Impact of Rising Inflation and Interest Rates on Financial Reporting

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After a sustained period of low interest rates, interest rates are now rising in Canada. At its September 2022 meeting, the Bank of Canada raised its benchmark interest rate by 75 basis points to 3.25 per cent.[1] This is the fifth consecutive increase since March 2022 as the Bank of Canada continues to tighten its monetary policy to help rein in inflation. A combination of rising inflation and an expectation of future interest rate hikes by the Bank of Canada also has resulted in an increase in Government of Canada bond yields.

Rising inflation and interest rates can have a wide impact on financial reporting. For example, they may impact the measurement of assets, liabilities, and net interest expense and trigger impairment losses. In addition, rising bond yields impact the pricing of long-term debt and equity instruments and enterprise value as the yields affect the cost of debt, the cost of equity and the weighted-average cost of capital (WACC).

The Group discussed various financial reporting considerations regarding rising inflation and interest rates. The issues the Group discussed are not exhaustive. Entities should consider their own circumstances when analyzing the impacts of rising inflation and interest rates on their financial statements.

Non-financial assets and leases

Impairment (IAS 36* Impairment of Assets*)

Impairment tests for goodwill, intangible assets, items of property, plant and equipment, and right-of-use assets require companies to determine the recoverable amount of the individual asset, or the cash-generating unit (CGU) to which the asset belongs. The recoverable amount is the higher of the asset's or CGU's fair value less costs of disposal (FVLCD) and value in use (VIU). VIU represents the discounted net future cash flows associated with the continued use and ultimate disposal of the asset or the CGU. Impairment losses arise when the carrying amount of the asset or the CGU exceeds its recoverable amount.

The discount rate is a key input to calculate VIU and also FVLCD when an income approach is used. As discount rates are commonly estimated using the WACC formula, rising long-term risk-free interest rates may result in higher discount rates. Absent any offsetting adjustments to cash flow projections, higher discount rates may reduce the VIU or FVLCD of an asset or CGU. This can indicate an asset may be impaired, even if previous impairment tests showed significant headroom.

[1] Bank of Canada, "Bank of Canada increases policy interest rate by 75 basis points, continues quantitative tightening," press release, September 7, 2022

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Estimates of future cash flows and the discount rate reflect consistent assumptions about price increases attributable to general inflation. Therefore, if the discount rate includes the effect of price increases attributable to general inflation, future cash flows should also include general inflation expectations and vice versa.

Lease assets and lease liabilities (IFRS 16* Leases*)

A lessee reports the lease liabilities and right-of-use assets at amounts that reflect discounted lease payments. Discount rates are often based on a lessee's incremental borrowing rate.

Although the discount rate is typically not revised throughout the lease term, some events that trigger a remeasurement of existing lease liabilities would require the lessee to revise the discount rate to reflect conditions at the date of remeasurement. Examples of these events include changes in lease payments due to a change in floating interest rates, changes in the lease term, and certain lease modifications. For those entities that need to remeasure existing lease liabilities at a revised discount rate, rising interest rates can drive higher discount rates, lower lease liabilities, and lower corresponding right-of-use assets. Consequently, in the long run, a greater proportion of the lease expenses recognized could shift from amortization to interest expense.

The Group's Discussion

Group members agreed with the analysis.

Several Group members observed that rising interest rates have reduced the headroom from previous impairment tests and triggered impairment testing. As rate hikes are expected to continue in Canada, these Group members noted entities should closely monitor their impact on the valuation models. Given the reduced headroom, some Group members noted that entities may need to perform a detailed impairment test during interim financial reporting periods, rather than rely on the detailed calculations used in the most recent annual impairment test.

Group members then discussed the impact of the current economic environment on the components of the valuation model. A few Group members noted that the growth rate used to calculate the terminal value incorporates long-term economic forecasts. They observed that the long-term growth rate is still targeted at a rate much lower than the current inflation rate. Consequently, the growth rate may not offset the impact of higher discount rates used in the recoverable amount calculation. Some Group members also noted that rising rates could also impact broader cash flow projections, including pricing and costing structures. In addition to interest and inflation rates, they observed that factors such as customer demand and geopolitical issues may impact the cash flow projections in the valuation model. They noted that these factors should be considered holistically in the valuation model to determine the recoverable amount of an asset or a CGU.

The Group also considered the disclosure implications around management estimates and judgments made in the impairment analysis. Given that discount rates are often a critical management estimate, some Group members commented that entities should consider requirements in IAS 1 *Presentation of Financial Statements* on significant judgments and sources of estimation uncertainty. In addition, these Group members noted that entities should consider whether their annual IAS 36 disclosures may require an update in their interim financial statements. In particular, updated disclosure may be warranted of any sensitivity analysis around a reasonable possible change in a key assumption in paragraph 134(f) of IAS 36.

