION 12.3

*What are the potential implications to the auditor's report as a result of conditions or events that raise substantial doubt about the company's ability to continue as a going concern?*

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### *PwC response*

There may be circumstances when the auditor concludes that an additional paragraph should be included in the audit report such as:

- A required additional paragraph as a result of the conclusion that there is substantial doubt about the company's ability to continue as a going concern
- A voluntary paragraph regarding liquidity/uncertainty despite concluding that there is not substantial doubt about the company's ability to continue as a going concern, or for unusually significant subsequent events

Simply put - an auditor may be required to include an additional paragraph, or they may voluntarily include one when they conclude it is important to highlight certain disclosures in the financial statements for the users' attention.

As defined by the auditing standards, neither a required nor voluntary additional paragraph results in a qualified opinion. However, it is important to recognize that such paragraphs may be defined differently within debt agreements and there could be an implication to debt covenants.

The differences between a required substantial doubt and a voluntary paragraph to highlight certain disclosures are as follows:

| ***Substantial doubt*** **(required)** | ***No substantial doubt*** **(voluntary)** |
|---|---|
| When there is substantial doubt, a going concern paragraph is required. The required paragraph states that the financial statements have been prepared assuming the company will continue as a going concern. It refers to the company's footnote disclosure and briefly summarizes the circumstances raising substantial doubt about the company's ability to continue as a going concern. It also refers to the footnote disclosure regarding management's plans. | When there are liquidity risks that are mitigated by management's plans, it may still be appropriate to include an additional paragraph that emphasizes the matter. This voluntary additional paragraph is to draw attention to certain important disclosures contained within the financial statements related to liquidity, material uncertainties, or unusually important subsequent events. It does not use the phrases "substantial doubt" or "going concern." |

*Interim reviews*

If the company discloses that there is substantial doubt about the company's ability to continue as a going concern in its interim financial statements, and the auditor issues an interim review report, such interim review report would include a going concern paragraph.

*Keeping current and reissuance of audit reports*

Management should also be aware that there are events and circumstances after the original issuance of the annual audited financial statements that could cause an auditor to reassess its originally issued report. In connection with capital raíses, debt offerings, and various other filing or regulatory requirements, the auditor may be asked to issue a consent, reissue its report, or otherwise be associated with a transaction or filing. In these situations, the auditor will likely be required to perform "keeping current procedures," which might include performing an assessment of management's ability to continue as a going concern both (1) one year from the date of the original issuance of the financial statements and (2) one year from the date of the keeping current procedures, as well as an evaluation of whether disclosures need to be updated.

If subsequent events have occurred, including those related to a company's liquidity and ability to continue as a going concern, a reissuance of the financial statements, and the auditor's report, may be required or otherwise deemed appropriate.

Accordingly, it is important for management to keep the auditor informed, early and often, of any potential transactions that may require keeping current procedures to be performed.

***Resources***

- PwC's *Financial statement presentation* guide, Chapter 24

# Fraud and illegal acts

## QUESTION 13.1

*The current environment and market conditions may increase the pressure to meet earnings and other performance targets. What actions can be taken to proactively mitigate any increased risk of fraud from such increased pressure?*

### *PwC response*

Increased pressure on targets or other key performance indicators can lead to negative behaviors such as financial statement fraud or earnings management. Companies with clear ethics policies and convenient hotline reporting methods can help to stay ahead of "bad behavior" and make clear the expectation to always act with integrity and in an ethical manner. For example, companies should:

- Ensure all employees - from the top down - understand the company's Code of Conduct and policies regarding unethical behavior or misconduct.
- Communicate to all global personnel (from lower level employees to senior executives) exactly how to report such unethical behavior via the company's hotline, which can be internal or external through a third party.
- Reinforce anonymity in hotline reporting, as well as emphasize non-retaliation policies against whistleblowers.
- Consider including the hotline reporting link on its external facing website.
- Engage in annual mandatory ethics and compliance training in local languages and require certification of completion.
- Reinforce wherever possible a "speak-up" culture (i.e., if you see something, say something).

The Department of Justice has issued several guidance documents around the evaluation of corporate compliance programs that can be helpful.

