Accounting in uncertain economic times

How current macroeconomic trends might affect an entity's financial statements

Our most recent PwC Pulse Survey, conducted in October 2022, found that 70% of CFOs are very concerned about the impact of macroeconomic conditions on their business and with good reason. In 2022, the Federal Reserve raised interest rates seven times and US inflation increased 7.1% over the same time last year*. At the same time, consumer confidence is waning, and the Russia Ukraine conflict continues. All of this is affecting supply chains that had not yet recovered from the challenges of COVID-19. That's a lot.

This uncertainty can create accounting, auditing, financial reporting, and regulatory risks. This *Accounting in uncertain economic times* placemat series is intended to assist reporting entities to identify how the prevailing macroeconomic trends may impact accounting and reporting in a number of areas, understand potential challenges associated with these areas, and locate additional resources to navigate these issues. To navigate these placemats, click on one of the macroeconomic trends below to learn more. Or refer to the *master slide index* to go directly to an area of interest. A companion *In depth: FAQ on accounting in uncertain economic times* that discusses the topics in these placemats in further detail is available on Viewpoint.

These placemats are intended as a high level summary of accounting and reporting considerations specific to prevalent macroeconomic conditions. They are not all-inclusive, and are not intended to be definitive guidance. Neither are they a substitute for consultation with professional advisors.

Macroeconomic trends

- **Rising interest rates**
- **Inflation**
- **Market volatility**
- **Supply chain challenges**
- **Geopolitical conflict**
- **Recession concerns**

* Data as of November 2022

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Master slide index

How macroeconomic trends might affect an entity's financial statements with links to additional resources

Deeper dive into accounting and reporting key reminders with links to additional resources

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Rising interest rates

Rising interest rates

As central banks look to curb inflation by curtailing the money supply, market interest rates are rising. This can impact asset values, increase the cost of capital, and put downward pressure on valuations developed using discounted cash flow projections, potentially leading to impairment. **Click on the buttons below to learn more:**

- Cash and cash equivalents
- Commitments, guarantees, and contingencies
- Debt modifications
- Derivatives and hedging
- Fair value
- Income taxes
- Intangibles and goodwill
- Investments in debt and equity securities
- Leases
- Pension
- Property, plant, and equipment
- Foreign currency transactions

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Supply chain challenges

Supply chain challenges

Global supply chains, particularly with respect to oil, commodities, and semiconductors, have been under strain since the onset of the global pandemic and were further exacerbated by other global events. These disruptions may have direct or indirect effects on business operations, with downstream financial reporting implications. **Click on the buttons below to learn more:**

- **Commitments, guarantees, and contingencies**
- **Inventory**
- **Commodities**
- **Property, plant, and equipment**
- **Derivatives and hedging**

Disclosure of supply chain challenges

Similar to the SEC's specific guidance on disclosure of the impact of COVID-19 and Russia's invasion of Ukraine, it is important that entities consider their disclosure obligations within risk factors (Item 105 of Regulation S-K), MD&A (Item 303 of Regulation S-K), and financial statement footnotes. These disclosures should enable an investor to understand how management and the Board of directors are analyzing the current and expected impact of supply chain challenges on the entity's operations and financial condition. Relevant disclosures may include information related to supply chain constraints, disruptions, shortages, excess inventory, cost increases, and any material inventory-related adjustments.The disclosures should not be generic or boilerplate. Rather, they should reflect the facts and circumstances specific to each entity.

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Inflation

Inflation

The annual inflation rate in the US was up 7.7% on a year-over-year basis.* While supply chain issues are a contributing factor, the increasing cost of labor and/or lack of supply of labor has compounded the cost increases across all sectors of the economy. In addition to the direct impacts of increased costs, rising prices that decrease consumer spending may also impact revenues and liquidity. **Click on the buttons below to learn more:**

- Cash and cash equivalents
- Commodities
- Intangibles and goodwill
- Inventory
- Leases
- Property, plant, and equipment
- Revenue and receivables
- Foreign currency accounting

Highly inflationary economies

Entities should be aware if they have operations in a highly inflationary economy, as defined by US GAAP. The financial statements of a foreign entity in a highly inflationary economy should be be remeasured as if the functional currency were the reporting currency. Therefore, a reporting entity with a US dollar reporting currency would be required to change the functional currency of their foreign currency operations to the US dollar. Turkey is an example of a country with a highly inflationary economy in 2022.

Read FX and inflation; Turkey expected to be highly inflationary to learn more.

* Data as of October 2022

Geopolitical conflict

Geopolitical conflict

The Russia-Ukraine conflict continues to create pervasive geopolitical uncertainty and risk, affecting businesses across the globe, especially those exposed to the energy and agricultural markets. **Click on the buttons below to learn more:**

- **Commodities**
- **Consolidation**
- **Exit or disposal costs**
- **Fair value**
- **Incomes taxes**
- **Investments in debt and equity securities**
- **Leases**
- **Revenue and receivables**
- **Segments**

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Market volatility

Market volatility

The uncertainty and/or negative outlook created by many of the other macroeconomic trends has led to significant volatility in the global capital markets, and, in turn, in the valuation of individual financial assets and liabilities. Given the variety of accounting models for financial assets as well as collateral implications, entities may need to consider whether financial assets are impaired and determine implications on liquidity. **Click on the buttons below to learn more:**

- Commitment, guarantees, and contingencies
- Commodities
- Debt modifications
- Investments in debt and equity securities
- Derivatives and hedging
- Fair value
- Income taxes
- Pensions
- Stock compensation
- Foreign currency accounting

Recession concerns

Recession concerns

In light of central banks attempting to curb inflation, the specter of an economic recession creates another negative overhang on the markets. While unemployment is at an all time low at 3.7%*, US GDP growth was negative for the first two quarters of 2022, the housing market shows signs of cooling, and some entities have announced layoffs or reorganizations. **Click on the buttons below to learn more:**

- Cash and cash equivalents
- Commitments, guarantees, and contingencies
- Debt modifications
- Income taxes
- Intangibles and goodwill
- Inventory
- Leases
- Property, plant, and equipment
- Revenue and receivables
- Segments
- Stock compensation
- Exit or disposal costs

* Data as of November 2022

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Cash and cash equivalents

	Macroeconomic trend		
	Rising interest rates	**Recession concerns**	**Inflation**
Cash management	Rising interest rates may incentivize entities to consider holding alternative instruments with higher yields that do not meet the definition of a cash equivalent. In order to qualify as a cash equivalent, an instrument must: (1) have an original maturity (from the date of acquisition) of 90 days or less, and (2) be readily convertible to cash. In practice, reporting entities have sometimes placed undue focus on the maturity characteristic, while overlooking the readily convertible to cash characteristic. To be considered "readily convertible to cash," an instrument must have both interchangeable units and quoted prices that are available in an active market. The active market must be able to handle a reporting entity's conversion of an instrument to cash quickly and without significantly affecting the quoted price.	Maintaining sufficient cash balances may become more important as financing could become more challenging in a recessionary environment. In connection with preparing interim and annual financial statements, entities need to evaluate whether the economic outlook specific to their business has impacted their ability to continue as a going concern and, if necessary, develop a plan to mitigate their liquidity risk. Considering factoring accounts receivable as a way to accelerate cash receipts will require an assessment of whether factoring arrangements qualify as sales of receivables under ASC 860 or should be reported as secured borrowings.	Inflation causes a currency to have less purchasing power, which in turn can impact the exchange rate relative to other currencies. Entities that have cash and other monetary transactions denominated in foreign currencies (e.g., loans receivable or borrowings) may have increased volatility in gains or losses related to foreign currency transactions. An increase or decrease in the US dollar value of a foreign subsidiary's net assets due solely to a decrease in the value of the foreign currency (FX) relative to the US dollar reporting currency is reflected in the CTA account in OCI.
Statement of cash flows	Cash management in response to rising interest rates can create complexities in the statement of cash flows. Unless the instrument meets the definition of a cash equivalent, an entity is likely purchasing a debt security (e.g., US Treasury securities) or an equity security (e.g., a money market fund). Purchases and sales of available-for-sale or held-to-maturity debt securities should be classified as investing cash flows and reported on a gross basis in the statement of cash flows. However, if the instrument is an equity security or a debt security classified as trading, an entity will need to consider the nature and purpose of the investment to appropriately classify the cash flow activities as either investing or operating.	Some factoring arrangements with banks or other financial institutions involve an initial cash receipt upon the date of factoring (sale or secured borrowing) with a follow on payment that is contingent upon collections on the underlying receivables, referred to as deferred purchase price (DPP). The DPP is reflected as a receivable from the bank or conduit. While the initial payment received may be classified as an operating activity, subsequent cash receipts attributable to the DPP are considered investing activities. If the entity ultimately repurchases the underlying receivables, subsequent collections on those receivables would continue to be classified as investing activities.	An entity with operations in foreign countries or with FX transactions must report the reporting currency equivalent using the exchange rates in effect at the time. If the pattern of cash flows and exchange rates are relatively consistent throughout the period, an entity may use an average exchange rate for translation. However, if it is not consistent or a particular exchange rate is volatile, the rate in effect at the time of the transaction should be used. This is likely to be the case for large and infrequent investing and financing transactions. Changes in CTA have no direct impact on the statement of cash flows, but the effect of exchange rates on cash balances is not a "plug." It is computed by adding (1) net cash flow activity measured in the functional currency multiplied by the difference between exchange rates used in translating functional currency cash flows and the exchange rate at year end and (2) the fluctuation in the exchange rates from the beginning of the year to the end of the year multiplied by the beginning cash balance denominated in currencies other than the reporting currency.

Resources

- FSP guide: Chapter 6
- In the loop: Assessing liquidity and going concern in an uncertain economy
- Foreign currency accounting placemat
- Podcast: Building your cash flow statement in uncertain times
- Podcast: Full disclosure: The statement of cash flows

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Commitments, guarantees, and contingencies

Macroeconomic trend

Considerations for transactions or arrangements that are not financial instruments

Rising interest rates

- The value of the assets pledged as collateral could change in light of rising interest costs rising interest costs leading to higher discount rates. This could have an impact on the sufficiency of asset values to meet contractual requirements.

Supply chain challenges

- Supply agreements that include unconditional purchase obligations, such as take-or-pay or throughput contracts, may be subject to fulfillment challenges, giving rise to the need to re-evaluate the variable components of such obligations.
- Entities should evaluate the need for and sufficiency of recognized contingent liabilities.
  - Suppliers may be more incentivized to enforce economic terms in contracts, such as penalties or fees, due to their own current financial circumstances.
  - Suppliers may also need to consider breach of contract risk associated with unfulfilled contracts.

Recession concerns

- Recession and stalled growth concerns may initiate or exacerbate going concern risks. In addition to assessing the impact of diminished demand for products and services, entities need to consider the risks arising from contractual and noncontractual obligations that may create substantial doubt about an entity's ability to continue as a going concern. For example, material litigation, especially those arising from an operational disruption or breach of a long-term commitment, may increase uncertainty.
- Guarantees within the scope of ASC 460 may need to be reassessed for changes in the probability or measurement of recognized guarantee obligations. For example, the likelihood of making a payment for a guarantee of a third party's financial performance may increase when the guaranteed party is experiencing financial difficulties (e.g. reduced operating cash flows, liquidity challenges, incurred losses).

Market volatility

- Rising interest rates and volatility in the valuation of assets could result in a decline in collateral values due to increased discount rates. As a result, financial metrics that are sensitive to collateral or asset values could be impacted resulting in, for example, increased interest costs, covenant breaches, and in more serious cases, liquidity concerns.
- Parties to long-term purchase commitments for commodities that were not hedged could experience significant P&L volatility.

