Financial reporting considerations in periods of uncertain economic conditions

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Assessing financial impact

The economy continues to face uncertainty as factors such as inflation, labour shortages, supply constraints, fluctuations in demand, ongoing international conflicts, and other factors are creating a volatile business landscape. In addition, after a sustained period of low interest rates, the Bank of Canada has increased and maintained its benchmark interest rate to combat higher inflation.

Higher inflation and interest rates can have a wide impact on an entity's operations and financial reporting. This publication identifies key financial reporting areas that entities should consider when determining the potential impact of current economic headwinds on their business and in their financial statements.

The information presented here is not exhaustive and there may be other areas not included in this publication that entities should consider. Companies are cautioned to consider their specific facts and circumstances and to connect with their Grant Thornton advisor when appropriate.

Overview

Financial statement considerations

The process of developing estimates, projections and assumptions is expected to be more complex in the current economic environment. Factors such as rising inflation, higher interest rates, labour supply shortages and supply chain disruptions need to be reflected in an entity's forward-looking estimates and projections. Since these estimates and projections can include highly unpredictable variables, entities may need to apply significant judgement on a wider range of outcomes and revisit facts and circumstances on a more frequent basis. In some cases, specialists in Grant Thornton's Valuations or Complex Financial Instrument Pricing teams may be able to provide assistance.

Higher inflation and interest rates can also impact specific financial statement items, regardless of which accounting framework an entity applies. Entities should be alert for events and conditions that may be more prevalent under current economic conditions and will need to be accounted for, such as:

- Indicators of impairment may appear, either within the entity itself or within its operating environment, counterparties, or customers, that necessitate an impairment review or impairment test.
- Potential violation of or difficulties in meeting covenants in debt arrangements, or obtaining debt modifications or refinancing in response to cash flow pressures.
- Revenue recognition patterns may need to be revised if collectability is in question, variable components of sales contracts are triggered, existing contracts become loss-making due to increasing costs, or an entity's estimated costs or efforts change (e.g., for contracts to which the percentage of completion method applies).
- New employee benefits or share-based payments may be offered as incentives in response to labour shortages, or termination benefits may be provided as part of restructuring plans (e.g., if an entity is downsizing its workforce).
- Owners may pursue tax planning arrangements as part of an exit strategy or otherwise seek to reduce their tax burden.

When entities are affected by current economic conditions, they must also disclose any material impacts and/or risks in the notes to the financial statements, and consider whether these factors affect the entity's ability to continue as a going concern.

There are various areas where a Grant Thornton advisor may be able to help. For example, our Restructuring or Transactions teams may be able to assist in reviewing credit agreements, provide advice on refinancing, or help enhance the value of a business for sale, and our Tax group may be able to help reduce an entity's tax burden by using tax losses or revisiting its corporate structure. Lastly, our Advisory team may be able to assist with strategies to alleviate inflationary pressures, adapt sales strategies to the current landscape, and manage labour market challenges.

The services and experiences described herein are illustrative in nature and are intended to demonstrate our experience and capabilities in these areas. However due to independence restrictions that apply to assurance clients of the firm, we may be unable to provide certain services based on individual facts and circumstances.

Assurance considerations

Entities that obtain an audit or review of their financial statements should be aware that, due to the rapidly changing economic conditions, there will likely be some changes to the approaches applied in their audit or review. Materiality judgements may need to be revisited due to changes in users or their needs, and items that were previously immaterial may become material. For example, due to rising interest rates, additional assurance procedures may need to be performed over discount rates used in impairment models, financial instrument valuations, and significant financing components in comparison to prior years, since these issues may become material to the financial statements. Another example is that entities experiencing financial struggles could see elevated risk assessments, leading to larger sample sizes, and greater costs and time to obtain assurance. Entities should reach out to their respective auditors or professionals in order to have upfront discussions on the impacts that economic conditions may have on their assurance engagements from both a financial and time perspective.

Valuations

The current economic environment may result in an increased need to utilize valuation specialists. For example, to assist with potential purchases or sales of businesses, evaluating impairment risks, and the fair value determination of various financial instruments or share-based payments.

A valuation for an audit or review engagement performed by the auditor's valuation team is not permitted from an independence perspective if the valuation is material to the financial statements. Depending on an entity's expertise and sophistication, it may be beneficial to engage another third-party valuator to assist with a valuation. In many cases, the use of a third-party valuator can result in a smoother and more effective audit or review engagement.

Advisory

Some entities may encounter additional difficulties in navigating and preparing for the future given the current economic environment. Grant Thornton's Advisory team has released an article entitled "See the future without a crystal ball" which discusses the importance of financial modelling to help companies prepare for the future.

Due to current economic challenges, some entities may be experiencing potential signs of financial distress, such as issues with staff capacity, liquidity constraints, declining trends in performance indicators, and loss of key customers or suppliers. Such entities may wish to contact the Grant Thornton Advisory team to determine if it is possible to receive assistance in developing financial models, turnaround plans and restructuring programs.

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Financial statement considerations

The financial statement considerations discussed in this publication are generally applicable regardless of whether an entity reports under International Financial Reporting Standards (IFRS), Accounting Standards for Private Enterprises (ASPE), Accounting Standards for Not-for-Profit Organizations (ASNPO), Accounting Standards for Pension Plans (ASPP) or Public Sector Accounting Standards (PSAS). Where there is framework-specific guidance, it is indicated as such. However, entities are cautioned to refer to the authoritative guidance for each topic and consider their specific facts and circumstances before reaching a conclusion.

