A look at this quarter's financial reporting matters

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Introduction

In the third quarter of 2022, President Biden signed the Inflation Reduction Act into law, billed as the largest climate legislation in US history. In addition to extending and creating numerous tax credits and incentives, the legislation enacts a new corporate alternative minimum tax and an excise tax on stock buybacks. We take a closer look at the provisions with potential financial reporting implications. Additionally, you'll want to make note of the SEC's recently finalized rules on executive compensation disclosures that may impact your next proxy.

Many companies are thinking about goodwill impairment testing, either in connection with their annual test or triggered by current economic conditions. In *Ask the National Office*, we provide timely reminders on impairment testing, including how rising costs and interest rates could have an impact.

On the regulatory front, we provide updates on ESG reporting proposals and highlight steps you should take now to prepare for climate reporting. In standard-setting updates, we summarize the FASB's activities this quarter, including the latest on the segment reporting project.

In this edition of *The quarter close,* we highlight these and other relevant accounting and reporting topics you should consider as you close out the third quarter of 2022.

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Accounting and reporting hot topics

The Inflation Reduction Act: What you need to know for your financial reporting

On August 16, President Biden signed the Inflation Reduction Act (the IRA) into law, which includes a wide range of tax, clean energy, and healthcare-related provisions. Key aspects of the IRA with potential accounting implications include a new corporate alternative minimum tax, an excise tax on stock buybacks, and significant incentives for energy and climate initiatives. Under US GAAP, changes in income tax rates and law are accounted for in the period of enactment. For US federal purposes, this is the date the President signs the bill into law although the majority of the provisions in the IRA will only impact financial statements prospectively.

Corporate alternative minimum tax

For tax years beginning after December 31, 2022, the IRA creates a 15% corporate alternative minimum tax (CAMT) on corporations with average annual adjusted financial statement income over a three-year period in excess of $1 billion. There are special rules for companies with a non-US parent that include an additional test to determine whether the company is subject to the CAMT. Companies that pay the tax will receive a non-expiring tax credit carryforward that can be claimed against regular tax in future years. ASC 740, *Income taxes*, requires deferred taxes to be measured using the regular tax rate even if a company anticipates being subject to the CAMT in the future. However, companies that expect to pay CAMT for the foreseeable future may need to reassess their valuation allowances in the period that includes the enactment date since certain existing deferred tax assets may no longer provide a future benefit under the CAMT regime.

Excise tax

The IRA imposes a nondeductible 1% excise tax on a publicly traded corporation for the value of certain stock that it repurchases (net of issuances), effective for repurchases after December 31, 2022. Because the excise tax is levied on a gross amount, its effects are not expected to be included in the income tax provision under ASC 740. We believe that it would be acceptable to consider the excise tax as a direct and incremental cost that is associated with the transaction that created it. Under US GAAP, many stock repurchases are accounted for as equity transactions with no income statement consequence, although certain equity transactions may have income statement consequences and not all shares of stock are classified as equity instruments. As a result, the accounting treatment for a stock buyback transaction may be relevant in determining the appropriate accounting for the excise tax.

Climate and clean energy initiatives

The IRA includes significant extensions, expansions, and enhancements of numerous energy-related tax credits and also creates new credits. Certain of the credits have a “direct-pay” election, which allows an eligible taxpayer to receive a current benefit from the credit without taxable income or a tax liability, while others provide for an election to transfer (i.e., sell) certain credits to another taxpayer.

The application of ASC 740 is warranted if a credit can only be claimed on the tax return and realized through the existence of taxable income. When a company is able to receive the benefit of a credit regardless of whether it has income taxes payable or taxable income, we believe the benefit should be accounted for outside of the income tax model. This would apply to credits with a direct-pay option. For credits with transferability provisions, if the company does not intend to transfer the credit, and will only realize its benefit by reducing income tax payable, it would account for the benefit of the credit as part of its income tax provision determined under ASC 740. However, if the company intends to realize the benefit of the credit by transferring it to another party, it should account for the credit outside of the income tax line. Companies will need to determine the appropriate accounting framework to apply to these credits, which may be akin to a government grant.

For more information

Learn more by reading our In depth, *Accounting for the Inflation Reduction Act and the CHIPS Act*, and listening to our podcast, *ESG incentives in the Inflation Reduction Act*.

SEC adopts pay versus performance disclosure rules

On August 25, the SEC adopted final rules that require enhanced disclosures related to executive compensation in proxy and information statements for many registrants, as mandated by the Dodd-Frank Act. For impacted calendar year-end registrants, the new rules will require incremental disclosures in proxy statements for 2022.