Considerations for financial instruments

Rising interest rates

- Entities should evaluate the need for an accrual for credit losses on certain off-balance sheet items, such as loan commitments and credit guarantees, separate from the valuation account related to the recognized financial instrument.

Market volatility

- The contingent component of a guarantee is only recorded if payment of the guarantee is probable, which is typically not the case at inception of the guarantee. Higher market volatilities could change the likelihood of occurrences of events or conditions triggering the guarantee. Entities should continually assess the need to recognize a liability for the contingent component of the guarantee. The noncontingent component is recognized at fair value and, unless the guarantee is accounted for as a derivative under ASC 815, it is not remeasured at fair value each reporting period.

Resources

- FSP guide: Chapter 23
- Podcast: Full disclosure: Commitments and contingencies
- Podcast: Full disclosure: Other liabilities

Commodities

	Macroeconomic trend		
	Geopolitical conflict & supply chain challenges	**Market volatility**	**Inflation**
Accounting and reporting considerations	Delivery of commodities may no longer be possible in areas impacted by the Russia-Ukraine conflict, international trade sanctions, and other global supply chain disruptions. The application of the normal purchases and normal sales (NPNS) scope exception - that is, when a commodity contract meets the definition of a derivative but derivative accounting is not required to be applied because the commodity is expected to be used or sold by an entity over a reasonable period in the normal course of business - may need to be discontinued if physical delivery is no longer probable. Once elected, whether and when a reporting entity should discontinue application of the NPNS scope exception partially depends on the form of net settlement applicable to the contract. Failure to deliver under a commodity contract may also result in penalties, refunds, or other damages. Cash flow hedge accounting may need to be discontinued if the likelihood of the forecasted transactions changes. See DH guide: Section 3.2.4 and DH guide: Chapter 10 for further details.	Commodity price volatility can drive significant fluctuations in operating income as the costs to acquire certain commodities increase and hedging strategies may become less effective. Uncertainty in the commodities market may also increase collateral requirements included in certain commodity transactions. Significant price increases may cause commodity transactions to become more material. If commodities are a significant element of materials cost, inventory valuations could be at risk and LIFO inventory calculations could have a much more significant impact on reported results.	Long-term, fixed price commodity supply contracts may become unprofitable for suppliers during periods of high inflation. Increased commodity prices that cannot be passed to customers negatively impact profit margins and cash flows. Cash flows from commodity contracts included in cash flow projections (for example, for impairment or valuation estimates) may need to be updated to reflect lower future margins and potential losses. Revenue recognition is dependent on customer collectibility. This is the case even when commodity sales to at-risk customers continue due to regulatory requirements (e.g., when moratoriums are in place as relief for customers). See Revenue and receivables for details.

Resources

Commodities can be classified in different ways. Refer to the following links for additional information that may be relevant for commodities based on classification:

- Inventory: UP guide: Chapter 11, *Inventory*, Inventory placemat
- Property, plant, and equipment
- Commodity instruments: accounted for as derivatives: UP guide: Chapter 3, *Derivatives and hedging*, Derivatives and hedging placemat
- UP guide: Chapter 2, *Leases*
- Consolidation

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Consolidation

	Macroeconomic trend	
	Market volatility	**Geopolitical conflict**
Deconsolidation and reconsolidation	In connection with the disposal of its operations in Russia, a reporting entity may enter into a call option to allow it to reacquire such operations if the situation changes in the future. The existence of a call option could affect the deconsolidation assessment of the operations, as the reporting entity must determine if the call option represents a retained variable interest or whether the disposed business is a variable interest entity (VIE), which would then require the reporting entity to determine the primary beneficiary. The determination of the primary beneficiary is a continuous assessment that is complex and may be further complicated by volatile market environments.	Conflicts, sanctions, and other geopolitical issues may affect a reporting entity's assessment of whether it continues to have control over an entity in a conflict region. Short-term disruptions to the ability to repatriate funds or communicate with local management would, by themselves not be expected to result in de-consolidation. A reporting entity's conclusion that it no longer controls a majority-owned subsidiary would need to be supported by such factors as: • inability to access various exchange mechanisms at the level required by the scope and size of its operations • limited ability to manage capital structure, product development, purchasing, production scheduling, product pricing, and labor relations due to government regulations • an evaluation of the current political and economic situation Reporting entities should also consider when a change in the conflict region has occurred, such that any restrictions and limitations that may have led to a deconsolidation conclusion have been mitigated, in which case, the reporting entity may need to reconsolidate the entity. Such a reconsolidation would represent a business combination pursuant to ASC 805.

Resources

- Consolidation guide
- Podcast: Consolidation: Back to the basics with 5 things you need to know
- Podcast: Consolidation: A journey through the VIE model
- Russian invasion of Ukraine: Four-part podcast series

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Debt modifications

	Macroeconomic trend		
	Rising interest rates	**Recession concerns**	**Market volatility**
Modification versus extinguishment	Changes in the yield curve may cause an entity to consider amending their existing agreements to change the length of their borrowing period. Interest rate changes may also impact the timing of when entities decide to restructure their debt. If an entity amends or restructures the terms of its existing debt agreements and retains the same lender, the entity should assess whether a modification or extinguishment has occurred (using the 10% test) as the accounting differs based on the conclusion. Increased interest rates may change cash flows more than 10%, resulting in extinguishment accounting.	Weaker operating results could lead to credit rating downgrades, thus minimizing an entity's ability to access capital. A tightening of financial markets may impact the timing of when an entity can refinance. When an entity is experiencing financial difficulty, any modification or extinguishment should be assessed to determine whether it constitutes a troubled debt restructuring.	Entities may be incentivized to rethink their capital structures if the cost of funding in certain markets becomes unattractive due to market volatility. While some entities may restructure debt, others may consider alternative forms of funding such as preferred stock. Preferred stock issuances should be analyzed under ASC 480 to determine whether they should be classified as liabilities or equity.
Classification	Entities with floating rate debt may experience difficulties servicing debt. If a debt covenant is violated, maturity dates may be accelerated, and entities may need to reclassify all or a portion of the debt to current liabilities, which could also have implications on liquidity and require an assessment of whether substantial doubt about an entity's ability to continue as going concern exists.	Entities should assess subjective acceleration clauses and their impact on debt classification. Restrictions on future borrowings and/or increased borrowing costs may also result from non-compliance with covenants, which may have implications on the going concern evaluation.	Volatile markets could lead to a high risk of default as a result of reduced revenues, negative operating results, and/or declining asset values that serve as collateral. An entity may also violate a covenant provision and trigger repayment of the debt. Classification of the debt between current and noncurrent is driven by when the violation occurred and whether (and when) a waiver or modification is made to avoid the violation. See FSP guide: Chapter 12 for further details.

Resources

- A deeper dive: Debt modifications placemat
- In the loop: Assessing liquidity and going concern in an uncertain economy
- Podcast: Accounting for debt in uncertain times: 5 things to know

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Derivatives and hedging

	Macroeconomic trend		
	Rising interest rates	**Supply chain challenges**	**Market volatility**
Fair value of derivatives	Changes in interest rates may lead to significant income volatility from interest rate derivatives not included in hedge accounting relationships that have to be marked to fair value through earnings. Entities may purchase interest rate caps as a way to mitigate the risks of floating rate debt. Interest rate caps generally meet the definition of a derivative and are recognized at fair value on the date the contract is entered into, even if the instrument is forward-starting. Interest rate caps will often be in an asset position at inception due to the premium paid to purchase the interest rate cap.	Valuation of forward commodity purchase and sale contracts may be impacted by supply chain issues as costs to acquire these commodities increase.	Counterparty credit risk, which may increase during times of increased market volatility, will impact the valuation of uncollateralized derivatives. In addition, reporting entities may experience significantly increased collateral requirements when markets are volatile.
Hedge accounting	Changes in interest rates may increase the desire to achieve hedge accounting to mitigate income statement volatility. Designating an existing derivative in a new hedging relationship may be challenging because the derivative will typically have a fair value other than zero, which can result in ineffectiveness. The degree to which an off-market derivative will impact the assessment of effectiveness may depend on the method of assessing effectiveness (see DH 9 for discussion of assessing effectiveness). In addition, reporting entities need to ensure they have met all eligibility and documentation requirements for hedge accounting.	Lower sales or purchase volumes as a result of supply chain challenges may cause issues for entities that use the normal purchases and normal sales (NPNS) derivative scope exception. If an entity determines it can no longer assert that it is probable that a contract will result in physical delivery, it may need to stop applying the NPNS scope exception. This could call into question an entity's ability to assert physical delivery is probable for other contracts. If an entity cannot apply the NPNS scope exception, those contracts would also not qualify to be designated as hedged items in a hedging relationship.	Reporting entities may seek to use hedge accounting to mitigate income volatility during periods of high market volatility. However, greater market volatility may result in less effective hedge relationships due to increased counterparty credit risk
Probability of a forecasted transaction	Entities may be looking to restructure debt to manage interest rate risk. If the restructured debt has been designated as part of an existing cash flow hedge, the potential refinancing transaction should be considered in an entity's assessment of whether the forecasted interest payments remain probable of occurring, and, in turn, whether hedge accounting continues to be appropriate.	Forecasted transactions must be probable of occurring to enter into or continue cash flow hedging relationships. Supply chain challenges must be considered when determining the probability of forecasted purchases or forecasted sales. If a forecasted transaction fails to occur, gains and losses from the derivative designated as a hedge that are accumulated in AOCI must be reclassified into earnings, and reporting entities should consider the disclosure requirements in ASC 815 as well as the impact to their probability assessment of forecasted transactions in other cash flow hedges.	Similar to rising interest rates, market volatility could lead an entity to reconsider raising capital (or repurchasing existing debt at a discount), which, in turn, could impact the probability of occurrence of forecasted transactions such as debt issuances or interest payments.