Financial statement considerations within this publication are grouped into two categories:

- **Forward-looking estimates and projections**
  Discusses the broad impact that changing economic conditions can have on management's forward-looking estimates, projections, and assumptions.
- **Financial statement items**
  Discusses the impacts that an entity may encounter with certain financial statement items. Furthermore, identifies circumstances that might indicate an entity's financial statements are particularly impacted and thus further investigation should be considered.

Forward-looking estimates and projections

Broad impact

Every financial reporting framework requires entities to make some degree of estimation and projection. Such estimates and projections can have a broad impact on an entity's financial reporting, including:

- the initial measurement of assets and liabilities (e.g., fair value of assets and liabilities acquired in a business combination);
- the subsequent measurement of assets and liabilities (e.g., impairment of assets and debt modifications);
- the method and timing of recognizing revenue and expenses; and
- management's assessment of the entity's ability to continue as a going concern.

In general, the process of forming these estimates, projections and assumptions becomes more difficult when circumstances are changing, because forecasting the magnitude and duration of the impacts can be challenging. Entities may simultaneously face factors such as:

- rising inflation;
- rising interest rates;
- labour supply shortages; and
- supply chain disruptions.

Due to ongoing economic uncertainty, many entities face a wider range of possible outcomes when preparing forward-looking estimates and projections. Furthermore, estimates or projections that were relevant in previous periods may no longer be appropriate due to changes in circumstances and expectations.

Evaluating forward-looking estimates and projections

Management should consider the following factors in preparing their forward-looking estimates and projections:

- **Inflation rate:** Over the past several years, many entities applied a growth rate of approximately 1-2% to their forward-looking estimates and projections, which was generally supported by the inflation rate in Canada during that time. However, as of December 2023, Canada's inflation rate was 3.4%.[1]

  Management's forward-looking projections and estimates, in particular the growth rate, may need to be updated to reflect the inflationary environment in Canada for the current year and expectations beyond that. The growth rate used to calculate the terminal value in a forecast must incorporate long-term economic expectations. As such, while a higher growth rate may be necessary for estimates and projections of the near future, it is likely more appropriate for the terminal growth rate to return to a value that is closer to the Bank of Canada's 2% target inflation rate.
- **Historical growth rates:** An entity's past growth rate may not be indicative of its future growth due to shifting consumer spending patterns and other macroeconomic factors. Since this rate is subjective and likely differs for entities in different industries, management should evaluate their industry, current operations and future strategies when estimating future growth.
- **Interest rates:** To combat higher inflation, the Bank of Canada increased its benchmark interest rate in recent years. This has increased the cost of borrowing for many entities. In addition, the discount rate used in measuring various elements of an entity's financial statements may be tied to the entity's borrowing rate. Entities should update their discount rates to reflect current interest rates.
- **Liquidity concerns:** Some entities may experience a cash crunch and might find it difficult to service existing debt and supplier payments. For example, some entities may have received funds from government assistance that they will no longer receive. Other entities may have hired new staff and/or expanded production/services and, due to evolving economic conditions, are not realizing their expected increase in cash inflows. Entities that are unable to service their existing debt arrangements may have difficulty complying with covenants or other terms of their debt agreements, which could lead to the lender demanding repayment earlier than anticipated.

1 https://www150.statcan.gc.ca/n1/daily-quotidien/240116/dq240116a-eng.htm

- **Contract modifications:** Entities may need to modify their sales contracts due to supply chain disruptions and/or labour shortages, which can result in unpredictable revenue estimates or projections. Furthermore, some entities may face penalties or potential lawsuits for the termination of contracts.
- **Supply chain disruptions:** Supply chain issues may result in entities not being able to receive anticipated quantities of inputs for their production process or inventory for resale in both the short and medium term. Input costs may also rise due to shortages. Entities should ensure their forward-looking estimates and projections consider the impacts of any supply chain disruptions.

Rising inflation and interest rates could also impact broader cash flow assumptions, such as pricing and costing structures. Factors such as customer demand and geopolitical issues could also impact cash flow assumptions.

General inflation should be reflected consistently in both the estimated cash flows and the discount rate. In other words, when price increases are included in an entity's estimated cash flows to reflect general inflation, the discount rate should also be increased to reflect general inflation. While this results in an offsetting effect for general inflation for discounted cash flow purposes, current economic conditions impact more than just general inflation (as discussed above). Specific future price increases or decreases would also need to be incorporated into cash flow estimates separately.

Many entities use information from prior periods (e.g., actual results, budgets, previously prepared forward-looking estimates) as a starting point when preparing forward-looking estimates and projections. In the current environment, such an approach may not be appropriate. Historical information and past expectations will likely need to be adjusted when making forward-looking estimates and projections.

Ultimately, there will likely be a greater level of subjectivity and estimation uncertainty involved in developing forward-looking estimates and projections under current economic conditions.

Valuations: Additional considerations for forecasting cash flows

- As a result of the changing economic environment, discount rates applied to forecasted cash flows in prior year fair value estimates should be revisited as they may no longer be appropriate. Careful consideration should be given to the company, industry, and overall economic outlook when determining the discount rates to be used in fair value measurements. The risk of achieving forecasted cash flows may have changed and, therefore, an update to the discount rates used in any valuation assessments may be necessary.
- When determining discounts rates and estimating cash flows, entities should consider the following:
  - Look-back test: how has the entity's actual performance compared to forecasts prepared in prior years? Have actual results generally fallen within forecasted performance?
  - Industry outlook: how do the entity's projections compare to the general outlook for the industry?
  - Economic outlook: how do the entity's projections compare to the general outlook for the economy?
  - Entity-specific: has there been any significant developments leading up to the valuation date (e.g., lost/gained customers, newly signed contracts, employee turnover/change in management, competitive landscape)?
- In general, more aggressive forecast assumptions may require the use of a higher discount rate, while stable/modest forecasted cash flows may warrant a lower discount rate.