Additionally, companies should be sure to have robust discussions with their external auditors to establish in advance the necessary communication protocols (e.g., reviewing the whistleblower log with the external auditors) outlining how to address any issues in a timely manner (i.e., before an issue arises).

## QUESTION 13.2

*How should a company react to the identification of a potential illegal act (e.g., via a whistleblower report, government inquiry, financial statement error)?*

### *PwC response*

The PCAOB, SEC, AICPA, and other regulatory bodies prescribe the appropriate response to discovering a potential illegal act. For example, there are certain distinct steps that should be taken by each of the following: those charged with governance (e.g., the audit committee), company management, and the external auditors. Guidance stipulates that the company should act timely upon becoming aware of a potential illegal act and take reasonable steps to understand the nature and extent of the issue. In many cases, timely action by management includes apprising the audit committee and external auditors.

In many cases, reasonable steps by the audit committee means engaging independent and objective counsel with relevant experience in conducting internal investigations to conduct an investigation into the issue. External counsel will set the scope of the investigation with the audit committee, including time period, identification of key witnesses to be interviewed, the collection of electronic and hard copy documents, and an evaluation of the impact, if any, on the company's books and records.

External counsel will work with those in management who are clear of the allegations to ensure the company has adequate data preservation processes in place. Counsel's investigation will be an assessment of the facts with respect to the potential illegal act, and, among other things, an understanding of whether there is any direct or indirect impact on the financial statements (including whether senior management was involved, knew about, or should have known about the situation) and/or impact to internal controls. External counsel's investigation should also conclude whether - based upon the evidence obtained - a violation of law and/or company policy has occurred.

External counsel will often provide recommendations and/or remedial actions for the audit committee to consider. See our Responsibilities Placemat for additional detail about what companies and those charged with governance should consider when responding to allegations of fraud or potential illegal acts.

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## QUESTION 13.3

*What information should be shared with external auditors about potential illegal acts and any related investigation and findings?*

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### *PwC response*

Auditors must obtain sufficient audit evidence from the client to meet their professional obligations. When auditors rely on the work of a company specialist (e.g., external counsel engaged to conduct an investigation into a potential illegal act), the standards require the auditor to evaluate that specialist's work and gather appropriate evidence. Companies should have early and frequent communications with the external auditors to make sure all parties understand what information is needed for the audit and how the auditors can obtain such information in an agreeable format. The auditing standards do not provide any exception for information that is claimed to be privileged.

## QUESTION 13.4

*In responding to the external auditor's request to schedule fraud inquiries with various company employees, is it appropriate for management to request that the auditor send the questions via email so that the company employees can provide written responses?*

### *PwC response*

Fraud inquiries are most effective when conducted in person (or via video conference if necessary) rather than in writing in order to facilitate a more engaging discussion and allow for follow-up inquiries in the moment. As such, adequate time should be scheduled for each individual with whom the auditor plans to conduct inquiries.

Auditing standards also note that fraud inquiries should consider whether any conditions change at the company that would impact which questions are asked and of whom. Such conditions may result in the need to inquire of other business departments or members of management not previously subjected to fraud inquiries. Additionally, the current company environment — including the impact of any macroeconomic events — may be relevant in assessing which questions to ask in fraud inquiries, so any pre-written or similar responses from prior years may not be appropriate.

## QUESTION 13.5

*A potential fraud or illegal act has been identified in a foreign operation that is not quantitatively material to the consolidated financial statements, and the operation is not in scope for the consolidated financial statement audit. Do we need to notify our auditors about the issue?*

### *PwC response*

Yes, in a rapidly changing global environment, it can be challenging to understand and determine the full extent of an issue's known or potential impact. Consequently, there could be a potential impact on the audit even if you believe the operation with the issue is not in scope (e.g., involvement or knowledge at the senior management level could qualitatively impact the overall audit). You should timely discuss the issue with your auditor so that they can determine whether additional audit procedures should be performed.