Resources

- A deeper dive: Fair value placemat
- Derivatives and hedging guide
- Podcast: Derivative toolkit: Hedging debt with derivatives
- Podcast: Derivative toolkit: Do I have a derivative?
- Podcast: Derivative toolkit: Deciphering foreign currency hedging

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Income taxes

	Macroeconomic trend		
	Rising interest rates	**Recession concerns**	**Market volatility**
Deferred taxes	The deductibility of interest expense for US Federal income tax purposes is limited under IRC §163(j). In an environment with rising interest rates, the amount of nondeductible interest and, in turn, a carryforward of that interest deduction, may grow in magnitude quickly. For tax years beginning after December 31, 2021, the calculation of adjusted taxable income used to determine the interest expense deduction limitation is defined similar to EBIT (earnings before interest and taxes) instead of 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 and additional valuation allowance considerations.	Market conditions may result in the impairment of tangible and intangible assets as well as goodwill, all of which may have an impact on a company's deferred taxes. The deferred tax implications of a goodwill impairment can be particularly complex when the goodwill in question is tax deductible. In the current environment, entities may be faced with changing liquidity needs that may require actions to bring cash back to the US to support operations. They may also be considering the need to exit business operations in certain markets due to heightened risks or uncertainties. Non-recognition of a deferred tax liability for outside basis differences is an exception to ASC 740's model. A company availing itself of that exception must continuously assert its intent to indefinitely reinvest unremitted earnings. Income tax expense should be adjusted in the period of a change in judgment.	For assets marked to fair value at each reporting period – either through P&L or OCI – periods of significant market volatility can have an impact on the nature and magnitude of temporary differences (i.e., deferred taxes). Companies should understand whether the character of any of those temporary differences (e.g., capital vs. ordinary) warrants use of a different tax rate to measure the deferred taxes.
Annual effective tax rate (AETR)	To compute the AETR, a reporting entity needs to estimate its full year ordinary income and its total tax provision, including both current and deferred tax benefit or expense. Rising interest rates may reduce ordinary income, which would require the need to update the full-year estimate of income and could impact the estimated AETR. When the AETR estimate changes, the year-to-date results are adjusted to the new AETR which can cause a larger change in the reported tax rate for an individual quarter.	The AETR only applies to the tax effect of ordinary income. Ordinary income for these purposes excludes significant unusual or infrequently occurring items that will be separately reported. While the scope and severity of the current economic impacts may be significant to many entities, many, if not all of those impacts are a function of economic uncertainty that is inherent in any business. Nevertheless, some entities may consider some of the effects to be infrequent even if not of an unusual nature and may determine that it is appropriate to exclude those items and their related tax effects from the AETR calculation. Jurisdictions in which the entity's operations are generating losses for which no benefit can be recognized (i.e., a full valuation allowance is needed) are excluded from the calculation of the AETR and a separate AETR is calculated for each of those jurisdictions.	At each interim period, a company is required to estimate its forecasted full-year AETR. While we generally expect entities to be able to make a reasonable estimate of ordinary income, if a reliable estimate cannot be made, ASC 740-270-30-18 indicates that the actual effective tax rate for the year-to-date period may be the best estimate of the annual effective tax rate.
Valuation allowance (VA)	Estimates of future taxable income may be particularly relevant when evaluating realizability of deferred tax assets in the form of loss, deduction, or credit carryforwards subject to a relatively short carryforward period or that are subject to annual usage limitations based on income. Rising interest costs may result in less taxable income to support the realization of such deferred tax assets. Entities that are not able to reliably forecast taxable income (and therefore are relying solely on reversals of taxable temporary differences to support realization) may need to perform a more detailed scheduling exercise to determine what portion of their 163(j) interest deduction carryforward is realizable. So-called "naked credits" (or taxable temporary differences on indefinite-lived intangible assets and goodwill) represent a source of future taxable income for carryforwards that do not expire.	The starting point for projections of future taxable income used for purposes of assessing the need for a valuation allowance should be consistent with other projections or estimates used in the preparation of the financial statements and in other disclosures. However, the future taxable income that may be considered in the VA analysis must be at a level that is objectively verifiable. Often, forecasts that are used in, for example, a goodwill impairment test may include growth and other assumptions that are not objectively verifiable. In addition, a recessionary environment may put significant pressure on a company's profitability outlook. US NOLs generated in taxable years ending after December 31, 2017 may be carried forward indefinitely. However, the mere existence of an indefinite carryforward does not alleviate the need for a valuation allowance. Entities still need to demonstrate that, at a more-likely-than-not level of confidence, they will generate sufficient future taxable income to realize the benefit of any NOL carryforwards. Also, due to their indefinite carryforward period, naked credits can also serve as a source of income for post 2017 US NOLs.	In projecting future taxable income, all available information should be considered. This includes operating results and trends in recent years, internal budgets and forecasts, and anticipated changes in the business. Generally, the most recent results should be considered indicative of future results, absent evidence to the contrary. In periods of market volatility, it may be harder to gauge whether the most recent results are indicative of future performance, and more judgment will be required. When an investments in debt or equity securities has been marked to fair value and fair value is less than the original cost, a deductible temporary difference results. The nature of the deductible temporary difference in these fact patterns is often capital instead of ordinary. As capital losses can only be used to reduce capital gains, it is important to understand whether the company has sufficient sources of capital gains income to realize those assets. If not, a valuation allowance may be needed, even if the entity is otherwise profitable.

Resources

Deferred taxes
PwC Income tax guide – **Chapters 3, 4, 10, and 11**
PwC Business combinations guide - **Chapter 9**
Accounting for outside tax basis differences - Podcast

Annual Effective Tax Rate (AETR)
PwC Income taxes guide – **Chapter 16**
Accounting for income taxes in interim periods- podcast

Valuation Allowance (VA)
Valuation allowance placemat
PwC Income taxes guide – **Chapter 5**
Tax toolkit: Valuation allowances, weighing the evidence podcast

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Intangibles and goodwill

Macroeconomic trend

Business combinations and asset acquisitions

Rising interest rates

- The increase in market interest rates likely impacts the discount rate assumption used in any discounted cash flow fair value estimation approach. For acquisitive entities, it is important to ensure that the valuation assumptions used in recognizing the acquired assets and liabilities are appropriate as of the date of acquisition, which may be earlier than when the fair value measurements are finalized.

Inflation

- Order or production backlog acquired in a business combination would meet the contractual-legal criterion and, therefore, may be recognized separately as an intangible asset. However, a reporting entity should consider if the sales order contracts are cancellable, as this fact may affect the measurement of the fair value of the associated intangible asset. This assessment may be more challenging in an inflationary market environment depending on the impacts to the entity's various customers and any disruption that may be caused by the transaction.

Market volatility

- In an asset acquisition, an assembled workforce obtained as part of a transaction may represent a separate intangible asset qualifying for recognition. The intellectual capital (e.g., specialized skills, knowledge, experience) of the employees that make up the assembled workforce would be included in the value of the recognized assembled workforce intangible asset. However, the reporting entity should consider whether the transfer of a workforce is an indication that the acquisition is actually that of a business. In the case of a business combination, any value related to an assembled workforce would be subsumed into any goodwill recognized by the acquiring entity.

Impairment

Rising interest rates

- The increase in market interest rates, in isolation, has an immediate downward impact on the value of future cash flows and, in turn, the fair value of an asset group or reporting unit. In addition, those higher interest costs may translate into lower gross cash flows for a highly leveraged business, thus increasing the likelihood of impairments.
- In any situation when management concludes that goodwill is impaired, it will be important to assess whether that goodwill is tax deductible and, if so, apply the "simultaneous equation" technique to measure the goodwill impairment (see BCG 9.9.1.1).
- If goodwill has recently been impaired, there is no headroom that can accommodate further downward pressure on fair values. Each time interest rates are raised subsequent to the initial impairment, additional impairment assessments are likely to be required and incremental charges would not be unusual.

Inflation

- When evaluating whether it is more likely than not that an indefinite-lived intangible asset or goodwill is impaired, the factors to consider include both macroeconomic conditions as well as entity-specific considerations, including impacts on operating costs. As inflation affects different industries and sectors differently, reporting entities should consider the interplay of all relevant factors in performing a qualitative assessment of whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount.

Recession concerns

- When evaluating whether it is more likely than not that an indefinite-lived intangible asset or goodwill is impaired, the factors to consider include both macroeconomic conditions as well as entity-specific considerations, including changes in customer demand. For example, in a recessionary environment when consumer demand contracts, demand for a company's goods and services may also be impacted. Reporting entities may need to consider the interplay of all relevant factors in performing the qualitative assessment for impairment and also whether circumstances continue to support an indefinite useful life for intangible assets, as well as any impact on the useful lives of existing finite-lived intangible assets.

Market volatility

- Market volatility and rising interest rates may represent triggers to test long-lived assets for an impairment and/or an interim goodwill impairment tests. Entities recently entering or planning to enter the IPO market, in particular, will need to monitor volatile prices in their shares just post IPO. Rising interest rates and increased business risks likely will result in higher discount rates applied to future cash flows, leading to decreases in DCF-based fair value models.
- An increase in the fair value of reporting units may reduce the difference between the cumulative fair values of all reporting units and the reporting entity's market capitalization, or control premium. An increase in the implied control premium should be skeptically assessed and evaluated. A larger control premium must be adequately supported and should consider the synergies inherent in a market participant's perspective of the fair value of a reporting unit.

Resources

A deeper dive: Nonfinancial asset impairment placemat

Property, plant, equipment and other assets guide

BC guide: Section 9.9.1

Inventory

	Macroeconomic trend		
	Inflation	**Supply chain**	**Recession concerns**
Impairment considera-tions	As inflation rises, increasing inventory costs put pressure on whether the net realizable value (NRV) of inventory still exceeds cost. Entities need to evaluate reasonable selling prices in the ordinary course of business and whether, in the current market, they are able to pass those cost increases on to customers. Inflation also impacts customer spending habits which may result in slower inventory turnover than expected and/or the need to reduce selling prices, which impacts net realizable value. And the inflationary pressure on margins will be exacerbated for those inventories carried at LIFO cost.	Prolonged supply chain challenges continue to put pressure on the availability of raw materials and finished goods across all industries. Entities need to assess the business and, in turn, financial reporting risks that exist in their supply chain. Mismatches in availability of supply and customer demand may result in entities experiencing longer than typical lead times and/or excess inventories, which in turn may impact the saleability or value of in-process inventory or complementary assets. Entities with inventory subject to cyclicality or spoilage are particularly sensitive to obsolescence risks. Entities with raw materials or inventory highly concentrated in certain geographic areas that are no longer accessible or experiencing significant delays may need to find new inventory sourcing options. The inability to obtain supply could result in a risk of being unable to fulfil contractual obligations and lead to other reporting implications. Importantly, potential losses from executory sales contracts are generally not accrued except in the context of a long-term construction contract.	Downturn in general economic conditions, restrictions on accessing capital, fluctuations in foreign exchange rates, consumer trends, and technological changes all may affect demand, and in turn, pricing for the sale of inventory (i.e., net realizable value). Further, decreases in demand might lead to entities having excess inventory.
Other considera-tions	Given the importance of margins to investors, entities should ensure that the margin impact of increasing inventory costs, especially in a LIFO context, and any inventory provisions that are necessary are clearly disclosed. Other than in a LIFO context, a write-down of inventory establishes a new cost basis of the inventory and should not be reversed until the inventory is sold.	Entities need to ensure transparent disclosure of the risks and impact of supply chain challenges on reported results, including specific segments, geographies, or product lines.	Entities should ensure the impact of of known trends or uncertainties are considered in their inventory net realizable value assessments and consider relevant forward-looking disclosures.

Resources

- Inventory guide
- The quarter close - Q2 2022
- Podcast: Accounting for inventory: 5 things you should know
- SEC comment letter trends: Inventory and cost of sales
- Podcast: Impairment toolkit: Inventory and other current assets

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Investments in debt and equity securities

	Macroeconomic trend		
	Rising interest rates	**Geopolitical conflict**	**Market volatility**
Fair value	Fixed-rate debt securities will decline in fair value as market rates rise. This may trigger (1) an impairment and/or (2) a need for an additional credit loss allowance or a write off of amortized cost. It should be noted that qualitative filters (e.g., credit rating) may not be sufficient to identify credit losses. In addition, decreases in fair value of debt and equity securities, including losses reported in OCI, may result in a cumulative loss condition for purposes of the income tax valuation allowance assessment. Additional analyses and significant judgment are required to determine whether a valuation allowance on deferred tax assets is needed.	The level of trading activity in a particular market may significantly decrease due to geopolitical conflict. When a market becomes inactive, observable transactions should be assessed to determine whether they continue to be relevant reference transactions for assessing fair value. An entity may choose to sell a portion of an investment accounted for under the equity method because of sanctions or a desire to divest from entities located in areas impacted by conflict. If the entity loses significant influence as a result of the sale, then the equity method of accounting should be discontinued and the investment should be accounted for under ASC 321.	Volatile markets can raise questions as to whether the observable prices on the measurement date are reflective of fair value. However, the mere presence of volatility in prices in a particular market does not indicate that transactions in that market are not orderly. In addition, an entity cannot ignore orderly transactions in the determination of fair value because of market volatility. An entity may have elected the fair value option to account for an equity method investment. Market volatility may create a desire to revert to the equity method, but the fair value option is irrevocable absent an event creating a new election date occuring.
Impairment	If an entity is using the measurement alternative on investments in equity securities, discount rates used in valuations and cash flow projections will increase, resulting in lower valuations even if there is no significant change to projected cash flows. This may have a significant effect on the outcome of impairment assessments.	Equity method investments in entities domiciled in regions directly involved in the Russia-Ukraine conflict may be at risk of other-than-temporary impairment. The measurement of impairment may become more complex when there is an associated CTA balance. Unless the entity has committed to a disposal plan that would otherwise cause the reclassification of CTA into earnings, this amount is excluded from the carrying value of the investment.	Volatile or decreased market values may trigger impairment assessments, either because the fair value of a debt security has declined below amortized cost or the decrease in prices is a qualitative indicator of impairment for an investment in equity securities measured using the measurement alternative. A decrease in the fair value of an investment due solely to exchange rate changes does not automatically result in an impairment loss.