Advisory services: Responding to the pressures of inflation

Grant Thornton's Advisory service line has issued a series of articles on how businesses can alleviate inflationary pressures or explore options to accelerate growth. Some of the suggested strategies include:

- Performing forecasts to understand cash flow and working capital needs, and to identify ways to improve cash flows (e.g., extending payments with vendors, tightening collection policies, prioritizing resources)
- Stress testing forecasts for different scenarios to determine if liquidity is sufficient
- Proactively reaching out to financial partners, such as lenders, if forecasts show that the business may have difficulty meeting debt obligations or the business is considering refinancing of existing debt
- Considering other sources of temporary financing
- Refreshing sales and marketing strategies, including pricing in light of rising costs, to attract new customers
- Identifying ways to access cash sooner (e.g., filing GST/HST returns sooner, filing corporate tax returns that impact R&D tax credits earlier, taking advantage of tax losses)

During these difficult circumstances, advisors in Grant Thornton's Advisory or Tax teams may be able to assist entities in facing some of their challenges or implementing particular strategies. In each case, the independence rules will need to be considered when an entity is (or was recently) an assurance client.

Financial statement items

This section discusses impacts that an entity may encounter with the following specific financial statement items.

a. Impairment of assets
b. Debt classification, modification and derecognition
c. Off-balance sheet arrangements
d. Revenue recognition
e. Employee future benefits
f. Restructuring plans
g. Investment property
h. Inventory
i. Derivatives and hedge accounting
j. Lease accounting
k. Share-based payments (IFRS & ASPE)
l. Tax planning arrangements
m. Deferred taxes (IFRS & ASPE future income taxes method)
n. Extraordinary items
o. Foreign currency translation
p. Insurance claims for business interruption
q. Fair value measurement

We strongly encourage companies to review their financial statements to determine which items may be applicable to them, as not all financial statement line items will be present in a company's operations. Additionally, this is not an exhaustive list of potential financial reporting impacts and the areas are not listed in order of importance. Entities should assess their particular exposure in these and other areas.

Impairment of assets

Presence of new indicators of impairment

The specific requirements around the timing, frequency and measurement of impairment losses varies based on the entity's financial reporting framework and the asset being assessed. However, regardless of the framework applied, an entity must at a minimum evaluate an asset for impairment whenever indicators of impairment are present.

While some indicators of impairment are based on internal information (e.g., damage to a tangible capital asset, plans to remove the asset from use), others are triggered by events and circumstances external to the entity. Below are examples of indicators of impairment that may appear more frequently under the current and expected economic conditions:

- **Inventory**
  - goods are damaged or spoiled (e.g., when an entity ceases or limits operations as a result of a decrease in demand)
  - deterioration of inventory turnover
- **Financial assets (e.g., accounts receivable, balances due from related parties, portfolio investments in other entities)**
  - changes in the expected timing or amount of future cash flows (e.g., deterioration in aging, delinquent payments)
  - requests from the counterparty for extended payment terms, payment vacations or a renegotiation of other terms
- **Investments other than portfolio investments (e.g., a subsidiary that is not consolidated, joint ventures, entities under significant influence)**
  - significant financial difficulty of the investee
  - a breach of contract (e.g., default or delinquency in debt payments)
  - it is probable that the investee will enter bankruptcy or other financial reorganization
  - significant adverse changes in the economic or legal environment in which the investee operates (e.g., recession)
  - disappearance of an active market for the investment due to the investee's financial difficulties
- **Tangible capital assets and intangible assets other than goodwill**
  - significant changes in the extent or manner in which the asset is used or is expected to be used (e.g., idling of a machine such that its future productive capacity may be affected)
  - significant changes in the legal factors or business climate that could affect the value of the asset (e.g., an entity expects a decrease in its exports to a particular foreign market due to international conflicts)
  - a decline in, or cessation of, the need for the services provided by the asset
  - **[IFRS]** increase in market interest rates which would cause a decrease in the asset's value in use
- **Goodwill**
  - a significant adverse change in legal factors or in the business climate (e.g., an entity expects a decrease in its exports to a particular foreign market due to international conflict)
  - a loss of key personnel that is other than temporary
  - impairment testing required for a significant asset group
  - the recognition of a goodwill impairment loss in an investee's separate financial statements
  - **[IFRS]** a significant decline in the entity's share price which could result in the carrying amount of the entity's net assets exceeding its market capitalization

In addition, an entity determining that it may have a going concern issue is also a general indicator of impairment for all of its assets.

Fair value or discounted cash flow calculations in relation to impairment testing

Regardless of an entity's reporting framework, impairment testing typically involves the determination of fair value or some other discounted cash flow calculation. As discussed in the previous section on forward-looking estimates and projections:

- The discount rate is a key input in such valuations. Rising long-term risk-free rates would likely result in higher discount rates unless other factors (e.g., the risk premium of the item being measured) decrease. Higher discount rates may reduce valuations unless the impact is offset by adjustments to forward-looking cash flow estimates and projections. This could result in the recognition of impairment losses where there were none in previous periods.
- Information from prior periods (e.g., actual results, budgets, previously prepared forward-looking estimates and projections) is often used as a starting point when preparing forward-looking estimates and projections. In this current environment, such an approach may no longer be appropriate. Careful consideration should be given to the company, industry, and overall economic outlook when determining the discount rates to be used.