# Other

## QUESTION 14.1

*Can a company record a receivable for expected insurance recoveries under business interruption insurance?*

### *PwC response*

Business interruption insurance policies (e.g., loss of use of property or equipment) generally cover losses of gross profit or reimbursement of certain expenses while a company is unable to conduct its business. When a business is interrupted, the writedown of an asset or the accrual of an obligation (e.g., salaries paid to idle workers) would be considered a loss recognized in the financial statements. An insurance recoverable asset can be recorded when there is an enforceable insurance contract in place that covers the event causing the loss. The timing of the initial recognition of an insurance recovery asset depends on assessing the enforceability of the claim under the insurance policy and whether the expected proceeds would result in a recovery of a recognized loss or represent a gain contingency. An insurance recovery for that loss should be recorded when the realization of the claim for recovery is probable. As such, we believe it may be challenging for an insured party to conclude that any insurance proceeds are probable until agreed to by the insurance carrier. Amounts in excess of recorded losses should be accounted for as gain contingencies and therefore are not recognized until realized or realizable.

However, the absence of expected revenue or income is not a loss recognized in the financial statements. Recovery of lost profits or revenue would not be recognized until the contingency is considered resolved. Typically, a business interruption recovery gain would not be recognized prior to the insurance carrier acknowledging that the claim is covered and communicating the amount to be paid to the company. Any stipulation from the carrier (e.g., "pending final review") should be reviewed to determine whether it is an indication the claim may not be realizable. The company's history in collecting such claims should also be considered. When the insured has received payment without the expectation of repayment or refund, the contingency is considered resolved and the gain should be recognized.

When a company incurs losses, typically the party the company owes and the insurer are not the same and the legal right of offset would not exist. Therefore the asset and liability would not be offset in the balance sheet. ASC 220-30-45-1 indicates that companies have a choice in how to classify business interruption insurance recoveries on the income statement as long as the classification is not contrary to other US GAAP. In the statement of cash flows, proceeds related to business interruption policies are operating inflows.

**Resources**

- PwC's *Property, plant, equipment and other assets* guide, *Section 8.2.5*
- PwC's *Financial statement presentation* guide, *Section 6.9.22*

## QUESTION 14.2

*If a company needs to remeasure its pension plans, what are some of the key considerations the company should focus on in the current environment?*

### *PwC response*

Upon remeasurement, all actuarial, and financial, and demographic assumptions are evaluated and updated, and a new determination of the plans' projected benefit obligation and asset values is made using current market values and assumptions. With potentially significant changes in headcount and human capital plans and programs, coupled with the volatility in the market for plan assets and interest rates, companies should carefully evaluate significant assumptions and the methods used to determine them in the current period. Certain approaches may need to be refined in the current period to ensure they reasonably reflect actual results. For example, a company that historically rolls forward certain participant census data from an earlier date to the measurement date, as might be contemplated in ASC 715-30-35-64, might need to further evaluate the impact of restructuring actions or changes in employee behavior or elections on such data. Similarly, credit downgrades of corporate bond issuers that were previously rated "high quality" may impact the population of bonds historically utilized to determine the discount rate for a company's pension and postretirement benefit plans.

***Resources***

- PwC's *Pension and employee benefits* guide, *Chapter 2*

## QUESTION 14.3

*How should a company account for payments made to or benefits provided to employees during a disruption from work?*

### *PwC response*

Companies may choose to continue to pay salaries and benefits to employees even if they are unable to work or have been displaced.

The accounting guidance for payments to employees varies and depends on the nature of the compensation arrangement and the way in which they are communicated to employees.

- Certain types of payments are accrued either as service is provided or when the events giving rise to the payments become probable and the amounts are estimable in accordance with ASC 712 (e.g., pre-existing plans to continue to provide medical benefits to furloughed employees or provide paid severance benefits for permanent termination of employment that varies based upon years of service).
- Special termination benefits offered for an employee's voluntary termination of service would be recognized when the employee irrevocably accepts the offer.

- One-time involuntary termination benefits would not be recognized until the criteria in ASC 420 are met and may be recognized over time if continued service is required to earn the benefit.

Management should evaluate the arrangements to determine whether one of the accounting models described above specifically applies to those payments.