The rules amend Item 402 of Regulation S-K and apply to all registrants, other than foreign private issuers, registered investment companies, and emerging growth companies. Under the new rules, registrants will be required to provide incremental disclosures that depict the relationship between executive compensation actually paid and the financial performance of the registrant. Smaller reporting companies (SRCs) will be permitted to provide scaled disclosures.

Summary of the new disclosures

In a new table, registrants subject to the rules will need to disclose total compensation for the principal executive officer (PEO) and the average for the other named executive officers (NEOs) for the five most recent fiscal years. The table must include both the total compensation included in the Summary Compensation Table (currently required under Item 402) and executive compensation actually paid as defined in the rule. Further, the table must show the following measures of financial performance:

- Total shareholder return (TSR) for the registrant
- TSR for the registrant's peer group
- The registrant's net income
- A "company selected measure" – a measure selected by and specific to the registrant that represents the most important financial performance measure used for the most recent fiscal year to link NEO compensation actually paid to company performance.

In addition to the new table, registrants will be required to describe the relationship between (a) the executive compensation actually paid to the PEO and the average executive compensation actually paid to the other NEOs and (b) the financial performance measures, as disclosed in the table. The discussion must also include a comparison of the TSR of the company to the peer group TSR. Registrants will also need to provide three to seven performance measures it determines are its most important financial performance measures used to link executive compensation to company performance during the most recent fiscal year, which may also include non-financial performance measures.

SRCs are not required to disclose a peer group TSR, a company-selected measure, or financial performance measures. Additionally, SRCs are only required to provide the disclosures for the three most recent fiscal years.

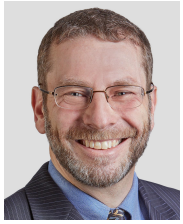
Effective date and transition

The new disclosures are required in proxy or information statements that include Item 402 executive compensation disclosures for fiscal years ending on or after December 16, 2022. Three years of information is required in the initial year of adoption, with an additional year added in each of the two subsequent annual filings. SRCs may provide two years in the initial year of adoption, with a third year added in the subsequent year.

For more information

Find more details in our In brief, *SEC adopts pay versus performance disclosure rules*.

Ask the National Office: Spotlight on goodwill impairment tests



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As a company completes either its annual goodwill impairment test or an interim test due to a triggering event, what should it be thinking about in the current economic environment?

The current economic landscape will largely impact companies' goodwill impairment testing in two ways. First, inflationary costs and supply chain disruptions could put pressure on future cash flows. Second, assuming all else stays equal, higher interest rates will result in lower present values. Both of these factors could impact fair value calculations. This differs from the last US recession we saw in 2008, when interest rates remained relatively low.

Additionally, companies performing their annual test may not be able to rely on a "Step 0" qualitative assessment given current macroeconomic conditions.

Any other reminders to pay attention to for the goodwill impairment test?

We tend to get questions on the deferred tax effects related to goodwill. Taxable business combinations can generate goodwill that is tax deductible. As that goodwill amortizes for tax purposes, a deferred tax liability is recognized. However, if an impairment charge is recognized for book goodwill, that could result in the recognition of a deferred tax asset if the impairment of goodwill for book purposes exceeds the cumulative amortization of goodwill for tax purposes.

Since the initial amount of the calculated goodwill impairment reflected the difference between the fair value of the reporting unit and its carrying value, recording a deferred tax asset for the impaired goodwill will result in the carrying value of the reporting unit again exceeding its fair value. This results in the need for a further amount of goodwill impairment to be recorded in an iterative process.

ASC 805 describes this approach as a "simultaneous equation" that is used to determine the appropriate amount of goodwill impairment to record. We discuss this further in Section 9.9.6 of our *Business combinations* guide.

What about impairments of other long-lived assets?

Impairments for most other long-lived assets that are held and used are addressed in ASC 360-10. This model is applied at the "asset group" level, and uses an undiscounted cash flow approach for Step 1 of the assessment. This could make the test easier to "pass" as compared to the goodwill impairment test. However, the same impact of inflation on future cash flows could impact these Step 1 assessments. If this test is failed, the asset group is written down to fair value, which could be affected by higher interest rates.

Additionally, subsequent to the adoption of the new leasing standard, right-of-use assets recorded by lessees are included in the asset group and tested for impairment following this model. This may result in significantly higher asset group carrying values as compared to past economic downturns.

What other transactions may give rise to impairments?