As interest rates in Canada are expected to remain higher than in recent history, for at least the near future, entities should closely monitor the impact on their valuation models. Entities may need to perform a detailed impairment test during interim financial reporting periods rather than rely on the detailed calculations used in previous impairment tests.

Changing the cash-generating units (IFRS) or asset groups (ASPE) used for impairment testing

An entity may be considering changes to the structure of the cash-generating units (CGUs) or asset groups it had identified in previous periods for impairment testing. While the reporting frameworks do not identify specific events or circumstances that would justify a change in cash-generating units or asset groups, generally such a change is only appropriate if there has been in a change in the entity's operations (e.g., different revenue-generating activities or different utilization of assets in undertaking those activities). Examples of some appropriate triggers include:

- business combinations or divestments;
- restructurings;
- introduction or withdrawal of products or services; or
- entry to or exit from new markets or regions.

Changing the business model used to classify financial assets (IFRS only)

An entity may be considering changes to the business model used for classifying its financial assets under IFRS 9. For example, due to volatile market conditions, management may be interested in reclassifying assets that were previously classified as fair value through other comprehensive income (i.e., business model is to both collect contractual cash flows and to sell the assets) to amortized cost (i.e., business model is to hold the assets to collect contractual cash flows). However, under IFRS 9 a change in business model must be determined by the entity's senior management as a result of external or internal changes, significant to the entity's operations, and demonstrable to external parties. Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations (e.g., when the entity has acquired, disposed of, or terminated a business line).

Expected credit losses on receivables (IFRS only)

Under IFRS 9, expected credit losses (ECLs) are recognized on trade receivables, loans, debt securities, contract assets, loan commitments, and financial guarantee contracts. ECLs incorporate not only information about past events and current conditions, but also forecasts of future economic conditions. As a result, when there is a negative economic outlook and/or cash flow difficulties experienced by customers, this should be factored into an entity's forecasts on a probability-weighted basis for ECL purposes. This may result in an increase in its provision for ECLs to reflect (a) a greater probability of default across many borrowers, even those that currently do not exhibit significant increases in credit risk but may in the future; and (b) a higher magnitude of loss in the event of a default, due to possible decreases in the value of collateral and other assets.

Customers filing for bankruptcy subsequent to period end

An entity should consider whether a customer filing bankruptcy after period end is confirming conditions that already existed at period end. If so, this would be an adjusting subsequent event and should be reflected in the entity's allowance for doubtful accounts or impairment losses as at period end.

[IFRS] In recognizing ECLs under IFRS 9, an entity should consider whether its forward-looking forecasts should have incorporated a higher probability for an increase in credit risk for that particular customer based on the reasonable and supportable information available at period end, such as economic conditions in the customer's industry or negative financial trends for that customer. The entity should also consider whether this event should be factored into its ECL forecasts for similar customers in the same industry.

Debt classification, modification and derecognition

Difficulty meeting covenants in debt agreements

Due to more difficult economic conditions, an entity that is normally able to comply with its debt covenants may find that it is now in violation. In some cases, the creditor may waive their right to demand repayment. Unless the waiver meets certain conditions—which vary under each financial reporting framework—an entity may still need to present the entire debt as a current liability. Management should assess whether the waiver is of the appropriate form and covers the minimum period required by the entity's financial reporting framework.

Loan modifications or renegotiations

An entity may negotiate a loan modification (e.g., deferring principal repayments) in response to financial difficulties or cash flow issues. Management will need to assess whether the change in terms represents a modification or extinguishment of the debt obligation and revisit the portion of the debt that is considered current versus non-current.

If a creditor forgives an amount owing by the entity, management needs to consider the point in time when the liability is discharged and can be derecognized, along with the appropriate accounting treatment.

Management should also consider whether financial or cash flow difficulties leading to a loan modification need to be factored into the entity's going concern assessment. Also, if an entity has debt that will be refinanced at current (i.e., higher) interest rates, this can lead to cash flow pressures that may also need to be factored into the going concern assessment.

Financing obtained through more complex instruments

An entity may use different instruments (e.g., preferred shares) or include additional features (e.g., conversion options) in their debt agreements to attract additional financing. The terms and conditions of such instruments will impact their accounting treatment, including classification as either equity or liability and whether there is a compound or hybrid instrument. The accounting treatment differs under each financial reporting framework.

Advisory services: Assessing debt arrangements and exploring financing options

Grant Thornton's Advisory group may be able to provide support in assessing a credit agreement, or provide advice on a current or future refinancing. Other sources of temporary financing might be available to some entities.

In each case, independence requirements will need to be considered when an entity is (or was recently) an assurance client.

Off-balance sheet arrangements

Increased likelihood of making a payment under a guarantee

An entity that has guaranteed an amount owing by another entity/individual should consider how the other entity/individual is impacted by the current economic situation. Depending on the circumstances, the entity may need recognize a liability related to the guarantee as opposed to only disclosing the existence of the guarantee.

Transfers of liabilities or underperforming assets to a related entity

An entity may decide to transfer liabilities or underperforming assets to a related entity in exchange for related party balances. Entities should ensure that such transfers are appropriately accounted for and disclosed in their financial statements, in accordance with their financial reporting framework.

Under some reporting frameworks, the decision to sell or transfer assets is considered an indicator of impairment that may trigger an impairment review. As such, the transferor may need to recognize any existing impairment prior to the sale or transfer. When an indicator of impairment exists, this guidance applies even for frameworks where related party transactions are measured at amounts other than fair value (such as carrying amount or exchange amount related party transactions under **[ASPE]**).

