HCLS: Economic uncertainty and financial reporting

Audit Insights

March 2023

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

Continuing economic uncertainty — rising interest rates, inflation, recession fears — 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 healthcare and life sciences (HCLS) companies

Healthcare

High inflation and the persistence of COVID-19 are compounding an acute labor shortage in the healthcare sector as the U.S. faces an aging population. The healthcare sector expects the most rapid acceleration in labor costs of any sector, according to a KPMG Economics survey, putting pressure on bottom lines. Rising interest rates affect healthcare organizations with variable rate debt, and variability in markets affects healthcare systems with significant investment portfolios.

The end of COVID-19 relief funds is affecting healthcare systems while tech startups are aiming to disrupt the healthcare industry, cutting further into high-margin areas for providers. Contract renegotiations with payors may also place revenue pressures on healthcare systems.

As a result, some smaller healthcare systems are seeing credit rating downgrades due to liquidity issues. Many rural hospitals are at risk of closing due to financial losses.

"Across the industry, healthcare finance executives may need to evaluate impairment testing and review bond covenant compliance given current economic headwinds," said **Marc Scher**, KPMG National Audit Industry Leader – Healthcare.

Life Sciences

Although the life sciences sector is in a time of rapid innovation, there is also uncertainty. KPMG's annual CEO Outlook survey found that 77% of life sciences CEOs expect and have planned for a recession.

The inflationary environment is top-of-mind: With the passage of the Inflation Reduction Act (IRA) in August 2022, the government will negotiate pricing for top-selling prescription drugs. The IRA rules affect revenue forecasting and valuation of assets in biopharma. They will also likely affect research and development decisions and lead to M&A deals as companies review their pipelines and product portfolios, according to KPMG's 2023 Healthcare and Life Sciences Investment Outlook. Additionally, the IRA will penalize drug manufacturers for price increases greater than inflation for the Medicare Part B and D segment. These factors may also influence how companies price new medications.

"The IRA is a top focus for life sciences companies as they make both short-term and long-term plans," said **Mark Drozdowski**, KPMG National Audit Industry Leader – Life Sciences.

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; and
- how the rising interest rate environment impacts discount rates used in impairment testing and in fair value calculations more broadly.

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 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.

Marc Scher
National Audit Industry Leader, Healthcare
KPMG LLP
314-308-8498
mscher@kpmg.com

Mark Drozdowski
National Audit Industry Leader, Life Sciences
KPMG LLP
973-912-6640
mdrozdowski@kpmg.com

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