While normal changes in financial forecasts and results can create an impairment trigger, some business decisions could give rise to a triggering event. Transactions such as decisions to restructure or sell off parts of the business, for example, may drive an impairment assessment since it may impact future cash flows of the remaining business or asset group.

Additionally, decisions to exit or sublease assets subject to lease could affect the composition of asset groups and trigger impairments of affected right-of-use assets.

For more information on impairments of goodwill and asset groups, refer to Section 9.5 of our *Business combinations* guide and Chapter 5 of our *Property, plant, equipment and other assets* guide.

Key reminders when assessing the realizability of deferred tax assets

The challenges of the current economic environment have put additional focus on the assessment of the realizability of deferred tax assets and the adequacy of the related valuation allowance, not only at year end but also during interim reporting periods. In some circumstances, this assessment can require significant judgment and a detailed analysis of the supporting evidence, so it's a topic to address early in the close process. We summarize some of the key considerations below.

Evidence to consider in the analysis

When assessing the realizability of deferred tax assets, the income tax accounting standard requires consideration of four sources of future taxable income:

- Taxable income in prior carryback years
- Future reversals of existing taxable temporary differences
- Tax planning strategies
- Projections of future taxable income

All available evidence — both positive and negative — must be considered, including operating results and trends in recent years. Companies should assign the most weight to the evidence that can be objectively verified. This means that what has already occurred (and thus can be objectively verified) carries more weight than what *may* occur. For example, projections of future income are not typically objectively verifiable.

Cumulative profitability or losses for the last three years is a significant factor when assessing the realizability of deferred tax assets. When considering historical results, it is often difficult to justify excluding items from prior periods under an assumption they will be "nonrecurring" given that events that have already occurred are typically the most objectively verifiable. Additionally, the absence of cumulative losses does not automatically result in the presumption of realizability of an entity's deferred tax assets.

It may be necessary to schedule out the future expected reversals of deferred tax assets and liabilities, if needed as support for realizability. This can be a complex exercise; therefore, it is important not to leave this aspect of the analysis to the last minute.

Other considerations

As a result of the 2017 Tax Cuts and Jobs Act, the calculation used to determine the interest expense deduction limitation for tax years beginning after December 31, 2021 is defined similarly to EBIT (earnings before interest and taxes) instead of the previously used EBITDA (earnings before interest, taxes, depreciation and amortization). The combination of this change and rising interest rates may result in larger deferred tax asset balances related to interest expense deduction carryforwards that will need to be assessed for realizability.

Lastly, don't forget that subsequent events can also impact the analysis. Companies should carefully evaluate events that occur after the balance sheet date but before the financial statements are issued for any potential impact to their valuation allowance assessments.

For more information

For more details, see Chapter 5 of our *Income taxes* guide and listen to our *Tax toolkit: Valuation allowances, weighing the evidence* podcast.

Home stretch for private company adoption of the new leases standard

Most private companies will be required to adopt the new leases guidance in ASC 842 when they report their 2022 annual financial statements. Below we highlight three critical areas for adoption as the reporting deadline nears.

Completeness of the lease population

Lessees will be required to record virtually all leases on the balance sheet, so it's critical to ensure all leases have been identified. Leases can be embedded in many different kinds of contracts, including service contracts. Identifying embedded leases requires judgment, and often involves detailed contract reviews and obtaining a thorough understanding of the terms and economics of arrangements that may contain a lease.

Adequacy of existing lease data

The considerable data requirements are another key challenge. Extensive data will be needed to calculate the right-of-use asset and lease liability, and to comply with the significant new disclosure requirements. Adoption is also likely to require new or different processes and modifications to internal controls over the new data and disclosure requirements.

Transition elections and policy choices

The new standard provides various transition-related expedients and policy elections that can ease the level of effort required to adopt the new guidance and simplify information needs. However, certain expedients and elections may also affect the amounts reported under the new standard. For example, if a lessee elects to combine lease and nonlease components, less effort is required because there is no need to allocate contract consideration. Lessees should keep in mind, however, that this election will increase the total lease liability recorded on the balance sheet, as well as the amounts classified as lease expense prospectively. Therefore, elections should be carefully considered, weighing both the benefits and the potential financial reporting consequences, to ensure the elections will make sense not only at transition but for the future. Lastly, it is important to clearly document judgments and accounting elections to set a solid foundation for transition and support your financial reporting on an ongoing basis.

For more information

For more information, read our publication, *Private company ASC 842 adoption: Key considerations*, listen to our podcast, *Leasing toolkit: Tips and tools for private company adoption*, and read our *Leases* guide.