In some arrangements, the conditions for the derecognition of the transferred asset or liability may not be met, depending on the degree of control or obligation the entity retains. In addition, if the entity does not expect a related party receivable to be repaid, the receivable may in substance form an investment in the related entity. The accounting treatment will differ under each financial reporting framework.

Revenue recognition

Collectability from customers

In most cases, an entity must stop recognizing revenue when collectability is no longer probable or no longer reasonably assured, with the required degree of certainty varying based on the entity's reporting framework. Collectability can be uncertain even if a customer has made partial payments or has made its payments to date—the entity must consider the customer's ability and intention to pay the rest of the consideration when it is due, including changes in the customer's circumstances given current economic conditions. In general, the entity's regular revenue recognition pattern for that customer/contract would only resume when the probability of collection is restored.

- **[ASPE]** Under ASPE, even when ultimate collection is uncertain, an entity may be able to justify recognizing a portion of the revenue as cash payments are received (e.g., if the payment is non-refundable and the revenue corresponds to the performance completed by the entity thus far).

Percentage of completion method

An entity that accounts for a sales contract using the percentage of completion method may need to revise/refine its calculations related to the degree of completion. For example, the entity may find that its estimate of total costs or expected efforts will change as a result of current economic conditions (e.g., changing prices of inputs). If there are changes in these estimates, there could be a direct impact on the amount of revenue recorded in a fiscal period.

Sales contracts with variable components (such as discounts or price concessions)

If the entity's contract/sales terms include variable components (e.g., discounts or price concessions), management must consider whether its previous estimates in this regard continue to be appropriate as economic conditions change.

- **[IFRS]** IFRS 15 provides extensive guidance around variable consideration and the related constraint. It may be necessary for an entity to begin constraining its variable revenue even if this was not considered necessary previously.

Existing sales contracts becoming less profitable or loss-making

Sales contracts may become less profitable, or even loss-making, in light of negative economic trends. For example, an entity might face penalties because of delays or incur increased costs that cannot be recovered due to replacing employees or needing to find alternative suppliers. Management needs to consider whether any contracts, in particular fixed-price contracts, are in an "onerous" position and whether a liability needs to be recognized. Under some reporting frameworks, the expected loss on a sales contract must be recognized as an expense in the period it becomes probable.

Contract modification on a sales contract

An entity may negotiate various contract modifications with its customers, such as extending payments terms, granting price concessions due to service delays, or extending the term over which goods or services are provided at no additional consideration. The specific guidance in the entity's reporting framework must be considered when determining how to account for a contract modification. For example, depending on the nature of the modification, some reporting frameworks may result in the modification being accounted for as either a separate contract, as a termination of an old contract and creation of a new contract, or as some form of cumulative catch-up adjustment.

Advisory services: Updating strategies to guide sales growth

Grant Thornton's Advisory service line has issued an insight entitled "How can I grow my sales and revenue?". Strategies that were successful in the past may no longer be effective in the current landscape to attract new customers. This insight highlights some of the methods for how entities might drive additional sales and revenue.

There may be opportunities for our advisors to assist entities with identifying where there may be gaps, or opportunities to update and upgrade their sales and marketing strategies. In each case, the independence rules will need to be considered when an entity is (or was recently) an assurance client.

Employee future benefits

Offering new employee benefits and/or new termination benefits

Due to labour shortages, an entity may decide to provide new benefits to attract new employees and/or retain existing employees. Financial support or benefits offered to employees will likely meet the definition of a liability; therefore, an entity will need to consider when to recognize the liability/expense and how it should be measured.

The entity must first determine whether the benefits provided are a result of past service (for existing employees) or if they will be provided as services are rendered, because that will impact when the liability is recognized. The specific guidance in the entity's reporting framework must be considered when making this determination. Generally speaking, a liability is incurred once a past transaction has occurred, and the entity has lost the discretion to avoid the obligation.

In some cases, as a result of difficult economic conditions, entities will downsize their workforce. If the entity offers or is required to pay termination benefits to affected employees, management must consider how and when to account for the liability/expense in accordance with the relevant financial reporting framework.

Defined benefit plans

Rising interest rates can have a significant impact for entities with defined benefit plans, because higher discount rates affect measurement in various areas:

- Present value of the defined benefit obligation
- Fair value of plan assets
- Pension allowance or asset ceilings on plan surpluses (present value of certain economic benefits)
- Net interest on the net defined liability (asset), recognized in the income statement
- Remeasurement gains or losses

While rising interest rates reduce defined benefit obligations, inflation and rising costs may have an offsetting impact on valuations. Another key factor in accounting for defined benefit plans is the market value of both financial and non-financial assets at the measurement date. Entities also need to consider whether changes to future funding levels may be required.

Most entities obtain full actuarial valuations approximately once every three years or as required by their regulator. In between, their actuary may perform an extrapolation to roll forward the figures for financial reporting purposes. Entities should consider whether the estimate needs to be adjusted as a result of the current state of the economy. Where there have been significant market value fluctuations, management may need to consider obtaining another full actuarial valuation before three years have passed in order to reflect changes in expectations.

- **[ASPE]** A significant change in the interest rate used to determine the discount rate for measuring a defined benefit obligation specifically does not trigger the need for a new actuarial valuation before three years have passed.

Rising inflation and interest rates may also impact other actuarial assumptions, such as demographic data and wage inflation. Entities should have discussions with their actuaries to ascertain whether the current state of the economy has impacted any assumptions in their reports such that their estimates may need to be revisited.