Resources

- A deeper dive: Fair value placemat
- A deeper dive: Financial asset impairment placemat
- Deferred tax asset valuation allowance placemat
- Loans and investments guide: Chapter 7, Chapter 8, Chapter 13

Leases

Macroeconomic trend

	Rising interest rates	Inflation	Recession concerns	Geopolitical conflict
Initial recognition	ASC 842 requires the use of the incremental borrowing rate (IBR) to calculate the lease liability if the rate implicit in the lease is not readily determinable. While increases in market interest rates or volatility in interest rates generally may influence a company's determination of its incremental borrowing rate, the IBR is entity-specific. There is a practical expedient for nonpublic business entities, which allows a lessee to use a risk-free rate in lieu of the IBR for a period comparable to the lease term. Lessees can apply this election to leases by class of underlying asset. Given the increase in yields on government securities, entities applying this election will see, all other things being equal, a reduction in the lease liability for new leases.	Variable lease payments that depend on an index (such as the Consumer Price Index) or a rate should be included in the calculation of lease payments when classifying a lease and in the measurement of the lease liability at commencement. These payments should be calculated at lease commencement using the index or rate at lease commencement; no increases or decreases to future lease payments during the lease term should be assumed. Variable lease payments other than those that depend on an index or a rate should not be included in lease payments for purposes of classification and measurement of the lease, unless those payments are in substance fixed lease payments.	A lessee or lessor should consider all relevant contractual provisions, including renewal and termination options, to determine the term of the lease at lease commencement. Only renewal or termination options that are reasonably certain of exercise by the lessee should be included in the lease term at lease commencement. A lessor may be experiencing cash flow pressures due to a lack of demand and look to sell its lease receivables to access liquidity and reduce its exposure to counterparty credit risk. These transactions should be evaluated as transfers under ASC 860 to determine whether they qualify as sales or secured borrowings.	An entity may acquire leased property or equipment located in a region affected by geopolitical conflict as part of a business combination. When establishing the right-of-use asset and lease liability, the potential developments in the geopolitical conflict could influence whether the entity will continue to utilize the leased asset beyond the initial contract term.
Modifications/ day 2 accounting	As financing costs are inherent in any lease arrangement, an increase in interest rates could result in a lessor proposing to modify a lease. Lease modifications require determining if the modified arrangement continues to meet the definition of a lease, and, for the lessor, remeasuring and re-allocating contract consideration based on revised payment terms to components based on their then-current relative standalone selling prices, as well as reassessing the lease term, discount rate, and lease classification at the modification date.	Variable lease payments, including those based on index (such as the Consumer Price Index) or a rate, should be recorded in the period in which the obligation for the payment is incurred. A lessee should not remeasure a lease liability when payments increase based on a change in CPI. The change to a reference index upon which some or all of these variable lease payment is based does not constitute the resolution of a contingency. These lease payments continue to be variable as they may increase based on future changes in the CPI.	Lessors may offer rent concessions to tenants that are affected by an economic downturn. If a rent concession is not based on an existing contractual right, lease modification accounting would apply. A lessor should reassess collectability of lease payments during the lease term. If collectability is no longer probable (i.e., the lease subsequently becomes "troubled"), and cumulative cash receipts are less than lease income recognized to date, the excess lease income would be reversed. If collectability changes back to probable, any difference between the lease income that would have been recognized if collectability was always probable and the income actually recognized to date is recognized as current period lease income, assuming the original agreement has not been modified or replaced. Recessionary pressures may lead to an entity to close locations. Refer to Geopolitical conflict for the implications for leases when an entity may cease use of the space.	Geopolitical conflict could lead to an entity deciding to cease using a space or a leased asset either immediately or in the future. 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.

Resources

Leases guide
Podcast: Full disclosure: Leases
Podcast: Getting lease measurements/modifications right
A deeper dive: Lease modification and remeasurement placemat

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Pensions

	Macroeconomic trend	
	Market volatility	**Rising interest rates**
De-risking	Given recent market volatility, the value of plan assets may have declined below the level of plan obligations or the plan may otherwise no longer be considered sufficiently funded under its terms or relevant retirement income security regulations (e.g., ERISA in the US). As a result, plan sponsors may need to accelerate contributions, or they may consider changing investment strategies or liquidating certain assets to minimize the impact of market volatility. In those cases, management will need to re-evaluate investment and asset allocation policies and the impact on future expected return assumptions.	Rising interest rates could result in an increase to the assumed discount rate used to measure pension obligations. That could present an opportunity for plan sponsors to offer lump sum payments to “buy out” participants or purchase annuities at more favorable prices. In those cases, plan sponsors would need to consider whether settlement accounting is appropriate. If so, ASC 715 requires the entire pension obligation and plan assets to be remeasured at the current value as of the settlement date, prior to accounting for the settlement transaction.
Measure-ment	A significant change in the value of plan assets is not a significant event requiring interim measurement. Any decision to undertake an interim remeasurement in such circumstances would establish a policy of more frequent remeasurements, regardless of market conditions. The value of plan assets may have decreased given overall market volatility. Entities should evaluate significant assumptions and methods used in determining the plan asset values, obligations, and as a result, funded status.	Rising interest rates will result in a new measure of the pension obligation. That new measure will affect the funded status of the plan and the amount of unrecognized gains and losses. In addition, interest on the pension obligation in future periods, which is recognized in the P&L, will reflect the higher interest rates.

Resources

- The quarter close - Q2 2022
- Pensions guide: Chapter 2
- Podcast: Full disclosure: Pension and other postemployment benefits

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Property, plant, and equipment

	Macroeconomic trend		
	Inflation/rising interest rates	**Supply chain challenges**	**Recession concerns**
Depreciation	When considering salvage value in calculating depreciation of a tangible asset, reporting entities should take into account all of the disposal costs that would be necessary to realize the salvage value of the asset. With inflation and higher interest rates, estimates of both the salvage value and costs of disposal may be higher than previously estimated. As a result, reporting entities may need to revisit estimates in cash flow forecasts for the asset, and also consider whether any changes in the expected useful life of the asset are necessary. While there is no explicit requirement to assess the useful life of a long-lived tangible asset each reporting period (as there is for intangible assets under ASC 360), entities may need to consider the impact of anticipated changes in useful life of an asset due to repurposing an asset as any change in useful life will have a direct impact on depreciation expense going forward.	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 or permanently repurpose the asset, 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 reassessing useful life.	Reorganization or disposal activities should be closely monitored, as depreciation does not cease until an asset or disposal group meets all of the criteria to be classified as held for sale. To classify an asset or disposal group as held for sale, all of those criteria must be met by the balance sheet date (i.e., a post-balance sheet decision is not pushed back). A loss on sale shortly after the balance sheet date may be an indicator of an impairment that should have been previously recorded.
Impairment	For an asset group that is under development, the undiscounted cash flow forecasts used to test the recoverability of the asset group should include cash flows associated with all future expenditures necessary to complete the development of the asset, including interest payments that will be capitalized as part of the cost of the asset. Thus, increased interest rates may require more capitalized interest to be reflected in those future expenditures. While more capitalized interest will increase the carrying value of an asset, which could put pressure on the undiscounted cash flow recovery test, higher interest rates will also reduce the estimated fair value using discounted cash flows, which could result in higher impairment charges.	Uncertainty with respect to an asset's cash-flow-generating capacity and physical output capacity may introduce additional challenges in estimating the cash flows used in the recoverability test or those used in calculating the asset's fair value. The period of time used to determine estimates of future cash flows for the recoverability test should be consistent with the remaining useful life of the asset (or primary asset within an asset group) that is used for depreciation purposes, which may not be as long as the asset's potential remaining economic life.	The carrying amount of a disposal group that is classified as held for sale should include the associated CTA, if any, that will be eliminated upon sale when measuring the disposal group at the lower of (a) its fair value less cost to sell or (b) carrying amount. However, such amounts should remain classified within AOCI until the actual sale occurs. Refer to the foreign currency placemat regarding whether CTA would be eliminated upon a sale of a disposal group.

Resources

PP&E guide: Section 4.2 and Section 5.1

A deeper dive: Nonfinancial asset impairment placemat

FSP guide: Section 8.6.1 and Section 8.6.3

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Revenue and receivables

	Macroeconomic trend		
	Inflation	**Recession concerns**	**Geopolitical conflict**
Revenue	Fixed price or long-term contracts may be impacted by cost increases, which could result in reduced revenue recognition or possible losses. Entities should review estimates of variable consideration and measures of progress. Outside of some specific circumstances (see RR 11.5.1), losses on executory contracts are not accrued in advance.	A broader economic recession may affect customer demand, and entities may consider alternative marketing strategies to stimulate demand. Entities should consider the accounting implications for any “customer goodwill” gestures (e.g., discounted goods or services, price concessions, or extended payment terms) and the implications on the transaction price. Those customer incentives may also have implications for the net realizable value of inventory.	A customer’s ability or intention to pay may be adversely impacted by geopolitical conflict. If, either prior to or during performance of a revenue contract, management concludes that collection is not probable, revenue recognition is precluded. Only after a receivable is recognized would a credit loss arise. In addition, entities should consider the impacts of contract modifications or terminations in response to sanctions or other circumstances arising from geopolitical conflict. In particular, entities should consider any penalties, refunds, or other payments for which it may be liable upon contract termination and whether those payments should be presented as a reduction of revenue.
Receivables	High inflation affects not only the reporting entity but its customers as well. Entities should review their receivables to evaluate whether inflationary pressures increase the likelihood of credit losses from their customer base.	The CECL model requires entities to consider current conditions and reasonable and supportable forecasts in developing an estimate of expected credit losses on their receivables. This estimate requires the use of judgment, especially in times of economic uncertainty. In practice, some entities use an approach to estimate losses on receivables using historical loss rates based on the days outstanding. Entities need to consider whether these historical rates require adjustment for the potential that a recession will negatively affect a customer’s ability to pay.	An assessment of a customer’s ability to pay an outstanding receivable may be directly or indirectly impacted by geopolitical conflict. The customer may not be located in the conflict region but may generate revenue from that region and therefore its ability to pay may be adversely affected. Absent changes in circumstances, we expect that entities will likely recognize additional allowances for credit losses related to their trade receivables and loans if there is a direct or indirect connection to a region with geopolitical conflict.