Regulatory developments

ESG reporting: What's next?

The comment periods have now closed for the SEC's climate disclosures proposal, the International Sustainability Standards Board (ISSB) exposure drafts on general sustainability and climate disclosures, and the European Financial Reporting Advisory Group (EFRAG) exposure drafts on disclosures impacting a broad range of environmental, social, and governance matters. Looking forward, we expect a final rule from the SEC as soon as the fourth quarter and final standards from the ISSB in early 2023. EFRAG is expected to submit its standards to the European Commission later this year, beginning a process that will be finalized in mid-2023.

Companies that may be in the scope of one or more of these disclosures should not wait for the final rules. Practical considerations, such as identifying participants and leadership for a cross-functional team and determining the scope, data requirements, and related gaps, are steps that can be started now. At a minimum the following steps will help you hit the ground running when the final guidance is issued:

1
Determine scope and timing of reporting requirements

2
Review existing disclosures, including those related to greenhouse gases, and assess the quality of underlying data

3
Map known climate activities and emissions to proposed disclosures, determine gaps, and create an action plan

Evaluating what actions you should be taking now begins with determining the applicable ESG disclosure frameworks, which will determine timing and what information is required. This may sound simple, but there can be complexities:

- **SEC climate disclosure proposal:** As currently proposed, the rules would be applicable to domestic registrants and foreign private issuers, with limited exceptions. Proposed disclosure requirements are expected to be effective on a phased basis dependent on filer status, with some requirements not applicable to certain companies (e.g., GHG scope 3 emissions would not be required for smaller reporting companies). The requirements may be applicable as early as 2023 for large accelerated filers. Read our In the loop, *The SEC wants me to disclose what?*, for more details.
- **EFRAG exposure drafts:** The scope of the CSRD includes US and other non-EU parent companies with EU subsidiaries. In addition to subsidiary or EU-level reporting, some non-EU parent companies will need to report at the global consolidated level. The directive would apply to all companies listed on EU-regulated markets and "large," as defined in the directive, unlisted companies or groups in the EU. For some entities, disclosure and attestation requirements would be applicable as soon as 2024. Read our In the loop, *What's CSRD? You should already know*, for more details.
- **ISSB exposure drafts:** Individual jurisdictions will have to decide whether to require or permit application of ISSB standards as a basis for sustainability reporting, akin to the process for adopting IFRS accounting standards for financial reporting. Although there is a lot of interest in the ISSB standards, it remains to be seen which jurisdictions will adopt them once finalized. Read our In depth, *What you need to know about the ISSB Exposure Drafts*, for more details.

For a comparison of the "big three" disclosure proposals, read our In the loop, *Navigating the ESG landscape*.

SEC and PCAOB release draft strategic plans

This quarter, both the SEC and PCAOB released their draft strategic plans for fiscal years 2022 to 2026 for public comment. The SEC's draft strategic plan includes three primary goals:

- Protecting working families against fraud, manipulation, and misconduct;
- Developing and implementing a robust regulatory framework that keeps pace with evolving markets, business models, and technologies; and
- Supporting a skilled workforce that is diverse, equitable, inclusive, and is fully equipped to advance agency objectives.

Among the initiatives to meet these goals, the SEC will seek to "modernize design, delivery, and content of disclosures to investors so they can access consistent, comparable, and material information while making investment decisions." The SEC refers to its efforts to enhance disclosures related to climate risks, cybersecurity, and human capital within this objective. Comments on the plan are due September 29.

The PCAOB's draft strategic plan sets out four goals and related objectives to support the achievement of those goals: modernize standards; enhance inspections; strengthen enforcement; and improve organizational effectiveness. Comments on the plan were due September 15.

New SEC Commissioners sworn into office

The SEC returned to a full slate of five Commissioners this summer when Mark T. Uyeda and Jaime Lizárraga were sworn into office on June 30 and July 18, respectively. Commissioner Uyeda fills the position most recently held by Elad Roisman, who left the agency at the end of January, and his term expires in 2023. Commissioner Lizárraga is taking over for departing Commissioner Allison Herren Lee, who announced in March her intention not to seek a second term. Lizárraga's term will expire in 2027.