Financial instruments (IFRS 9 *Financial Instruments*)

Measurement

After initial recognition, financial assets, and financial liabilities are measured at amortized cost or fair value. For floating-rate financial instruments measured at amortized cost, their accounting may be affected by rising interest rates as anticipated cash flows may need to be re-estimated to reflect current and expected conditions. Any period re-estimation of cash flows will affect the effective interest rate of a floating-rate financial asset or financial liability.

Rising interest rates will directly affect the measurement of financial assets or financial liabilities measured at fair value since their value is commonly based on discounted cash flows.

Expected credit losses (ECLs)

The ECL model covers, among other items, financial assets measured at amortized cost and investments in debt instruments measured at fair value through other comprehensive income. ECLs are based on the present value of expected cash shortfalls. The rate to discount ECLs is the original effective interest rate, unless the financial asset has a floating rate, in which case the current effective interest rate is used. Therefore, ECLs for floating-rate financial assets may be lower due to the effect of higher discount rates. However, any such reduction in ECLs could be offset by potential increases in the estimates of cash shortfalls if borrowers are adversely affected by rising interest cost and inflation.

Derivatives and hedge accounting

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 also 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 interest rate risk.

The Group's Discussion

Group members agreed with the analysis.

Some Group members observed that in financial institutions, the inflation outlook and the possibility and the severity of a recession are considered as forward-looking information and are incorporated in the ECL calculation. As a result, some financial institutions may have increased their ECL reserves to reflect these macro-economic uncertainties. They also noted that because of the timing differences between re-pricing of financial assets and financial liabilities, some financial institutions may encounter pressure on their net interest margin.

For corporate entities, a few Group members noted that rising interest rates and inflation can increase the cost of borrowing and reduce liquidity for their customers. They also observed that the credit spread for many entities widened in 2022. Therefore, entities should monitor their customers' credit in the current economic environment and consider its impact on their ECL calculation.

Employee benefits and provisions

Defined benefit plans (IAS 19 **Employee Benefits***)*

Rising interest rates can have a significant impact for entities with defined benefit pension plans as higher discount rates may affect various areas of measurement, including:

(a) present value of the defined benefit obligation;

(b) fair value of plan assets;

(c) asset ceilings on plan surpluses (present value of certain economic benefits);

(d) net interest on the net defined liability (asset), recognized in the income statement; and

(e) remeasurement gains or losses recognized in other comprehensive income or loss.

While rising interest rates reduce defined benefit obligations, inflation and rising costs may have an offsetting impact on the underlying valuations. Entities may also need to consider whether any changes to future funding levels may be required.

Canadian entities that sponsor defined benefit plans are required to monitor for significant market fluctuations during the interim financial reporting period. Some key drivers that may result in significant market fluctuations include economic assumptions, specifically the discount rate and inflation, and the market value of both financial and non-financial assets at the measurement date.

Some defined benefit pension plans may have limits imposed on the net asset or liability positions in accordance with IFRIC Interpretation 14 *IAS 19 –The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*. These entities should consider whether they need to remeasure the net defined benefit liability or asset during interim financial reporting periods.

Determining whether there is a need to remeasure the net defined benefit liability or asset for interim financial reporting requires judgment. The potential materiality of a remeasurement is assessed in relation to the interim financial statements.

Provisions (IAS 37 **Provisions, Contingent Liabilities and Contingent Assets***)*

Where the effect of the time value of money is material, a provision shall be measured at a discounted amount, being the present value of the expenditures expected to be required to settle the obligation. Rising interest rates could lead to more long-term provisions needing to be discounted. Examples of long-term provisions that may be impacted include decommissioning or asset retirement obligations, especially in the extractive industry. In addition, the impact of higher discount rates on the provision may be offset by rising costs and risk adjustments. Finance expenses may increase because the unwinding of the discount is presented as interest costs.

Rising inflation may also trigger inflation adjustments. While IAS 37 provides no guidance on whether the discount rate should include the effects of inflation, in practice, companies ensure they use a consistent approach: If the cash flows are expressed in current prices, the effects of inflation are not included in the discount date (i.e., a real discount rate is used). If the cash flows include inflation, the discount rate also includes the effects of inflation (i.e., a nominal discount rate is used).

The Group's Discussion

Group members agreed with the analysis.

Regarding the impact on defined benefit plans, one Group member noted that rising inflation and interest rates may also impact other actuarial assumptions. Therefore, entities should consult with their actuaries to update key assumptions (e.g. demographic data and wage inflation) to ensure these actuarial assumptions are consistent.

