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Asset Management: Economic uncertainty and financial reporting

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It's not business as usual: Economic uncertainty and financial reporting

Continuing economic uncertainty — rising interest rates, inflation, recession fears and a hot financial services job market — means that reporting season is not business as usual.

The aftereffects of the global pandemic and the ongoing geopolitical unrest are reverberating throughout the economy, changing consumers' spending habits and disrupting the supply chain.

The current economic environment makes accounting estimates and forecasting cash flow even more difficult than they already are.

Preparers should be mindful of having the right resources lined up to address this year's reporting challenges. The current economic trends are likely to make accounting judgments more complicated and may require more resources than the financial reporting function has needed in the past.

These concerns cut across industry and geography, regardless of company size. Additional attention should be given to asset impairment analyses and other accounting areas requiring significant judgment.

Considerations for asset management

The volatile market conditions are squeezing earning margins and putting pressure on asset management firms' profitability.

Asset managers are facing an increasingly competitive global marketplace, evolving regulatory and tax landscape, and changing investor trends.

With economic uncertainty expected to continue throughout 2023, asset managers are weighing their options. Rising costs, rising interest rates and widening credit spreads are prompting asset managers to evaluate whether they can adjust the price of their debt to market interest rates. In an environment where private credit and other asset classes are attractive, asset managers are contemplating launching new products or product rationalization to drive profit.

Those moves are options, but there are variables they need to consider such as –

"With rising interest rates and increased cost of services, as well as the changes to the economic environment, asset managers continue to look for ways to reduce operating costs, potential product rationalization and opportunities to launch innovative products that will increase revenue. Asset managers should factor in both regulatory and accounting implications when considering these opportunities," said Matt Giordano Deputy Lead Partner, Public Investment Management.

Know before you go

Regardless of the industry, preparers should ask:

- what aspects of financial reporting are impacted if the entity has experienced a prolonged decrease in its share price and how impairment testing is affected;
- whether management's projections are consistent with expectations in the current environment;
- how their business has been impacted by inflation;
- whether there are other financial challenges their customers may be facing, and the possible impacts on demand;
- how the rising interest rate environment impacts discount rates used in impairment testing and in fair value calculations more broadly; and
- do you have the accounting and regulatory expertise to launch new products.

Inflation affects the cost of doing business and companies may not be able to increase prices to customers enough to offset rising inflation, putting pressure on forecasted profit margins. Margins are often key inputs into companies' long-lived asset and goodwill impairment testing.

The fair value estimates inherent in goodwill and other asset impairment analyses can be sensitive to discount rates, so a rising interest rate environment can have very significant impacts to some companies.

Monitoring for triggering events is a continuous assessment. So even if an annual impairment test has already been performed, another may be necessary as conditions evolve.

In response to economic uncertainty, companies may also modify revenue and debt contracts to reduce minimum quantity commitments, adjust delivery schedules for certain goods or services, change the price of those goods or services, or extend payment terms. These modifications may require companies to assess that change under the specific contract modification guidance for how they recognize revenue.

Furthermore, companies may be adjusting share-based payment arrangements to better align with the current macroeconomic environment to motivate employee behavior toward company goals. For example, an original sales target may no longer be attainable due to economic headwinds, and a company may lower that threshold under the compensation arrangement to make it more likely that its employees can vest in the awards. These modifications can have significant accounting and reporting consequences and should be evaluated carefully, ideally before any changes are implemented.

Preparers should be mindful that this year-end reporting season is not 'business as usual'. Challenges posed by the current economic environment may require additional attention and judgment.

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