Defined benefit plan with a plan surplus

In some cases, economic conditions will result in a defined benefit plan moving from a liability position to an asset position. For example, the actuarial gains on the defined benefit obligation from increasing interest rates may exceed the losses on the plan assets from negative returns on equities during the period.

While the particular requirements differ across reporting frameworks, in general, the entity must recognize an allowance against such an asset so that the amount on the balance sheet only reflects the amount of the surplus that is available for a refund. For example, management and the actuary should consider how minimum funding requirements limit the entity's ability to reduce future contributions, or whether the plan trustee has discretion to use the surplus amounts for other purposes without the entity's consent.

Advisory services: Managing labour market challenges

Grant Thornton's Advisory service line has issued a series of insights on managing labour challenges and how businesses can remain competitive. There may be opportunities for our advisors to assist entities in identifying solutions to their challenges, such as investing in technology, making an acquisition, considering remote work models, identifying inefficiencies and creating a strong work culture. In each case, the independence rules will need to be considered when the entity is (or was recently) an assurance client.

Restructuring plans

Contemplating/implementing a restructuring plan (such as a sale or downsizing of operations)

An entity may consider restructuring plans such as the sale or closure of part of its business or the downsizing of operations (either temporary or permanent). Management should consider whether any long-lived assets need to be classified as held for sale or if any portion of its business must be presented as a discontinued operation. If an entity offers termination benefits to its employees as part of a restructuring plan, the section above on employee future benefits discusses additional considerations.

Investment property

Investment property measured at fair value

Certain reporting frameworks allow investment property to be measured at fair value. In the real estate industry, current economic conditions may result in fewer observable transactions. For example, as benchmark interest rates and similarly risk-free rates rise, fewer investors may choose to spend their capital on real estate at the previous prices. The lack of market transactions will make it difficult for entities holding the investment properties to find comparable transactions to use to determine the fair value of their properties.

Management must determine their best estimates of cap rates, with particular attention paid to consistency in assumptions used across various estimates, and the use of market participant assumptions and observable inputs where available. For example, if market lease rates have declined in certain sectors (e.g., commercial office spaces due to remote or hybrid work models), this should be reflected in the entity's estimates and models. Due to the changing economic environment, new market data obtained closer to the effective date of a valuation will be more persuasive than market data from earlier in the year.

Inventory

Supply chain disruptions and/or seasonal inventories

Some entities may experience supply chain disruptions. Seasonal inventories and perishable products might be exposed to the risk of loss due to damage, contamination, physical deterioration, obsolescence, changes in price levels or other causes. Entities need to assess whether, at the reporting date, an adjustment to the carrying value of their inventory is required to bring them to their net realizable value in accordance with their respective accounting framework. Estimating net realizable value in volatile market conditions may also be a challenge, on account of economic uncertainties.

Inventory production level is lower than normal

If an entity's production level is abnormally low (e.g., due to a temporary a shutdown or slowdown of production), it may need to review its inventory costing to ensure that unallocated fixed overheads are recognized in profit or loss in the period in which they are incurred (i.e., "excess capacity" should be expensed rather than being added to the cost of inventory).

Derivatives and hedge accounting

Use of derivative contracts

Rising interest rates may affect the fair value measurement of derivatives, along with the hedge effectiveness assessment of any related hedging relationships. In addition, entities may seek to close out existing hedge positions and terminate hedging relationships. On the other hand, rising interest rates may also motivate entities to enter into derivatives or other hedging arrangements to limit the exposure to further interest rate risk.

Change in the probability of a hedged forecast transaction occurring

An entity that applies hedge accounting in accordance with its reporting framework may determine that an expected transaction is no longer highly probable or expected to occur. In such cases, management would need to revisit how the entity accounts for its hedge relationships.

Lease accounting

Potential change in the entity's borrowing rate

Determining the incremental borrowing rate is often necessary for a lessee to account for leases under IFRS, and for capital leases under ASPE. Due to economic trends, including changes to benchmark interest rates and to the entity's own credit risk, this rate may need to be reconsidered. Depending on the entity's reporting framework, a change in the incremental borrowing rate can impact new leases that the entity enters into, changes in the lease term, or certain lease modifications. All else being equal, a higher incremental borrowing rate will result in a lower lease liabilities and corresponding asset (right-of use asset under IFRS and asset under capital lease under ASPE). This also results in a greater proportion of the lessee's lease expenses shifting from amortization to interest expense.

Lease modification

In response to operational disruptions or financial difficulties, lessors and lessees might agree to modify their lease arrangements. Both lessors and lessees must consider how to account for such modifications, including determining whether the changes result in a new lease or a modified lease.

Share-based payments (IFRS & ASPE)

Changes in valuation assumptions / modification of arrangements

If an entity is negatively impacted by the current state of the economy, this may decrease the probability that it will meet a performance vesting condition for an existing share-based payment (e.g., stock options issued to employees that vest upon the entity's share price reaching a certain target). Assumptions used in an entity's valuations models (e.g., risk-free rates, volatilities) may also need to be updated due to higher interest rates and volatile capital markets.

Furthermore, an entity may choose to modify or cancel its share-based compensation arrangements. Management must consider how the accounting for such plans needs to be revised based on the guidance in the applicable financial reporting framework.

