Applying IFRS

Accounting considerations related to economic volatility

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Contents

What you need to know

- Globally inflation and interest rates remain high and entities need to consider the effects on IFRS financial reporting.
- This publication addresses the financial reporting considerations of high inflation and high interest rates for entities.
- Management need to carefully evaluate the implications for projections and other assumptions used in preparing the financial statements.
- Further information is available in our publication, *International GAAP®*, which is freely available at ey.com/ifrs.

1. Overview

There are several IFRS standards that specifically refer to inflation as one of the assumptions to be considered for measurement purposes

Inflation rates and interest rates globally remain high, with associated impacts on commodity prices, foreign exchange rates and other macroeconomic factors. As these high rates look set to continue for some time, entities need to carefully consider the impact on financial reporting under IFRS.

Higher inflation has prompted central banks around the world to push up interest rates. Entities that have debt will face increased borrowing costs and, potentially, higher refinancing costs in the future. Furthermore, many IFRS standards use discounting to account for the time value of money in measuring non-current assets and liabilities (for example, the fair value measurement of investment properties using discounted cash flows). When interest rates increase, the present value of those assets and liabilities will decrease. This may affect a number of areas of financial reporting including: impairment calculations; provisions; retirement obligations; leases; financial instruments; and revalued tangible and intangible assets.

There is now a general business risk that, with inflation at a multi-decade high in many economies, many entities may have fixed-price sales contracts which no longer cover the cost of fulfilling those sales, making their contracts onerous. Entities may also have contracts that are explicitly inflation-linked and this may mean assets and/or liabilities, for example, real estate leases, or inflation-linked bonds need to be adjusted for inflation.

There are a number of IFRS standards that specifically refer to inflation as one of the assumptions to be considered for measurement purposes. For example, inflation is particularly relevant in assessing asset impairments, which require estimates to be made about future revenue and expenditure. Inflation also affects many other areas of accounting, such as determining the residual value of property, plant and equipment and net realisable values of inventories. The measurement of provisions for obligations in the future (for example, decommissioning provisions), can also be significantly impacted by inflation.

Entities may also need to consider the implications of recent developments in the global banking sector, including government-aided acquisitions and bank failures in the US. This publication provides a reminder of some of the existing accounting impacts that entities may need to consider.

2. Key considerations

For current reporting periods, including both interim and annual reporting periods, entities will need to determine the impact of the macroeconomic environment and ongoing market uncertainty and consider whether changes to financial reporting are required.

Entities will also need to consider whether changes to disclosures are required including disclosure of additional risks, changes to significant accounting policies and changes to the disclosure of significant judgements and sources of estimation uncertainty, as required by IAS 1 *Presentation of Financial Statements*. See section 12 below.

The specific financial reporting issues that entities may need to consider are addressed in the remainder of this publication, as follows:

- Uncertain estimates and judgement disclosures (Section 3)
- Asset Impairments (Section 4)
- Financial instruments (Section 5)
- Revenue recognition (Section 6)
- Fair value measurement (Section 7)
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3. Uncertain estimates and judgement disclosures

The financial statement disclosure requirements will vary depending on the magnitude of the financial impact of volatile economic measures, such as inflation and interest rates. For example, there may be additional risks that the carrying amounts of assets and liabilities require material adjustments within the next financial year. Similarly, entities should carefully consider whether additional disclosures are necessary to help users of financial statements understand the judgement applied in the financial statements. IAS 1 requires disclosure of information about the assumptions concerning the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities, such as non-current assets subject to impairment, within the next financial year. The nature and extent of the information provided will vary according to the nature of the assumption and other circumstances, but may include:

Significant changes in commodity prices, inflation rates and interest rates may be indicators of impairment.

- The nature of the assumption or other estimation uncertainty
- The sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity
- The expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected
- An explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved

Entities need to consider the level of volatility when determining the relevant sensitivity disclosures. That is, in times of high volatility, a reasonably possible change will generally involve more significant changes than in times of low volatility.

An entity is also required to disclose the judgements, apart from those involving estimations, that management has made in the process of applying its accounting policies and that have the most significant effect on the amounts recognised in the financial statements. Further information about the requirements of IAS 1 is available in Chapter 3 of the 2023 edition of *International GAAP®*.

4. Asset impairments

4.1. Non-current assets (IAS 16)

IAS 36 *Impairment of Assets* requires an entity to test all assets that are within its scope for potential impairment when indicators of impairment exist and test at least annually goodwill, intangible assets not yet available for use and intangible assets with indefinite useful lives. If there is an impairment indicator, an impairment test must be performed.