Resources

A deeper dive: Financial asset impairment placemat

Viewpoint hot topics: Revenue recognition

Revenue guide: Section 2.6, Section 2.9, Section 4.2, Section 4.3 and Section 6.4

SEC comment letter trends: Revenue recognition

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Segments

	Macroeconomic Trend	
	Recession concerns	**Geopolitical conflict**
Segment reporting considera-tions	Reporting entities may experience market driven conditions that result in considerable shifts in sales or profitability and may impact a reporting entity's operating segments. Prolonged periods of substantial growth or significant declines could impact segment reporting metrics, such as percentages of combined revenue, profit, or assets of all segments. This may require a quantitative assessment of operating segments. Entities may also need to re-evaluate conclusions regarding materiality of segments or the aggregation of segments. As a result of recession and slow growth, we observed reporting entities considering making permanent shifts in business strategy, geographic footprint, and resource allocations, among other operational changes, all of which may result in evaluating the business differently than in prior years and impact the information reviewed by the chief operating decision maker (CODM). The CODM's information needs may also be affected by various events and circumstances such as employee layoffs, reorganization activities, market disruptions due to technological changes, and increased product and service competition. Any of these circumstances could result in the need to reassess the composition of the company's operating segments.	A reporting entity is not required to disclose segment information for a reportable segment that qualifies for discontinued operations reporting. In some instances, geopolitical conflict may result in a reporting entity developing a disposal strategy within a conflict region that involves a "run-off" of operations (i.e., it will cease accepting new business but continue to provide service under existing contracts until they expire or are terminated). If the reporting entity determines that the run-off operations do not meet the criteria for discontinued operations, the reporting entity should evaluate the run-off operations to determine if they meet the definition of an operating segment, which is dependent on whether the performance of the operations are regularly reviewed by the CODM.

Resources

FSP guide: Chapter 25
SEC comment letter trends - Segment reporting

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Stock compensation

	Macroeconomic trend	
	Recession concerns	**Market volatility**
Modifications, including repricings, and reclassification of awards	• Given recent declines in stock prices and the challenges the current environment may put on achieving original performance targets, entities may look to modify awards, for example, by modifying performance targets or reducing the exercise prices of options to make awards more attractive to employees. Modifications to awards may result in additional compensation expense or an accelerated recognition of compensation expense. • Entities also need to consider the impact of shifting vesting expectations. For example, current labor market trends (e.g., labor shortage, ability to retain and attract talent, remote work opportunities) might lead entities to reassess the probability of vesting of the granted awards. If it is determined that stock awards granted are no longer probable of vesting and are modified, a new measurement date and fair value would be required.	• In light of the volatility in the stock market, the assumptions, particularly the risk-free interest rate and expected volatility, used in measuring the fair value of stock option awards may need to be revisited. While this will only affect new awards (or modifications) prospectively, the impacts could be significant. • If it is determined that an existing arrangement that was originally expected to be settled in shares becomes probable of being settled in cash (e.g., a contingent cash settlement event that was not probable of occurring becomes probable), the arrangement may need to be reclassified as a liability, which would trigger modification accounting.

Resources

- PwC Stock-based compensation guide
- Podcast: A refresh on stock comp basics before you modify your stock options
- Podcast: Compensation toolkit: Making sense of stock award modifications
- Stock-based compensation modification placemat
- Podcast: Compensation toolkit: Classifying awards as equity and liability

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Exit or disposal cost obligations

	Macroeconomic trend	
	Recession concerns	**Geopolitical conflict**
Severance/ employee costs	A downturn in general economic conditions may put pressure on margins and ultimately trigger registrant strategic restructuring decisions related to businesses (including headcount reduction) to make those businesses fit for growth, and product lines. Entities may offer special termination benefits for a short period of time in exchange for an employee's voluntary termination. These are recognized when an employee irrevocably accepts the offer and the amount can be reasonably estimated. Entities may offer one-time involuntary termination benefits that are not provided under the terms of an ongoing benefit arrangement. These are recognized when management commits to sufficiently specific plan, obtains board approval if necessary, and communicates the plan to employees. Communication must occur prior to the balance sheet date. Expense is recognized immediately if future services are not required, or ratably over the period of required future service (e.g., staying bonuses). Some entities may have an existing severance plan that provides a stated benefit for any involuntary termination. When such a plan exists, a liability for severance benefits would be accrued when it is probable that such benefits will be paid. No separate communication to employees is required.	Current geopolitical events may result in mandatory/statutory benefit costs. Contractual termination benefits may be required due to statutory requirements or by the terms of an existing plan or agreement only upon the occurrence of a specified event (e.g., a plant closing) that causes employees' services to be terminated involuntarily. In those cases, the cost of such benefits are recognized when it is probable the employees will be entitled to benefits (i.e., when it is probable that the specified event will occur) and the amount can be reasonably estimated. A specific communication to the affected employees is not required. However, in some territories, there may be further statutory requirements or approval by a union or workers council that are necessary which could affect the timing of the accrual.
Other exit and contract termination costs (not a lease)	A downturn in general economic conditions may ultimately drive the need to modify or terminate a contract. Other exit costs may also be incurred for (1) protecting and maintaining an asset while held for sale, (2) plant closings, and (3) employee or facility relocations necessitated by these conditions. • A liability should only be recognized for these costs when they meet the definition of a liability (as per Concepts Statement 6*) - i.e., a present obligation to a third party for which, as a result of a transaction or event, the entity has little or no discretion to avoid the future transfer or use of assets to settle the liability. Management's commitment to an exit or disposal plan alone is not a sufficient basis to recognize a liability. • Disposal cost liabilities are generally recognized at fair value under ASC 420-10 when incurred. Given current conditions, fair value assumptions need to be closely evaluated. Other costs such as lease termination or impairment of long lived assets are not within scope of ASC 420.	Entities should consider any penalties, refunds, or other payments for which it may be liable upon contract termination particularly if a company unilaterally ceases performing, which may constitute a breach of contract, as a result of a decision to exit operations due to current events. This will often be a legal determination and require evaluation of contract termination rights, force majeure clauses, and contractual remedies upon breach of contract.
Disposal activity	Reporting entities looking to address economic pressures or to exit a conflict area may consider dispositions of operations. Sellers should assess if the disposal group represents a business. If it does, a portion of the relevant reporting unit's goodwill should be included in the disposal group in accordance with ASC 350-20-40-3. If the disposal group does not constitute a business, no goodwill should be attributed in determining the gain or loss on disposal.	

* Although CON 6 has been superseded, ASC 420 continues to reference CON 6.

Resources

Restructuring activities may also create implications for accelerated amortization/depreciation and impairment of property, plant, and equipment, other long lived assets, and inventory. Refer to the Property, plant, and equipment and other assets guide, section 6.4 and section 5.3, Inventory guide section 1.3.2, and Pensions and employee benefits guide section 8.

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Lease modification and remeasurement: overview

Depending on the facts and circumstances, a lease modification may be accounted for by the lessee and lessor as either (1) two contracts – the original contract and a separate new contract, or (2) one modified contract. ASC 842 also describes other circumstances in which a lessee must reconsider certain assumptions made at the lease commencement date (e.g., whether exercise of a renewal or purchase option is reasonably certain) and remeasure the lease liability and adjust the related right-of-use asset.

Key concept	Concept description
Two contracts	An additional right of use is granted when the lease contract is modified to give the lessee a right to use an additional underlying asset that was not included in the original lease. If the additional right of use is commensurate with its standalone price and contains a lease, this is accounted for a new separate lease.
Single modified contract	If a lease modification is not accounted for as a separate contract, a lessee or lessor should reassess whether the contract contains a lease. If the modified contract is a lease or contains an embedded lease, a lessee or lessor should reallocate contract consideration, reassess the lease classification, remeasure the lease liability, and adjust the right-of-use asset.
Lease remeasurement	A lessee should reallocate the contract consideration among the lease and nonlease components, remeasure its lease liability, and adjust the related right-of-use asset upon the occurrence of certain events (e.g., resolution of a contingency upon which variable lease payments is based, the assessment of whether the lessee is reasonably certain to exercise or not to exercise an option). How the lease liability is remeasured and the right-of-use asset adjusted will depend on the reason for the lease remeasurement; in some cases, it will result in an entry to profit or loss.

See key reminders

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Lease modification and remeasurement: key reminders

Accounting considerations

- A lessee should not remeasure a lease liability when payments increase based on a change in CPI. Based on an exception in the leases standard, the change to a reference index upon which some or all of the variable lease payment is based does not constitute the resolution of a contingency. The lease payments continue to be variable as they may increase based on future changes in the CPI.
- A modified lease could have multiple components. For example, if a lease is modified such that an additional right of use is granted (e.g., additional space is leased), but the modification is not recorded as a separate new contract, there will be two separate lease components in the new modified lease.
- A lessor is not subject to lease remeasurement guidance like a lessee. A lessor should account for the exercise by a lessee of an option to extend or terminate the lease or to purchase the underlying asset as a lease modification, unless the exercise of that option by the lessee is consistent with the assumptions that the lessor made in accounting for the lease at the commencement date.
- Management should assess if a lease modification is an indicator of potential impairment of its long-lived assets.

Reporting and disclosure

- Leasing disclosures for lessees and lessors (FSP Chapter 14) are extensive. If there are material lease modifications, management should consider ensuring such disclosures are updated accordingly. Potential areas of change from material lease modifications may include changes in the: incremental borrowing rate, future lease expense, gain or loss, change in right-of-use assets or liability, change in financing/operating classification, and non-cash disclosures.
- ASC 230 requires disclosures for all noncash investing and financing transactions. All noncash transactions related to adjustments to the lease liability or right-of-use asset should be disclosed as noncash. This includes all noncash changes related to any modification or reassessment events (even when there is a decrease to the right-of-use asset).
- If a lease modification for a lessor is driven by a deterioration of the lessee's creditworthiness, the lessor should consider disclosing the driver of the lease modification and consider any other relevant disclosures related to counterparty creditworthiness.

Where can you find more information:

- Leases guide
- Full disclosure podcast
  - Full disclosure: Leases
- Leasing toolkit podcasts
  - Getting lease measurements/modifications right
  - Tips and tools for private company adoption

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Financial asset impairment: overview

The impairment model for a financial assets depends on the type of asset. The model for some assets was impacted by the adoption of ASC 326, which is currently effective for all SEC filers and is now effective for calendar year nonpublic entities as of January 1, 2023. For entities that have not adopted ASC 326, refer to ARM 5010 for guidance on impairment. This placemat does not address pre-CECL impairment.

Type of financial asset	Model
Assets measured at amortized cost • Loans • Held-to-maturity debt securities • Trade receivables Certain Off-balance sheet items • Loan commitments • Credit guarantees	Current expected credit losses (CECL) - estimate credit losses expected over the “life” of an asset (or pool of assets) - consider: • Historical & current information • Reasonable and supportable forecasts of future events and circumstances • Estimates of prepayments • Certain contractually-provided extension options
Available-for-sale debt securities (Fair value through OCI)	Credit allowance may need to be established if the fair value of the debt security is less than its amortized cost basis. Allowance is established at the individual security level.
Equity investments in securities without a readily determinable fair value (ASC 321 measurement alternative)	Impairment is recognized if (1) an observable transaction for the identical or similar instrument of the same issuer occurs at a price less than carrying value, or (2) a qualitative assessment indicates that the investment is impaired and the estimated fair value is less than carrying value.
Equity method investments	Impairment charge recognized in earnings when a decline in the fair value of the investment below the carrying amount is determined to be other than temporary. Entities first need to ensure that any underlying impairments of the investor’s basis in the assets of the investee (e.g., PP&E, goodwill, etc.) have been reflected in the investor’s US GAAP carrying value.