Tax planning arrangements

Implementing tax planning arrangements

More entities may be considering tax planning arrangements to weather financial difficulties or support an owner's exit from a business. The accounting for tax planning arrangements is often complex and can have a significant impact on an entity's financial statements. Furthermore, it is often possible for the accounting treatment and tax treatment of a tax planning arrangement to differ. If a tax planning arrangement is not accounted for appropriately, this can result in unexpected impacts on the appearance of the entity's financial statements and inaccurate calculations of key ratios or financial covenants.

If a tax planning arrangement includes some form of restructuring, such as closure of a part of the business, the section above on restructuring plans discusses additional considerations.

Advisory services: Sale of business

Grant Thornton's Advisory group has issued an insight entitled "A short guide to selling your business in an economic downturn", targeted towards helping entities that are looking to increase the value of their business when it is sold. Additionally, the group has released an article entitled "How much is your business worth?" which outlines key factors and considerations that may affect the value of a business. One important pre-transaction step that might involve a tax advisor is revisiting the entity's corporate structure to minimize the tax implications on the sale. Grant Thornton's series of insights on planning an exit strategy may also be relevant.

There may be opportunities where Grant Thornton's advisors can help entities navigate through the sales process, from initial planning to successful close. In each case, the independence rules will need to be considered when the entity is (or was recently) an assurance client.

Deferred taxes (IFRS & ASPE future income taxes method)

Entity has recognized deferred/future tax assets but now anticipates additional losses in the future

If an entity has historically recognized a deferred/future tax asset on its balance sheet, but now anticipates additional losses in the future, it may need to revisit its assumptions about the likelihood and amount of the asset being realized in the future. Management may determine that it is no longer appropriate for the entity to recognize the deferred/future tax asset on the entity's balance sheet.

Entity has assumed that earnings in foreign jurisdictions are indefinitely reinvested into foreign entities

When an entity asserts that earnings in foreign jurisdictions are reinvested indefinitely, it does not recognize a deferred/future tax liability on those accumulated earnings and other taxable outside-basis differences. That assertion may need to be revisited if an entity's current cash flow estimates and projections have changed. For example, if a parent company in Canada is under cash flow pressures, it may no longer be reasonable to assume that it can leave accumulated profits reinvested in a foreign subsidiary. If the Canadian parent now requires that cash, then the deferred/future tax liability associated with the taxable outside-basis differences must be recognized, and this may have a significant impact on entity's deferred/future tax expense.

Tax planning tips

Grant Thornton has published year-end tax planning tips for 2023. In light of current economic conditions, some important considerations for entities include:

- Finding the most tax-efficient way to extract funds from the business
- Being aware of the tax implications of borrowing from the corporation
- Being cognizant of intergenerational transfer rules and potential changes
- Taking advantage of new tax incentives for depreciable asset purchases

Furthermore, it may be beneficial for an entity to connect with a tax advisor to look for ways to reduce their tax burden and take advantage of losses. If the entity has experienced additional losses under current economic conditions, there may be ways that it can utilize the losses to improve its tax situation. An advisor from Grant Thornton's Tax service line may be able to provide guidance on how an entity can increase their tax efficiency.

Extraordinary items

Labelling amounts in the financial statements as "extraordinary"

It is important for entities to note that, depending on the reporting framework, the accounting standards either explicitly forbid or do not provide guidance allowing the presentation items of income or expense as "extraordinary" items in the income statement or in the notes to the financial statements.

Foreign currency translation

Fluctuations in foreign exchange rates due to economic uncertainty

Under each financial reporting framework, an entity must translate foreign currency transactions into its reporting/functional currency using the spot rate in effect on the date of the transaction. As a practical expedient, an entity may translate revenue earned and expenses incurred in a foreign currency using an average rate (e.g., a monthly or annual average). In years where the exchange rate remained fairly stable, a monthly average rate may have reasonably approximated the use of the spot rate. However, with some exchange rates fluctuating significantly, an entity may need to revisit the way it translates foreign currency transactions, including using the average rate for a shorter period, such as a week.

Insurance claims for business interruption

Insurance covering losses from business interruption

An entity may have an insurance policy that covers losses from business interruption. If the entity is forced to temporarily cease operations, it may be entitled to recover some or all of its losses from its insurance provider. While contingent gains/assets are generally not recognized until they are virtually certain, they would be disclosed in the notes to the financial statements as long as their existence is likely.

Fair value measurement

Assets or liabilities that are initially or subsequently measured at fair value

The fair value of an item (e.g., certain financial instruments, investment properties, items of property, plant and equipment) must reflect market participant views and market data at the measurement date under current market conditions. There may be an increase in the amount of subjectivity involved in fair value measurements, especially those based on unobservable inputs. Estimates of fair value often include some form of discounted cash flow calculation. Entities should also refer to the overall discussion on forward-looking forecasts from earlier in this publication.

Fair value assessments – Specialists

Grant Thornton's Complex Financial Instrument Pricing Group (CFIP) can potentially assist entities with valuations of complex financial instruments such as convertible notes, options, derivatives, complex payouts, and hedge accounting effectiveness analyses.

Disclosures

An entity may need to revise existing disclosures in its financial statements and/or add new disclosures for the financial statement areas discussed above. In addition, entities should keep in mind the general disclosure requirements regarding the use of judgements and estimates, and under some frameworks, disclosures on the sources of estimation uncertainty and changes in accounting estimates. Discount rates are often a critical management estimate.