An asset is assessed for impairment either at an individual asset level or the level of a cash generating unit (CGU). This depends on the level at which the recoverable amount can be determined, meaning the level at which independent cash inflows are generated.

Assets, group(s) of assets or (groups of) CGUs are impaired when an entity is not able to recover the carrying value, either by using or selling the assets, groups of assets or CGUs.

Impairment indicators

Indicators of impairment may include both external and internal sources of information. Significant changes in commodity prices, inflation rates and interest rates may be indicators of impairment.

If there is an indicator of impairment, an impairment test must be performed in accordance with IAS 36 and it may also be necessary to examine the remaining useful life of the affected assets, their residual values and the depreciation methods used. Further information is available in Chapter 20 of the 2023 edition of *International GAAP®*.

Measurement of impairment losses

When performing an impairment test, entities are required to determine the recoverable amounts of the assets, being the higher of fair value less costs of disposal (FVLCD) and value in use (VIU). When measuring FVLCD, fair value is measured in accordance with IFRS 13 *Fair Value Measurement*, which is explained below. Costs of disposal are calculated in accordance with IAS 36. The estimation of the VIU involves estimating the future cash inflows and outflows that will be derived from the use of the asset and from its ultimate disposal; and discounting the cash flows at an appropriate rate.

There has been a significant increase in interest rates in a number of countries. This may affect an entity's discount rate when using a discounted cash flow model, which, as defined by IAS 36, reflects current market assessments of (a) the time value of money; and (b) the risks specific to the asset(s) or CGU(s) for which the future cash flow estimates have not been adjusted.

When significant uncertainty exists and judgement is required, an expected cash flow approach based on probability-weighted scenarios may be more appropriate than a single best estimate for estimating value in use. In practice, this could mean probability weighting scenarios (i.e., worst case and best case), as well as factoring in different pricing curves. Even when a probability-weighted scenario approach is used, an entity would still need to consider the time value of money and risks not reflected in the cash flows when determining the discount rate.

Disclosure

The more uncertainty there is, the more important it is for entities to provide detailed disclosure of the assumptions made, the (preferably external) evidence they are based on and the impact of a reasonably possible change in the key assumptions (sensitivity analysis).

4.2. Inventories (IAS 2)

IAS 2 *Inventories* generally requires entities to account for inventories at the lower of cost and net realisable value. In the current economic climate, estimates of NRV could be subject to greater estimation uncertainty and determining the appropriate assumptions might require significant judgement.

Increases in commodity prices and supply chain disruptions for certain raw materials and component parts are contributing to inflation, which could result in higher costs that are capitalised into inventory. If an entity is unable to pass higher costs on to customers, the carrying amount of the inventory might not be recoverable and the entity might be required to write the inventory down to its net realisable value.

Disclosures for inventories, including the measurement bases used, assist users in understanding how transactions, events and conditions are reflected in the financial statements and the sensitivity to change. At a minimum, entities will need to disclose the amount of any write-down of inventories recognised in profit or loss in annual financial statements and, if significant, in interim financial statements. Further information on inventories is available in Chapter 22 of the 2023 edition of *International GAAP®*.

4.3. Equity accounted investments (IAS 28)

Entities will need to consider whether the current economic environment, including high inflation and interest rates, indicates that the carrying amount of equity accounted investments may not be recoverable and therefore require an impairment test. For example, if the current market environment indicated significant financial difficulty of the associate. The investor in an associate or joint venture considers whether the net investment in an associate or joint venture is impaired if there is objective evidence of impairment as a result of events that occurred after the initial recognition of the net investment that have an impact on the estimated future cash flows that can be reliably estimated, as described in paragraph 41 of IAS 28 *Investments in Associates and Joint Ventures*.

5. Financial instruments

5.1. Derivatives and hedge accounting

Entities looking to protect themselves from rising interest rates may enter into interest derivatives (such as interest rate swaps) to hedge interest rate risk related to forecast debt issuances or existing variable-rate debt. Similarly, entities may enter into non-interest derivatives (such as options or forward contracts) in order to hedge themselves against rising energy or commodity prices. Entities that seek to apply hedge accounting to these transactions will need to consider the requirements of IFRS 9 *Financial instruments* (IFRS 9) and IAS 39 *Financial instruments: Recognition and Measurement* (IAS 39), in particular the requirements to qualify for hedge accounting.