See key reminders

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Financial asset impairment: key reminders

Accounting considerations

- If the fair value of an AFS debt security is below amortized cost, it is impaired. Assuming an entity does not intend to sell nor would be required to sell the security, it may attempt to use qualitative factors, rather than the present value of expected cash flows, to conclude whether the impairment is due to credit or other factors, per ASC 326-30. However, entities should consider whether these qualitative factors are sufficient given current economic conditions.
- Declines in the market values of other equity securities in an investee's industry may be a qualitative indicator of impairment for an equity security measured under the measurement alternative, even in the absence of observable transactions.
- CECL requires entities to consider the impact of current conditions and economic forecasts relating to specific sectors, geographic areas, and borrower-specific exposure. 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.
- If an entity has liquidity issues, it may have challenges asserting that (i) it does not intend to sell an impaired security and (ii) it is not more likely than not that it will be required to sell an impaired security before recovery of its amortized cost basis. This could result in the need to recognize an impairment loss through P&L for the excess of the amortized cost basis over the security's fair value.
- Credit enhancements, such as guarantees or insurance, cannot be considered when assessing for credit losses in either the AFS debt security model or the amortized cost basis model unless they are embedded in the instrument at origination or purchase. Freestanding guarantee contracts are accounted for separately using applicable GAAP.

Reporting and disclosure considerations

- Credit loss disclosures should enable a user of financial statements to understand the credit risk inherent in a portfolio, how an entity monitors that credit risk, and any changes in the estimate during the period.
- Disclosures should be disaggregated by portofolio segment or class of financing receivable. An entity should consider whether the credit quality indicators disclosed continue to be relevant in the current environment
- Following a systematic and well-documented process consistent with the guidance in SAB 119 (SAB Topic 6-M) will continue to be important in developing the estimate for credit losses. In addition, it will be important for entities to provide transparent disclosures on the impact of the current economic environment, including assumptions used and their impact on the estimate for credit losses.
- For all critical accounting estimates, Item 303 of Regulation S-K requires numerous disclosures, including why the accounting estimate is subject to uncertainty; how the estimate has changed over the relevant period; and the sensitivity of the reported amount to the methods, assumptions, and estimates underlying the calculation.

Where can you find more information:

Various quantitative and qualitative disclosure requirements exist and depend on the type of financial asset being considered for impairment. The following PwC guides outline the reporting and disclosure requirements for each type of financial asset impairment:

- Equity securities measurement alternative - FSP Section 9.7.1
- Equity method investments - Equity method of accounting guide, Section 4.8.
- Post-ASC 326 adoption - Loans & investments guide, Chapter 7

- Podcast: Impairment toolkit: Financial instruments
- Full disclosure podcasts
  - Investments - debt and equity securities
  - Loans and credit losses

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Nonfinancial asset impairments: overview

Macroeconomic trends can affect a reporting entity's impairment assessments across different classes of nonfinancial assets. Inflation, supply chain challenges, and slowing economic growth will all impact projected cash flows. Rising interest rates will increase the discount rates used to discount those cash flows, which will result in lower estimated fair values.

Long-lived assets subject to depreciation and amortization (PP&E, finite-lived intangible assets, and right-of-use assets under leases)

- Long-lived assets that are held and used are tested for impairment at the asset group level, though some long-lived assets may have largely independent cash flows, and as a result, should be tested for impairment individually.
- Events or changes in circumstances should be evaluated to determine if there is any indication that the asset group's carrying value may not be recoverable.
- When events occur that indicate an asset group may not be recoverable, other assets in the asset group (e.g., accounts receivable, inventory, indefinite-lived intangible assets) should be tested for impairment under the applicable framework (CECL, lower of cost or NRV, estimated fair value, respectively) first.
- Then, entity-specific undiscounted cash flows should then be calculated to test the recoverability of the asset group.
  - If the carrying value of the asset group is less than the the undiscounted value of its estimated future cash flows, there is no impairment
  - If the carrying value of the asset group exceeds the undiscounted value of its estimated future cash flows, an impairment loss should be recognized for the amount by which the carrying value of the asset group exceeds its fair value
- Some long-lived assets, such as a corporate headquarters facility, may be shared among several asset groups. Such "enterprise assets" should generally be tested for recoverability on an entity-wide basis after testing the individual asset groups for impairment.

Indefinite-lived intangible assets

- Indefinite-lived intangible assets are required to be tested for impairment at least annually, or between annual tests if events or circumstances change that would more likely than not reduce the fair value below the carrying value of the underlying asset. They are tested at the individual asset level.
- An indefinite-lived intangible asset is impaired if its carrying value exceeds fair value.

Goodwill

- Goodwill is tested for impairment at the reporting unit level at least annually. If events or changes in circumstances make it more likely than not that the fair value of the goodwill is less than its carrying value, an interim impairment test must be performed at that point. Goodwill of a reporting unit that includes long-lived assets that have been impaired need to be tested for impairment.
- Goodwill is impaired if the fair value of a reporting unit that contains goodwill exceeds its fair value.
- An entity can choose to first perform a qualitative assessment of impairment or an entity can bypass the qualitative assessment and proceed directly to the quantitative impairment test; this election is available each period. However, in times of greater volatility and economic uncertainty, a qualitative assessment alone may not be sufficient, especially when historical headroom in the reporting unit is low.
- If goodwill that is tax deductible is impaired, special consideration of the deferred tax implications of the impairment are required.

Long-lived assets held for sale

- Assets that are held for sale, classification of which requires specific criteria to be met by the reporting date, must be tested for impairment by comparing the fair value less cost to sell of the disposal group to their aggregate carrying value.
- All other assets in the disposal group, including current assets, indefinite-lived intangible assets, and goodwill, must be tested for impairment prior to testing the disposal group for impairment.
- If an entity is contemplating sale of a business but it does not yet meet the held-for-sale criteria, the entity should consider whether sale-related cash flows should be considered in the undiscounted cash flow recovery test and/or potentially revise the remaining estimated useful lives of the assets in the disposal group. In some cases, the undiscounted cash flow recovery test should consider a probability weighted set of held-and-used and disposal cash flows

See key reminders

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Nonfinancial asset impairments: key reminders

Fair value considerations

Macroeconomic conditions may have a significant impact on the inputs to an entity's fair value estimates under ASC 820-10:

- The determination of the appropriate market participants with whom the entity would transact, including the validity of historically applied perspectives and the availability of certain counterparties, should be re-evaluated given geopolitical conflicts and increased market volatility.
- The market participant determination will also impact the market-based prices that those participants would consider when pricing the asset, which may also differ from an entity's previous assessments.
- Inputs to a discounted cash flow analysis and similar valuation methodologies, including significant increases in interest rates, volatility in foreign currency exchange rates, and other cost volatility (e.g., commodity-based industries) may require more judgment or warrant additional scenarios to be assessed by management.

Reporting and disclosure considerations

For all critical accounting estimates, Item 303 of Regulation S-K requires numerous disclosures, including how each estimate has changed over the relevant period and the sensitivity of the reported amount to the methods, assumptions, and estimates underlying the calculation.

Long-lived assets

- Specific disclosures are required when an impairment loss is recognized for a long lived asset held and used (ASC 360-10-50-2 and FSP 8.6.1) and for each impairment loss recognized related to an intangible asset (ASC 350-30-50-3 and FSP 8.8.1).

Goodwill

- ASC 350-20-50-2 requires disclosure of the facts and circumstances leading to each goodwill impairment and the amount of the impairment loss (including the method of determining the fair value of the reporting unit) (FSP 8.9.2). For private entities that have yet to adopt ASU 2014-02 and have a measurement date prior to the ASU effective date, if impairment loss recognized is an estimate, disclosure of that fact and reasons for the impairment loss is required to be disclosed.
- ASC 275-10-50 requires a reporting entity to disclose its use of estimates when it is reasonably possible that the estimates will change in the near term and the effect of the change will be material. Disclosure may be required even if a reporting entity concludes that an impairment charge is not required. For example, we have seen reporting entities disclose either the percentage or dollar amount of headroom in a close call goodwill impairment assessment when they conclude the goodwill of a reporting unit is not impaired.
- The SEC staff have provided comments regarding triggering events that may indicate that an interim impairment assessment is necessary and the timing of goodwill and intangible asset impairment charges.

Where can you find more information:

- Business combinations and noncontrolling interests guide
- Property, plant, equipment and other assets guide
- Full disclosure podcast

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Fair value: overview

Under ASC 820, fair value is 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. Said differently, fair value is an "exit price," not the transaction price or entry price. Fair value is a market-based measurement, not an entity-specific measurement. As such, management's intended use of an asset, or planned method of settling a liability, is not relevant when measuring fair value. An entity should use a valuation technique that is appropriate in the circumstance. The guidance in ASC 820 lists three widely used valuation techniques:

- Market approach ("mark-to-market") - often used as the primary valuation approach for financial assets and liabilities when observable inputs of identical or comparable instruments are available; may also be used as a secondary approach to evaluate and support the conclusions derived using an income approach
- Income approach ("mark-to-model") - converts future amounts (for example, cash flows or income and expenses) to a single current amount (discounted present value), which contemplates current market expectations about those future amounts
- Cost approach ("mark-to-cost") - assumes that the fair value would not exceed what it would cost a market participant to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence

While using one of the three valuation approaches listed above may be sufficient, in other cases, the reporting entity may need to incorporate multiple approaches, depending on the specific facts and circumstances. Current macroeconomic trends, including rising interest rates, inflation, geopolitical conflict, and market volatility, may increase the amount of judgment involved in a particular valuation approach and/or the risk(s) associated with the inputs to the valuation approach, which are highlighted below as it relates to the fair value hierarchy.

	Macroeconomic trend		
	Rising interest rates	**Geopolitical conflict**	**Market volatility**
Fair value hierarchy	Inputs used to determine fair value may be more challenging to estimate in periods of rising interest rates, including the impact of nonperformance risk on the price to sell an asset or transfer a liability in an orderly transaction from the perspective of external market participants. The weighted-average cost of capital (WACC), i.e., discount rate, will also be impacted by rising interest rates, which a reporting entity should determine based on the industry-weighted average return on debt and equity from a market participant's perspective.	Disruption to certain markets and the ability to obtain observable (i.e., Level 1) inputs may be significantly impacted by geopolitical conflicts and the domestic and global reactions to them. Government sanctions and corresponding responses thereto may result in historically available market-based prices becoming unavailable, and may require increased judgment related to uncertainties around inputs such as interest and foreign currency rates. A significant decrease in activity in a particular market may result in an input being classified as Level 2.	If market assumptions change, an unobservable input with little impact on the valuation of an asset or liability at initial recognition could now have a significant remeasurement impact. A reporting entity should consider this with respect to its determination of which inputs are significant and the corresponding impact on the classification of the asset or liability in the fair value hierarchy.

See key reminders

Fair value: key reminders

Accounting considerations

- Significant events may occur after the close of a market but before the end of the measurement date. Reporting entities should establish and consistently apply a policy for identifying and incorporating events that may affect fair value measurements.
- Fair value is based on the price to sell an asset or transfer (not settle) a liability
- Restrictions on sale or use of an asset should be analyzed to determine whether those restrictions are specific to the holder or if they form part of the unit of account of the asset, which may have fair value measurement implications. See Fair value guide 4.8 for additional information on analyzing restrictions.
- Use of net asset value (NAV) for investments in certain funds is permitted as a practical expedient for value under certain circumstances, but it is not automatic.