PCAOB signs agreement related to inspections in China

On August 26, the PCAOB announced it had signed a Statement of Protocol with the China Securities Regulatory Commission and the Ministry of Finance of the People's Republic of China. The agreement establishes a framework for the PCAOB to access the audit work papers, audit personnel, and other information needed to inspect registered public accounting firms in mainland China and Hong Kong. Under the US Holding Foreign Companies Accountable Act (HFCAA), if a position taken by an authority in a foreign jurisdiction prevents the PCAOB from inspecting and investigating "completely" a registered public accounting firm for three consecutive years, a company audited by that firm would be prohibited from trading on US markets.

The significance of this agreement in the context of the HFCAA will be borne out later this year, as the PCAOB is planning to have an inspections team in China by mid-September. According to PCAOB Chair Erica Y. Williams, "the real test will be whether the words agreed to on paper translate into complete access in practice."

Standard-setting updates

Proposed ASU addresses accounting for investments in certain tax structures

On August 22, the FASB issued a proposed ASU reflecting the consensus-for-exposure reached by the EITF to expand the use of the proportional amortization method of accounting to investments in tax credit structures beyond low-income housing tax credits if the arrangements meet certain criteria. The proportional amortization method results in the tax credit investment being amortized in proportion to the allocation of tax credits and other tax benefits in each period, and also results in net presentation within the income tax line item. Comments are due by October 6, 2022.

FASB votes to move forward with segment reporting proposal

At its July 27 meeting, the FASB voted to issue a proposal that would amend the segment disclosure requirements. The proposal would add new disclosures of significant segment expenses that are both (1) regularly provided to the chief operating decision maker (CODM) and (2) included in the reported measure of segment profit or loss. Significant segment expense categories would include those that are "easily computable" from the management reports that are regularly provided to the CODM. The FASB also decided to require disclosure of the title and position of the CODM, and to permit companies to report multiple measures of a segment's profit or loss. The disclosures would be required in both interim and annual periods and would also apply to companies with a single reportable segment. The proposal will have a 75-day comment period.

Project spotlight

FASB looks to modernize guidance on software costs

The accounting for costs to acquire or develop software has become increasingly relevant across all industries as companies invest in technology and digital transformation. In June, the FASB added a project on software costs to its agenda, with a focus on modernizing the guidance and increasing transparency.

In the current guidance, there are different accounting models for (a) software used for internal use only (including software used to provide cloud-based services) and (b) software externally marketed to customers. This can result in significant differences in financial reporting depending on the model that applies. Although the FASB has not yet made any decisions, some Board members expressed interest in exploring an approach that would provide a single accounting model for all software costs.

For more information, refer to the FASB's project page. To learn more about the current guidance, refer to our *Software costs* guide and listen to our podcast, *Buying or developing new software? Know which guidance to use*.

For a complete list of recently issued accounting standards and their effective dates, including links to PwC resources, refer to the *Guidance effective for calendar year-end public companies* and *Guidance effective for calendar year-end nonpublic companies* pages on Viewpoint.

PwC reference library

PwC's accounting podcasts

PwC's accounting podcast series includes a library of podcasts covering today's most compelling accounting, reporting, and business issues. Subscribe to our podcast feed on your platform of choice.

In our Toolkit podcast series, we are taking a deep dive into one accounting topic each month that goes beyond the basics and into areas that require judgment. In September, we're focused on impairment, and you'll want to revisit our past toolkits on compensation, derivatives, leases, and more.

Some of our most popular podcasts this quarter:

Strategy, emissions, and more: The SEC's rules aimed at ESG funds

Beyond the SEC, global bodies are moving fast on ESG

SEC climate disclosure proposal: What did respondents say?

Derivative toolkit: Do I have a derivative?

Derivative toolkit: Hedging debt with derivatives

Accounting and reporting webcasts

PwC's accounting and reporting webcasts keep you informed about emerging accounting, regulatory, and market developments impacting financial reporting. Register here for our upcoming CPE-eligible webcasts.

In depths

Accounting for the Inflation Reduction Act and the CHIPS Act

Perspectives on SAB 121 and safeguarding crypto assets

Amendments to CECL eliminate TDRs and add disclosures

Implications of the Russian government's invasion of Ukraine

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SEC adopts pay versus performance disclosure rules

SEC proposals on fund and advisor ESG disclosures and fund names

ISSB proposes two sustainability standards

SEC proposes new rules related to SPAC and de-SPAC transactions

SEC proposes new cybersecurity disclosure requirements

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Don't wait until the SEC staff asks you about climate change

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The board's role: building trust in a multi-stakeholder world

The corporate director's guide to overseeing deals

The corporate director's guide to shareholder activism

Risk oversight and the board: navigating the evolving terrain

Boardroom recap: The 2022 proxy season

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