Entities that hold derivative instruments, in particular, interest rate derivatives, may experience substantial gains or losses, which could affect collateral requirements, liquidity, profit and loss, or OCI, and, consequently, equity. In addition to measurement consequences, there are also disclosure consequences, such as the requirement to disclose the quality of collateral held, or a maturity analysis for derivative financial liabilities. Similarly, the valuation of other derivatives, such as commodity derivatives, may also be affected. In addition, changes in a derivative counterparty's credit risk or an entity's own non-performance risk could affect fair value estimates of derivatives, as well as hedge effectiveness assessments for derivatives that are designated as hedging instruments.

The6 current market conditions may result in the discontinuation of hedge accounting, for example, if a forecasted transaction did not occur (or is no longer expected to occur), if the hedging instrument expires, or if effect of credit risk dominates the value changes of the hedging relationship.

Further information on hedge accounting is available in Chapter 43, section 1.2, and Chapter 48, section 6.1, of the 2023 edition of *International GAAP*®.

5.2. Expected credit loss (ECL) assessment

Entities will need to consider the current economic environment and the requirements in IFRS 9 when measuring expected credit losses on assets such as loans, trade receivables and contract assets. Inflation and high interest rates may adversely impact the ability of borrowers to repay their debts and, therefore, could trigger impairment losses.

The impact of the current economic environment should be incorporated into the ECL in a way that reflects an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes. Calculating a probability–weighted amount does not require a complex analysis or a detailed simulation of a large number of scenarios and the standard suggests that relatively simple modelling may be sufficient. For instance, the average expected credit losses of a large group of financial instruments with shared risk characteristics may be a reasonable estimate of the probability–weighted amount. In other situations, the identification of scenarios that specify the amount and timing of the cash flows for particular outcomes and the estimated probability of those outcomes will probably be needed. In those situations, the ECLs are required to reflect at least two outcomes in accordance with the IFRS 9 requirements. Additionally, the impact of the current environment could be reflected through management overlays. Entities should avoid double-counting the effects of various assumptions applied in the individual assessment, macroeconomic scenarios and management overlays. It is important that there is acceptable evidence to support management's judgements relating to these overlays, and where significant, these judgements should be disclosed (see Disclosures below).

If the payment terms of loans are extended due to the current economic circumstances, the terms and conditions of the extension will have to be assessed to determine their impacts on the classification of the asset and on the ECL estimate, as well as any other accounting impacts (see also Contract modifications below). For example, the extension may represent a significant increase in credit risk (resulting in the classification of the asset as stage 2) or it may be considered a concession that would result in the classification of the asset as credit-impaired (i.e., stage 3), depending on facts and circumstances.

Further information on impairment of financial assets is available in Chapter 46 of the 2023 edition of *International GAAP®*.

5.3. Asset classification and business model assessment

As a result of the current economic conditions, entities may decide to dispose of investments classified at amortised cost under IFRS 9, possibly driven by a deterioration of the credit quality of the borrower of a financial asset. If the sale is due to an increase in credit risk, this could still be consistent with the business model objective of 'hold-to-collect', because the credit quality of financial asset is relevant to the entity's ability to collect contractual cash flows. The sale of a financial asset because it no longer meets the credit criteria specified in the entity's documented investment policy could be an example of a sale that would be consistent with the 'hold-to-collect' business model.

An increase in the frequency and value of sales in a particular period is not necessarily inconsistent with the objective to hold financial assets in order to collect contractual cash flows if an entity can explain the reasons for those sales and demonstrate why sales in the future will be lower in frequency or value. However, in the current environment, where inflationary and interest rate pressures may be ongoing, any sales for liquidity reasons should be reviewed with increased scrutiny, as it may be difficult to prove that they will not be repeated in the future.

Importantly, reclassifications triggered by a change in the business model for managing financial assets are expected to be very infrequent and will occur only in the rare cases when an entity either begins or ceases to perform an activity that is significant to its operations and is demonstrable to external parties (for example, an acquisition, disposal or termination of a business line). In such cases, the reclassification should be applied prospectively from the reclassification date, which is the first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets.

Further information on the reclassification of financial assets is available in Chapter 43, section 8, of the 2023 edition of *International GAAP®*.

5.4. Contract modifications

Affected entities may experience cash flow challenges as a result of disruptions in their operations, higher operating costs or lost revenues. Such entities may need to obtain additional financing, amend the terms of existing debt agreements or obtain waivers if they no longer satisfy debt covenants. In such cases, they will need to consider the guidance provided in IFRS 9 to determine whether any changes to existing contractual arrangements represent a substantial modification or potentially a contract extinguishment, which would have accounting implications in each case. For financial liabilities, an entity should derecognise the liability if the cash flows are extinguished (i.e., when the obligation specified in the contract is discharged, cancelled or expires) or if the terms of the instrument have substantially changed.