Reporting and disclosure considerations

- For all critical accounting estimates, Item 303 of Regulation S-K requires numerous disclosures, including why the accounting estimate is subject to uncertainty, how the estimate has changed over the relevant period, and the sensitivity of the reported amount to the methods, assumptions, and estimates underlying the calculation.
- Fair value disclosure requirements are extensive and impact both assets and liabilities measured at fair value on a recurring and nonrecurring basis. This includes specific requirements related to concentration of credit and market risk of all financial instruments. General reporting requirements are set out in detail in FSP guide Chapter 20
- If the reporting entity changes the valuation approach and/or technique, it should disclose the change for each class of instrument. This requirement applies to both recurring and nonrecurring fair value measurements for assets and liabilities in Levels 2 and 3 of the fair value hierarchy Changes in a valuation approach and/or technique are generally considered changes in estimate, not changes in accounting principle.
- ASC 820 requires a narrative disclosure about the sensitivity of recurring Level 3 fair value measurements to certain changes in significant unobservable inputs by asset class
- Other-than-temporary impairments (OTTI) under ASC 320 and credit losses under ASC 326 on available-for-sale debt securities may be considered realized or unrealized losses in the rollforward of assets in Level 3 of the fair value hierarchy
- Fair value disclosures are consistently an area of focus by the SEC staff. Comment letters frequently arise related to the valuation techniques applied, key inputs used, and whether management used a third-party valuation specialist. Additionally, for Level 3 fair value measurements, comments focus on improving disclosure related to unobservable inputs, including sensitivity of the fair value measurement to changes in those unobservable inputs. Refer to SEC Comment letter themes - Fair value for further discussion.

Where can you find more information:

- PwC Fair value measurements guide
- PwC Financial statement presentation guide - Chapter 20, Fair value
- Podcast: Full disclosure: Fair value
- Podcast: COVID-19: Fair value questions, answered

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Debt modifications: overview

Issuers of debt instruments will need to evaluate the accounting for debt restructurings under ASC 470. This assessment begins with an analysis of whether a troubled debt restructuring (TDR) has occurred. This analysis involves first determining whether the issuer is experiencing financial difficulties, and second whether the lender has granted a concession. If the modification or exchange is not determined to be a TDR, the guidance below should be considered.

	Type of debt instrument	
	Term loan or debt security	**Line of credit or revolving debt arrangements**
Modification versus extinguish-ment	Entities should perform the “10% test” to determine whether the terms of the new debt instrument are substantially different than the existing borrowing. The “10% test” compares the present value (at current interest rates) of the cash flows of the new debt to the present value (at current interest rates) of the remaining cash flows under the original debt. If the change is equal to or greater than 10%, then extinguishment accounting applies; otherwise, it’s a modification. If extinguishment accounting is applied, a gain or loss is recognized based on the carrying amount of the existing debt and the fair value of the new debt. In a modification, no gain or loss is recorded and a new effective interest rate is calculated based on the current carrying amount of the debt (including previously capitalized debt issuance costs).	As the carrying amount of most lines of credit or revolvers are similar to their fair value, outside of a TDR scenario, the principal consideration is the treatment of any unamortized fees when such arrangements are modified. To determine the accounting for any unamortized fees, entities should compare the borrowing capacity of the new and old arrangements on a lender by lender basis. The borrowing capacity is the product of the remaining term multiplied by the maximum available credit. If the borrowing capacity is reduced, a proportionate amount of the unamortized fees are written off. New costs and any remaining unamortized costs are amortized prospectively over the term of the new arrangement.

See key reminders

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Debt modifications: key reminders

Accounting considerations

- Economic substance should be considered when assessing whether a modification or extinguishment has occurred, regardless of the legal form of the transaction.
- If either the new or original debt instruments are callable or puttable, the exercise of such provisions, as well as any changes in the principal balance and lender fees, should be factored into the cash flow assumptions. Refer to Example FG 3-4 for how the 10% works when there are prepayment options.
- The 10% test for syndicated loans should be performed on a lender-by-lender basis which may result in a conclusion that borrowings from certain lenders ere modified and borrowings from others were extinguished.
- Multiple modifications within one year should be further evaluated for whether, in the aggregate, the modifications constitute an extinguishment.

Reporting and disclosure considerations

- Numerous reporting considerations can arise depending on the type of debt restructuring; refer to chapter 3 of the *Financing transactions* guide and chapter 12 of *Financial statement presentation* guide.
- For debt that is considered extinguished, ASC 470-50-50 requires disclosure of a general description of the transaction and the amount of debt that is considered extinguished at the end of each period that debt remains outstanding.
- For a TDR, ASC 470-60-50 provides a number of specific disclosures.
- For debt with related parties, consider the guidance in FSP 26.5.
- If the debt modification or extinguishment affects the guarantor structure of the borrowing, consider any impact on the Regulation S-X Rule 3-10 reporting requirements.

Where can you find more information:

- Podcast: Accounting for debt in uncertain times
- Podcast: Borrowers accounting for debt restructurings: 5 things to know
- Podcast: Full disclosure: Debt
- Podcast: Assessing Liquidity and going concern in an uncertain economy
- *Financing transactions* guide
- *Financial statement presentation* guide

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Deferred tax assets valuation allowance (VA): overview

Evaluating the need for, and amount of, a valuation allowance for deferred tax assets often requires significant judgment and extensive analysis of all available positive and negative evidence to determine whether all or some portion of the deferred tax assets will not be realized. A valuation allowance must be established for deferred tax assets when it is more likely than not (a likelihood of more than 50%) that they will not be realized. ASC 740-10-30-18 identifies the four sources of taxable income that may enable a company to realize a tax benefit (i.e., an incremental cash tax savings) for deductible temporary differences and carryforwards.

They are listed here in order of the most objective to the most subjective:

Sources of taxable income	Key takeaways
1. Taxable income in prior carryback years if carryback is permitted under the relevant tax law	• Carryback is an objectively verifiable source to the extent taxable income existed in the year that carryback is permitted under the law. • Taxable income in the carryback period needs to be of the appropriate character (e.g., ordinary or capital).
2. Future reversals of existing taxable temporary differences	• The mere existence of taxable temporary differences does not make them a source of taxable income for the recognition of deductible temporary differences. Timing of reversal must match between the taxable and deductible temporary differences (or the expiration period for carryforwards) to allow them to be a source of income to realize deductible temporary differences. • When the deductible temporary difference is indefinite in nature (i.e., an NOL, interest or credit carryforward that does not expire), it may be appropriate to consider the taxable temporary difference associated with an indefinite-lived asset (e.g., goodwill, land, indefinite-lived intangible assets) as a source of income to support realization.
3. Tax-planning strategies	• Consideration of tax planning strategies is not elective; if they are available, they must be considered. • A tax-planning strategy needs to: (1) be both prudent and feasible, (2) be one that a company would not ordinarily take, but would take to prevent a tax attribute from expiring unused, and (3) result in realization of deferred tax assets. • The economic benefit of the strategy must be assessed at the enterprise level (i.e., net incremental savings). • Tax planning strategies are not applicable for an indefinite-lived attribute since the attribute will never expire.
4. Future taxable income exclusive of reversing temporary differences and carryforwards (i.e., projections)	• Projections of future pretax book income (adjusted for permanent differences) are used when assessing the realizability of deferred tax assets. • Adjustments of historical results for "one-time" or "non-recurring" charges should be assessed to determine whether such items are truly aberrational and appropriate to exclude from a company's analysis of earnings from core operations. • Generally, the most recent results should be considered indicative of future results, absent objectively verifiable evidence to the contrary.

REMINDER: If one or more sources are sufficient to realize deferred tax assets, no further consideration is required of the remaining sources. However, all four sources must be considered if this is not the case.

See key reminders

Deferred tax assets valuation allowance (VA): key reminders

Accounting considerations

- VA assessments should be performed separately for each tax jurisdiction.
- Cumulative profitability or losses for the last three years is calculated based on what has occurred (i.e., not adjusted for items deemed to be aberrational). That income history is a significant factor when assessing the realizability of deferred tax assets, but it is not determinative without further analysis of all relevant facts and circumstances.
- Entities should consider changes in tax laws that have future effective dates in forecasts of future taxable income.
- It is often difficult to justify the exclusion of “nonrecurring items” because their occurrence is objective. This determination can be highly judgmental.
- Entities should 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. In many cases, it will be appropriate to consider them in the valuation allowance assessment as of the prior year-end date (i.e., as recognized subsequent events)

Reporting and disclosure

- Disclosure of changes in valuation allowances should clearly explain the rationale and timing of the change in judgment (i.e., new quantitative and/or qualitative information that modifies previous judgments).
- Management should consider disclosing the extent to which the realization of deferred tax assets depends on future taxable income and the relevant positive and negative factors considered, such as sustained pre-tax profitability, when assessing the realizability of deferred tax assets.
- The SEC expects early warning disclosures of potential changes in valuation allowances. Such disclosures should include a description of any uncertainty and indication that it is at least reasonably possible that a change in the estimate will occur in the near term (ASC 275).

Where can you find more information:

- See PwC Income taxes Guide - Chapter 5 and Chapter 16
- See PwC Financial statement presentation guide - Chapter 16
- Podcast: Tax toolkit: Valuation allowances, weighing the evidence
- Viewpoint: Accounting hot topics- Income tax accounting

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Stock-based compensation modifications: overview

ASC 718 defines a modification as a change in the terms or conditions of a stock-based compensation award. Examples of a modification include an option repricing, an extension of the vesting period, changes in the settlement terms, and changes in the terms of a performance condition. Changes in circumstances that result in a change in the classification of the award (e.g., equity to liability) may result in a modification even if there is not a legal modification to the terms.

Types of modifications	Accounting treatment
Modifications of equity classified awards with a performance or service condition	
Type I: Probable-to-probable This type of modification does not change the expectation that the award will ultimately vest.	The cumulative amount of compensation cost that should be recognized is the original grant date fair value of the award plus any incremental fair value resulting from the modification. A Type I modification will result in incremental fair value if terms affecting the estimate of fair value have been modified (e.g., a repricing or a modification that extends the expected term). The original grant date fair value represents the minimum or “floor” amount of compensation to be recognized if either the original or the modified conditions are satisfied.
Type II: Probable-to-improbable This type of modification changes the expectation that the award will ultimately vest.	Specifically, a condition that the company anticipates will be satisfied is replaced with a condition that the company expects will not be satisfied. Type II modifications are relatively uncommon because employees are unlikely to accept this kind of change unless they receive other compensation or the company also changes other terms of the award. For Type II modifications, no incremental fair value would be recognized unless and until vesting of the award under the modified conditions becomes probable. If the original vesting conditions are satisfied, compensation cost equal to the award’s original grant-date fair value would be recognized, regardless of whether the modified conditions are satisfied.
Type III: Improbable-to-probable This type of modification changes the expectation that the award will ultimately vest.	Specifically, a condition that the company expects will not be satisfied is changed to a condition that the company expects will be satisfied. The cumulative compensation cost recognized for the original award should be zero immediately prior to the modification as none of the awards are expected to vest. The incremental fair value is therefore equal to the fair value of the modified award (the value of the modified award compared to its prior zero value). The incremental compensation cost is recognized over the remaining requisite service period, if any. A Type III modification could result in the recognition of total compensation cost that is less than the award’s grant date fair value because at the modification date, the original vesting conditions are not expected to be satisfied.
Type IV: Improbable-to-improbable This type of modification does not change the expectation that the award will ultimately not vest.	The company would not recognize additional compensation cost on the modification date because it continues to expect that the award will not vest. Therefore, no cumulative compensation cost should be recognized for the award. If, at a future date, the company determines it is probable the employees will vest in the modified award, it should recognize compensation cost equal to the fair value of the award at the modification date. A Type IV modification effectively establishes a new measurement date for the award (the modification date).
Modifications of equity-classified awards with a market condition	ASC 718 does not provide specific guidance on how to account for the modification of an award with a market condition. Instead, the market condition is reflected in the fair value measurements used to calculate the incremental fair value on the modification date.
Modifications of liability-classified awards	A liability-classified award is remeasured at fair value at the end of each reporting period. Therefore, a company simply recognizes 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; the total compensation expense will equal the fair value on the settlement date.

