Rising interest rates and inflation: what impact on financial reporting do companies need to prepare for?

Interest rates and inflation are on the rise. This could have both short and long-term impacts on business. Companies will need to make a number of decisions that will affect financial reporting, key performance metrics and how they communicate with stakeholders. In this paper, we outline the key considerations for businesses as they navigate this changing landscape.

Potential risks across a business

Rising inflation and interest rates present risks across the entire business. Companies will need to respond to, and manage, these risks which could lead to changes in risk assessment, business plans and even longer term strategy.

Possible impacts on business include:

- Reduced margins from increased labour, production and other costs - does the pricing of goods or services need to change?
- Suitability of existing agreements given rising costs e.g lease agreements or fixed price contracts - do leases or fixed price supply contracts need to be renegotiated or are they onerous and cost out measures need to be taken?
- Financing arrangements (including covenants) which may become cumbersome - do financing arrangements need to be renegotiated?
- Increasing costs of capital projects - how will the increased cost to complete key projects be funded?
- Financial risk management (including foreign exchange risk) and hedging strategies set for a low interest rate environment - are risk management and hedging strategies fit for purpose?
- Do short and longer-term business plan assumptions including returns to investors remain appropriate?
- How will key performance indicators and ratios change and are there any potential credit rating impacts?

Financial reporting considerations for FY22

Rising interest rates and inflation will have various short-term effects. These include both interim and annual financial reporting and operational decisions made in response as well as longer-term financial reporting. To prepare, companies should consider the following:

Greater risk of impairment of intangible assets with little or no headroom

Risk-free interest rates usually form the basis of discount rates used in discounted cash flow models for testing impairment or to determine the fair value of non-financial assets. Increasing interest rates, along with the addition of other relevant risk weightings, such as the risks associated with climate change, will increase the discount rate. This will, in turn, decrease the overall value of the discounted cash flow model having a direct effect on headroom of assets tested for impairment including goodwill. This decrease in value will need to be offset by updated business plans supporting improved cash flow assumptions otherwise there is a greater risk of impairment.

Also, inflation may impact margins if the effects of rising costs cannot be passed onto customers increasing the potential for impairment.

Decline of investment and asset values could impact the strength of company balance sheets

Non-financial assets including investment properties, or other investments measured at fair value, may decline in value due to increasing discount rates and underlying business performance. There may however be other changes in valuation variables which negate the impacts. Understand the consequences well in advance of period end and consider any continuous disclosure obligations that may arise.

Addressing current hedging strategies

Existing effective hedges may not be a concern in the current environment. However, as businesses change their plans they may also adapt their hedging strategies. For example, a business may plan to close out an existing effective interest rate hedge to realise a significant fair value gain resulting from rising interest rates. The accounting outcome of these changes may not necessarily follow the cash outcome. Before finalising any changes in economic hedging strategies, be sure to also consider the accounting implications to minimise surprises.

Companies may now decide to undertake more significant economic hedging activities than when interest rates were falling, or relatively flat. This could mean that the associated accounting implications are more material and subject to increased focus from stakeholders including auditors.

Additional financial reporting impacts to consider:

- The ability of debtors to repay loans or receivables and the effect this has on estimated credit losses (impairment). It may not be possible to revert back to pre COVID-19 assumptions for impairment assessments. The expected impact of rising interest rates and inflation will need to be factored in.
- Rising interest rates will increase the discount rate applied to financing arrangements provided to customers. This potentially reduces the amount of revenue recognised upfront.
- Almost all leases are now recognised on balance sheets at amounts discounted using the interest rate implicit in the lease or the entity's incremental borrowing rate (IBR). The change to recognising leases on balance sheet was made in a low interest rate environment. The IBRs applied to new leases or where lease arrangements change will likely be higher. This will mean lower values for new lease liabilities and right of use assets than they would have been with the lower interest rate environment.
- The valuation of other liabilities, such as retirement or restoration obligations and employee benefits (defined benefit obligations) - given the impact of higher interest rates (i.e. the discount rate applied) and rising costs, may change. These may fall in value with higher discount rates but interest costs will rise. Employers with defined benefit retirement plans may see employer contributions rise.

Communicating with stakeholders

Disclosures in financial statements

Disclosure of risk exposures and how those risks are managed may need to be revised including the ranges of possible outcomes considered and provided in sensitivity analysis.

From both an interim, and annual financial statement perspective, there may be a need to disclose these matters as significant judgements and estimates. Consideration needs to be given to what additional qualitative information needs to be disclosed to enable stakeholders to understand the impact on the financial statements of rising interest rates and inflation.

Other disclosures

Once the broader business and financial reporting impacts are understood, develop a stakeholder communication plan to ensure the short and long-term effect on the company's operations is clearly communicated and transparent. Communications should outline the potential impact on the company's results, and shareholder returns, as well as its financial reporting in a timely manner.

Rising interest rates and inflation could have significant implications for companies and their financial reporting. In this paper we have highlighted some of the key areas to be aware of.

More information on our audit and assurance practice can be found **here.**

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