One Group member commented that the decommissioning obligation related to a property, plant, or equipment may increase when the effects of inflation are greater than the effects of the rising discount rate. Consequently, the higher decommissioning obligation reduces the carrying value of the asset base. This Group member commented that the carrying value of the asset should be reduced prior to the CGU being tested for impairment. Another Group member also highlighted the disclosure requirement in paragraph 84 of IAS 37 which requires the entity to disclose the effect of any change in the discount rate on its provisions.

One Group member noted that entities with fixed price contracts should consider the impact of rising costs and assess whether they have become onerous based on the guidance in IAS 37.

Other matters

Revenue recognition (IFRS 15 Revenue from Contracts with Customers*)*

The effect of the prevailing interest rates in the relevant market is one factor an entity should consider when assessing whether a contract contains a financing component and whether that financing component is significant. As a result, rising interest rates may affect the entity's assessment of whether a new contract with a customer contains a significant financing component. Entities that provide financing to their customers may see a reduction in revenue and an increase in interest income.

Borrowing costs (IAS 23 Borrowing Costs*)*

Borrowing costs are capitalized if they are directly attributable to the acquisition, construction, or production of qualifying assets. Qualifying assets are generally assets that are subject to major development or construction projects. Borrowing costs eligible for capitalization will likely increase with rising interest rates because interest expense would be expected to increase.

Financial statement disclosures

There are differences in the specific disclosure requirements for present value measurements between IFRS 13 *Fair Value Measurement*, IAS 19, IAS 36 and IAS 37[2]. For example, disclosure of the discount rate itself is not required by all standards, and the method used to determine discount rates is not always required to be disclosed. Due to these differences in the disclosure requirements, entities need to apply judgment to determine what information should be disclosed.

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[2] IASB, "Project Summary, Discount rates in IFRS Standards," appendix A, February 2019, 15.

For financial instruments, entities should disclose the nature and extent of the risks arising from them and the related mitigation efforts. These disclosures generally include both qualitative and quantitative information.

Entities should also consider disclosure requirements pertaining to the sources of estimation uncertainty in IAS 1 and any changes in accounting estimates under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. They also need to exercise judgment when considering the disclosure requirements in IAS 34 *Interim Financial Reporting* when preparing interim financial statements.

The Group's Discussion

The Group agreed with the analysis.

Several Group members commented that given the recent changes in the macroeconomic environment, entities should consider the disclosure requirements in various IFRS Accounting Standards and make necessary updates to disclosures from previous reporting periods. For example, entities should examine whether the sensitivity analysis around the range of reasonable expectations needs to be broadened considering the changes in interest rates, inflation, commodity prices, and other economic factors. Entities should also reflect the changes in the economic environment in their disclosures around risks such as interest rate risk, liquidity risk, and counterparty credit risk.

Several Group members observed that rising interest rates may also have broader implications on other assets that are measured at fair value, such as investment properties and biological assets. The rising discount rates may reduce the fair value of these assets and the net income of those entities in, for example, real estate investment and cannabis industries. If these reductions are significant, entities may risk violating their debt covenants that are based on net income or earnings before interest, taxes, depreciation and amortization, which may result the debt being classified as current liabilities on their balance sheet. An observer highlighted that entities need to closely monitor and incorporate the impact of rising rates in their forecasts to identify any issues with loan covenants to allow them to work with their lenders on obtaining any necessary relief on their loans before the reporting date.

Some Group members considered the additional pressure some entities may face when refinancing their loans at higher interest rates. The additional interest costs combined with the overall rising costs of doing business may cast significant doubt about their ability to continue as a going concern. These Group members noted entities should update their going-concern assessment to incorporate rising inflation and interest rates and other relevant economic factors to support their ability to continue as a going-concern. A representative of the Canadian Securities Administrators emphasized that the entities in so-called close-call situations should disclose key assumptions and judgments made in concluding that there are no material uncertainties related to events or conditions that may cast significant doubt upon their ability to continue as a going concern.

In addition to financial reporting topics discussed in the analysis, a few Group members raised the impact of rising inflation and interest rates on the following topics:

- IFRS 17 *Insurance Contracts*– the measurement of insurance contract liabilities;
- IAS 12 *Income Taxes*– the ability to realize any deferred tax assets;
- IFRS 14 *Regulatory Deferral Accounts*– accounting for rate regulated deferral account balances;
- IAS 1 *Presentation of Financial Statements*– disclosing information, if material, about the impact of rising rates on the recognition and measurement of financial statement items; and
- IAS 10 *Events after the Reporting Period*– assessing whether subsequent events are adjusting or non-adjusting events and the need to provide additional disclosure on interest and inflation rate increases after the reporting date.

Overall, the Group's discussion was to raise awareness of the pervasive impact of the rising interest rates and inflation environment on many standards. The Group emphasized that entities should stand back and carefully contemplate all the implications of the current environment on the financial statements. No further actions were recommended to the AcSB.