For payments to employees that are not clearly addressed by the existing accounting models, judgment will be required.

- *Decision to pay salaries to employees unable to work* - A company's discretionary decision to continue to pay salaries to employees unable to work might be similar to the continuation of compensation and benefits under ASC 712. However, because the employees' rights to that compensation do not vest or accumulate based on past service, they would be accrued when they are probable and estimable, in accordance with ASC 450, *Contingencies*. Under this approach, the communication of the company's intention to continue to pay salaries for a period of time to employees who are displaced or otherwise unable to work could lead to a determination that the payment of such amounts are probable. Significant judgment would be needed in the determination of what amounts are reasonably estimable.
- The continued payment of salaries to employees unable to work could alternatively be seen as a discretionary one-time action, in which case it would not represent a mutually understood "plan." Under this view, payments of salaries to employees who were unable to work due to government-imposed restrictions on access to facilities are expensed as incurred, unless the criteria for accrual for compensated absences are met. In most cases, the criteria would not be met, as the right to these payments did not vest or accumulate based on past service. Therefore, the payments would be expensed as incurred.
- If accrual of future compensatory payments is considered appropriate, management needs to assess whether any of the payments, or portions thereof, will provide any current benefit to the company. ASC 710-10-25-4 prohibits the accrual of future costs that will provide a benefit to the employer as they are incurred. In this context, while employees may not be directly providing services, the payments may be designed to keep the company's active workforce available when the company is able to re-commence operations. In that case, recognizing the cost of the employee compensation as paid, rather than accruing an estimate of the total amount to be paid at the point at which employees ceased working, may be appropriate.
- Companies may also decide to make advance payments to employees for humanitarian reasons. Management will have to consider the likelihood of those employees actually being able to return and perform services in exchange for those prepaid salaries and benefits. Unless it is probable that the employees will provide future services thus supporting recognition of a prepaid asset, which may be difficult to assess at this juncture, such payments would be expected to be expensed as paid.

Based on the above considerations, we generally believe that arrangements that are not covered by a "substantive plan" and under which the rights to compensation do not vest or accumulate based on past service would result in recognizing the related payments as an expense when the payment is made.

This assessment would be appropriate for any type of continued payments to employees who are unable to work including, for example, salary, medical benefits, other fringe benefit costs, vacation accruals, and stock-based compensation.

***Resources***

- ASC 710, *Compensation*
- ASC 712, *Compensation - Nonretirement postemployment benefits*
- ASC 420, *Exit or Disposal Cost Obligations*
- ASC 450, *Contingencies*

## QUESTION 14.4 (added January 2023)

*Should cash held at Russian financial institutions be classified as restricted cash in light of sanctions imposed against Russia?*

### *PwC response*

The economic sanctions imposed against Russia have impacted the ability of some companies to use or withdraw cash held at Russian financial institutions. For example, multinational companies may be able to use their cash freely within Russia but may be precluded from transferring cash to a bank account outside of Russia. Some companies may have ceased operations in Russia but cannot transfer remaining cash out of their Russian bank accounts to overseas bank accounts.

There is no GAAP definition of restricted cash. However, while not defined, we believe the concept of restricted cash refers to cash that is legally restricted as to withdrawal or use (e.g., held in escrow, reserved for collateral purposes). Classification of funds as restricted for reasons beyond legal restrictions depends on a reporting entity's accounting policy. We believe that if the cash held in a Russian financial institution can be used freely within Russia, it generally would not be considered legally restricted. If a reporting entity has a policy to present cash that is restricted beyond legal restrictions, it should consider its policy in light of the sanctions as well as funds in any other jurisdictions where similar circumstances may exist.

When establishing a policy for restricted cash, we recognize that reporting entities may not have contemplated restrictions associated with international sanctions. Therefore, if a reporting entity decides to present cash balances affected by sanctions as restricted cash, we believe that this presentation would not be considered a change in accounting principle under ASC 250 but rather the result of adoption of an accounting principle necessitated by new events occurring that had not been previously considered under the existing policy.

***Resources***

- PwC's *Financial statement presentation* guide, Section 6.5.3

**To have a deeper discussion, contact:**

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