Under all reporting frameworks, entities must also disclose the nature and extent of risks arising from financial instruments, including liquidity risk, credit risk and market risk, along with their mitigation efforts. Due to the rapidly changing economic environment, an entity may find that it is subject to new or increasing risk or concentrations of risk. In addition, an entity may find that its risks have changed from the prior period. The required disclosures generally include both quantitative and qualitative information. Some frameworks, in particular IFRS, require entities to disclose sensitivity analyses for significant risk exposures. Due to uncertain economic conditions, the range of reasonable expectations for the sensitivity analyses is likely greater than in past periods and should consider inputs such as interest rates, inflation, commodity prices, and other economic factors.

In addition, an entity that is otherwise not economically dependent on another entity or individual may find that circumstances change during this period of economic uncertainty. Management should consider whether disclosure regarding economic dependence should be added to the financial statements.

Example disclosures

- **[IFRS]** Entities reporting in accordance with IFRS may find the following resource helpful: "IFRS Example Consolidated Financial Statements 2023." Although this publication does not contain disclosures specific to the impact of economic conditions, entities can use the general disclosures outlined as a starting point and tailor them for the entity's specific circumstances.
- For entities seeking sample disclosures under other financial reporting frameworks, please contact your Grant Thornton advisor for assistance.

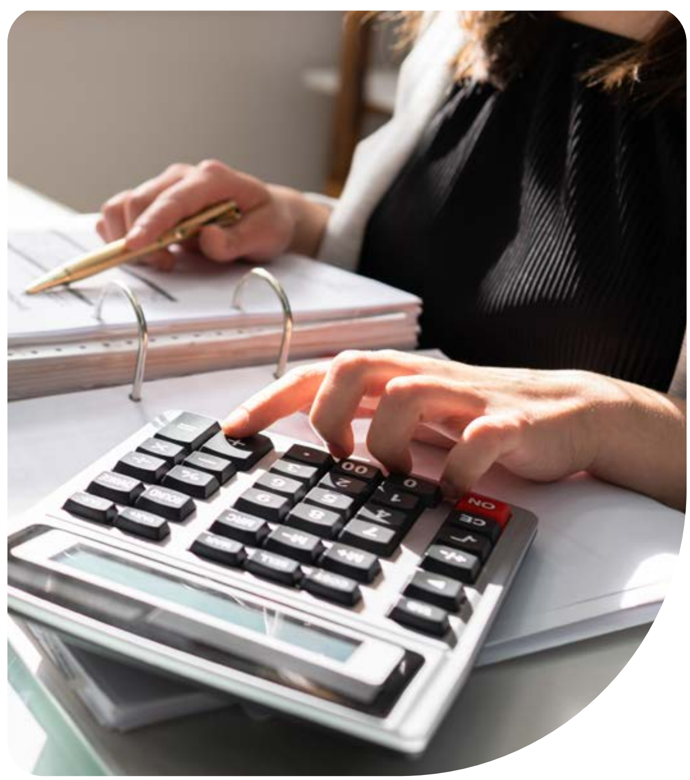
Assessing the ability to continue as a going concern

All frameworks contain guidance related to the going concern assumption and outline when financial statements are prepared on the assumption that the entity will continue as a going concern. IFRS, ASPE, and ASNPO explicitly state that at each reporting date, management is required to assess the entity's ability to continue as a going concern and consider all available information about the future, which is at least, but not limited to, twelve months from the balance sheet date. Management should consider a wide range of factors, such as: current and expected profitability, debt repayment schedules and potential sources of replacement financing, the ability to continue providing services and, for ASNPO only, the ability to discharge its stewardship responsibilities. This assessment should also consider factors with respect to current and expected economic conditions (e.g., changes in interest rates, inflation).

This assessment involves judgement and numerous assumptions. Furthermore, a small change to these assumptions can have a big impact on estimates and projections.

Liquidation basis of accounting

If management concludes that the entity may be liquidated, either by choice or because it has no realistic alternative but to do so, the going concern assumption would not be appropriate and the financial statements may have to be prepared on another basis, such as a liquidation basis.



Subsequent events

Under all Canadian financial reporting frameworks, entities are required to distinguish between subsequent events that are adjusting (i.e., those that provide further evidence of conditions that existed at the balance sheet date) and non-adjusting (i.e., those that are indicative of conditions that arose after the balance sheet date). Entities are required to adjust the amounts recognized in their financial statements to reflect any adjusting events that occur during the subsequent events period.

Entities will also need to determine whether they should make additional disclosures to describe the impacts of current and expected economic conditions in the subsequent period. Generally, disclosure should be made of events during the subsequent events period that do not relate to conditions that existed at the date of the financial statements, but cause significant changes to assets or liabilities in the subsequent period and either will, or may, have a significant effect on the future operations of the entity.

For material non-adjusting events, an entity must disclose: (a) a description of the nature of the event; and (b) an estimate of the financial effect, or a statement that such an estimate cannot be made. Examples of non-adjusting events that would generally result in disclosure include:

- Breaches of covenants, waivers or modifications of contractual terms in lending arrangements
- Supply chain disruptions
- Assessment of certain purchase or sale agreements as onerous contracts
- Announcing a plan to discontinue an operation
- Announcing, or commencing the implementation of, a major restructuring or downsizing (temporarily or permanently)
- Declines in the fair value of investments held after the reporting period (e.g., pension plan investments)
- Abnormally large changes in asset prices or foreign exchange rates
- Entering into significant commitments or contingencies, such as issuing significant guarantees to related parties

Conclusion

It is important to remember that this situation is constantly changing. Judgements, estimates and assumptions need to be kept up to date, and entities must continue to assess the potential impact of current economic headwinds on their business and in their financial statements.

Now more than ever the need for entities and their auditor or advisor to work closely together is essential, so if you would like to discuss any of the points raised, please reach out to your Grant Thornton advisor.

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