See key reminders

Stock-based compensation modifications: key reminders

Accounting & tax considerations

- Compensation cost for a modified equity-classified award should generally equal the original grant date fair value plus any incremental value resulting from the modification, unless on the modification date the original performance or service condition is not probable.
- Entities who choose to modify performance conditions of awards (e.g., revenue, EBITDA) need to identify the appropriate type of accounting modification model (see previous slide) based on a probability assessment of achievement of the targets before and after the modification.
- For modifications of awards with market conditions, no separate probability assessment is required as the impact of the change is factored into the value immediately before and after the modification.
- Cancellation of an existing award accompanied by a concurrent grant of a replacement award is accounted for as a modification. However, if an award is cancelled without the concurrent grant of a replacement award, the cancellation should be treated as a settlement and all remaining unrecognized compensation cost should be accelerated.
  - Entities need to distinguish between an award that has been settled or repurchased and an award that has been modified to change its classification to a liability as there could be a significantly different accounting impact.
- Option repricings are an adjustment to (typically a reduction of) the exercise price of a stock option, which results in a change in value that is generally accounted for as a Type I modification. Refer to the accounting framework for such modifications on previous slide.
  - Repricings applicable to holders who are no longer an employee/service provider would result in the option becoming subject to other applicable GAAP (e.g., financial instruments guidance).

Reporting and disclosure considerations

- Entities need to disclose the impact of stock-based compensation modifications, including a description of significant modifications, the number of employees affected, the total (or lack of) incremental compensation cost resulting from the modifications, as well as any broader plan design changes.
- Entities also need to disclose total compensation cost related to nonvested awards not yet recognized and the weighted-average period over which they are expected to be recognized.
- An entity should consider whether additional disclosures and/or management commentary is necessary to provide a sufficient level of transparency regarding how its stock award plans are impacted by significant current market trends.
- An entity's audit committee should oversee the financial reporting, disclosure, and valuation issues related to ASC 718. Additionally, Compensation Discussion and Analysis and SEC executive compensation proxy disclosure rules require disclosure of and reference to ASC 718 calculations, including reference to the assumptions used to estimate fair value. Entities should consider those rules in Item 402 of Regulation S-K.

Other considerations

- Entities must determine whether plan documents allow for option repricing or other modifications and verify share plan limits for the pool authorized for that plan.
- Consideration should be paid to shareholder approval requirements, as well as other stakeholder inputs (i.e. employee consensus, BoD approvals, and corporate governance needs).
- If non-US participants are eligible for repricing attention should be paid to local accounting and tax rules and regulations.
- Proxy advisory firm views on repricings should be considered -- historically have taken strong positions against repricing programs.
- With regards to tax implications, entities should consider:
  - Repricings may trigger Section 409A tax penalties or lose Section 422 ISO qualification. Any repricing must be evaluated to determine impact on the option status.
  - For underwater options, a reduction of the exercise price to current FMV may be treated as a new grant. The new grant may independently satisfy Section 409A or ISO rules (as applicable) including recalculation of the ISO $100,000 limit.
  - Implications on any personal taxes at employee level.

Where can you find more information:

- PwC Stock-based compensation guide: SC 4.3, SC 4.10, SC 2.11
- Podcast: A refresh on stock comp basics before you modify your stock options
- Podcast: Compensation toolkit: Making sense of stock award modifications

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Foreign currency accounting: overview

Depending on the structure of its consolidated operations, a reporting entity may have transactions denominated in a foreign currency (which need to be measured in its functional currency), and/or it may have foreign entities that it consolidates (the assets, liabilities and results of which need to be translated into the reporting currency). To prepare consolidated financial statements, all amounts denominated in foreign currencies should be either measured or translated (or both) into the reporting currency. The table below summarizes the key steps in the application of ASC 830. **Click the orange button below to see effects of macroeconomic trends on foreign currency accounting.**

Framework	Overview
Step 1: Identify the reporting entity's reporting currency	The reporting currency is often the currency of the country in which the reporting entity is located, but it does not have to be. A private reporting entity may select any currency for its reporting currency. Rule 3-20 of Regulation S-X requires US incorporated registrants to present their financial statements in US dollars, with limited exceptions. It is also possible that a non-US domiciled registrant may use the US dollar as its reporting currency.
Step 2: Identify the reporting entity's foreign entities	A foreign entity is a distinct and separable operation that is combined, consolidated, or accounted for using the equity method of accounting and has a functional currency other than the reporting entity's reporting currency.
Step 3: Determine the functional currency of each entity	The functional currency of the reporting entity or a distinct and separable foreign operation is a question of fact; it is not a choice. The determination of the functional currency may be straightforward, but is often complex and may require significant judgment. It is not common for the functional currency of an entity to change, unless there are significant changes in external economic facts and circumstances. The functional currency of a reporting entity or a distinct and separable foreign may not be the same as the entity's reporting currency established in Step 1.
Step 4: Measure foreign currency transactions	When an operation has transactions denominated in a currency other than its functional currency, they must be measured (practically in real time) in the functional currency. Changes in the expected functional currency cash flows caused by changes in exchange rates are included in net income in the period (i.e, assets and liabilities denominated in a currency other than the functional currency are marked to the period-end spot rate through P&L).
Step 5: Translate financial statements of a foreign entity if its functional currency is different from the reporting currency	Foreign currency translation is a necessary process to include a foreign entity's assets, liabilities, and results of operations in the reporting entity's consolidated financial statements denominated in its reporting currency. Assets and liabilities are translated at the exchange rate in effect on the balance sheet date; revenues and expenses are, in principle, translated at the exchange rate in effect when they are incurred, but average rates are commonly used in practice. As a result of the translation process, the reporting entity will generate other comprehensive income (CTA).
Step 6: Evaluate whether CTA should be released into net income	ASC 830-30-40-1 requires CTA to be reclassified from equity (OCI) to net income "upon sale or upon complete or substantially complete liquidation of an investment in a foreign entity." Therefore, when disposing of any foreign operation, it is important to understand if that foreign operation constitutes a foreign entity, or is only a component of a foreign entity. Acquiring control of a foreign operation in a step acquisition may also require that CTA accumulated for an equity method investment prior to gaining control be reclassified to net income.

See effects from macroeconomic trends

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Foreign currency: impact of macroeconomic trends

	Macroeconomic trend		
	Rising interest rates	**Market volatility**	**Inflation**
Accounting and reporting considerations	**Foreign currency translation** As interest rates rise, investments in the US dollar become more attractive, which tends to increase the relative value of the US dollar. During 2022, the US dollar has strengthened against most of the world's major currencies. US multinationals with significant foreign operations can expect to report lower earnings in US dollar terms, even if there are no other fundamental changes to their business. This is because the value of sales and operating profits generated in foreign jurisdictions, when translated into US dollars, is reduced as the foreign currencies decline in value relative to the US dollar. Similarly, if an entity has significant net assets outside the US, it will likely experience a larger-than-normal loss in the foreign currency translation component of OCI. **Foreign currency transactions** The relative strength of the reporting entity's functional currency can also affect reported results when there are intercompany transactions. Although intercompany transactions and balances are eliminated in consolidation, any intercompany balances denominated in a currency other than the functional currency of a party to the transaction create foreign currency gains and losses that survive consolidation. Foreign currency transaction gains and losses related to intercompany loans or advances that are of a long-term-investment nature should be accounted for as translation adjustments in OCI, rather than through P&L.	**Functional currency considerations** Changes in the relative strength of currencies can influence a reporting entity's decision on whether to denominate contracts in their functional currency or the functional currency of their customers or suppliers. For example, consider an entity domiciled in Canada that has determined that its functional currency is the Canadian dollar, but it sells predominantly to US customers. Historically, this entity has denominated its sales contracts in Canadian dollars. As the US dollar has strengthened significantly versus the Canadian dollar, the entity has decided to begin denominating its sales contracts to US customers in US dollars. In addition to the value of the entity's sales being subject to changes in the USD/CAD exchange rate, any receivables that arise from those sales would give rise to foreign currency transaction gains and losses that would be recognized immediately in the P&L. To mitigate these effects, this entity might consider changing its functional currency to the US dollar. However, changes in an entity's functional currency are expected to be rare, and should reflect a permanent change in the primary economic environment in which the company generates revenues, incurs costs, and finances its operations. The relative strength of one currency to another is constantly changing, and an entity should not base a decision to change its functional currency on factors that are not expected to be permanent. **Foreign currency transactions** When recognizing revenue in accordance with ASC 606, exchange rate fluctuations do not result in variable consideration and therefore should not be considered for purposes of applying the constraint on variable consideration.	The financial impact of a strong US dollar on a reporting entity is heavily influenced by the operating structure of that entity. A US-based entity with significant foreign sales will likely experience downward pressure on selling prices and/or decreased demand in foreign territories as the strong US dollar makes its products more expensive in its customers' local currencies. Alternatively, an entity based outside the US that is dependent on US suppliers for raw materials will find that its costs in its local functional currency have increased substantially, as it requires more local currency to purchase the raw materials in US dollars. The inverse of that could be true for a US entity sourcing materials overseas. Each of these scenarios will impact a company's expected future cash flows that drive long-lived asset impairment analyses. Reporting entities should consider disclosure regarding the broader economic circumstances surrounding exchange rates to enhance understanding the effects on the results of operations and to improve the comparability of current results with prior periods. In assessing impairment of foreign long-lived assets held for sale, consideration of the cumulative foreign currency translation adjustment (CTA) account differs depending on whether the foreign operation meets the definition of a foreign entity established in ASC 830. The sale of a controlling financial interest in a foreign entity as well as a complete or substantially complete liquidation of the net assets of a foreign entity would lead to the reclassification of the CTA to net income as part of the gain or loss on sale. Thus, in assessing the need for an impairment when a foreign entity is held for sale, the CTA account should be considered as part of the net assets of the disposal group.

Resources

If an asset or liability is denominated in a foreign currency, there can be additional considerations related to the accounting. The following placemats have additional information regarding the potential effects of changes in foreign currency rates:

- Cash and cash equivalents
- Investments in debt and equity securities
- Property, plant, and equipment
- Nonfinancial asset impairment
- Fair value

Other relevant guidance:

- FX guide: Chapter 4, Chapter 6, Chapter 7 and Chapter 8
- FSP guide: Chapter 6
- Revenue guide: Chapter 4
- Podcast: Foreign currency risk: Back to the basics
- Podcast: Accounting for foreign currency- 5 things you need to know
- SEC guidance: Changes in functional currency

Thank you

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