IFRS 9 provides guidance on determining if a modification of a financial liability is substantial, which includes a comparison of the cash flows before and after the modification, discounted at the original effective interest rate (EIR), commonly referred to as the '10% test'. If the difference between these discounted cash flows is more than 10%, the instrument is derecognised. However, other qualitative factors could lead to derecognition irrespective of the 10% test (e.g., if a debt is restructured to include an embedded equity instrument). For financial assets, there is no explicit guidance in IFRS 9 for when a modification should result in derecognition. Hence, entities apply their own accounting policies, which are often based on qualitative considerations and, in some cases, include the '10% test'. However, the IFRS Interpretations Committee has indicated that applying the '10% test' in isolation would not always be appropriate, because of potential inconsistencies with the impairment requirements in IFRS 9.[1]

[1] IASB Staff Paper 10-A, Project: New items for consideration, Topic: IAS 39 Financial Instruments: Recognition and Measurement – Derecognition of financial asset, IFRS Interpretations Committee Meeting, May 2012, paras. 32-36. Available on the IFRS Foundation's website.

Further information on contract modifications is available in Chapter 45, section 3.8, and Chapter 47, section 3.4.2, of the 2023 edition of *International GAAP®*.

5.5. Own use exemption

Entities that have revised their expectations on purchases or sales of non-financial items downwards due to the current economic environment, should consider how these changes affect the classification and measurement of such contracts and whether they continue to meet the so called 'normal purchase or sale exception' in IFRS 9. If a contract which was originally entered into as a normal purchase or sale ceases to be held for that purpose at a later date, it should subsequently be accounted for as a financial instrument under FRS 9. However, if the contract was not originally held for own use and was therefore accounted for under IFRS 9, but, subsequently, the contract begins to be held for own use, the contract remains within the scope of IFRS 9.

Further information on the own use exemption is available in Chapter 40, section 3, of the 2023 edition of *International GAAP®*.

5.6. Disclosures

IFRS 7 *Financial Instrument: Disclosures* requires entities to provide disclosures in their financial statements that enable users to evaluate:

- The significance of financial instruments for the entity's financial position and performance

  And

- The nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks. These risks include credit, liquidity and market risk

Given the current environment, and recent events in the market, including the crisis or collapse of significant financial institutions, disclosures of these risks have become particularly relevant to users of the financial statements, with a particular emphasis on liquidity risk.

Current vulnerability due to concentration and liquidity risks

In the current economic environment entities may be exposed to:

- Concentrations of risk (for example investments or cash and cash equivalents held with only a limited number of financial institutions)

  Or

- Liquidity or refinancing risk

This risk should be reflected in the financial statement disclosures. For example, paragraph 34(c) of IFRS 7 requires that concentration of risk should be disclosed if not otherwise apparent from other risk disclosures provided. Similarly, IFRS 7.B11F requires disclosures such as funding sources and lines of credit that can be accessed to meet liquidity needs, or concentrations of liquidity risk in the assets held. Entities should be mindful that this disclosure is consistent with their assessment of the going concern assumption, and in severe cases of liquidity risk, significant judgements made relating to the going concern assumption will need to be disclosed.

Significant judgements and estimates

Given the inherent level of uncertainty and the sensitivity of the judgements and estimates involved, the disclosure of the key assumptions and judgements is important. Key disclosures relating to ECLs include, for example, the values of the key macroeconomic inputs used in the multiple economic scenario analysis and the probability weighting of these scenarios, as well as the assumptions used to determine how the different challenges for specific sectors have been taken into account, and the effect of any management overlays.

In addition, IFRS 13 requires a number of disclosures designed to provide users of financial statements with additional transparency regarding:

- The extent to which fair value is used to measure assets and liabilities
- Valuation techniques, inputs and assumptions used in measuring fair value
- Effect of Level 3 fair value measurements (using significant unobservable inputs) on profit or loss (or other comprehensive income).

As a consequence of the volatility caused by the current environment, and the resulting impact on fair values, these disclosures are of particular importance. See section 6 Fair Value Measurement below for further considerations relating to fair value measurement.

Further information on financial instrument disclosures is available in Chapter 49, section 4.5 and section 9.1, of the 2023 edition of *International GAAP®*.

6. Revenue recognition

Entities account for revenue under IFRS 15 *Revenue from Contracts with Customers*.

Estimates of variable consideration in new and ongoing customer contracts will need to be evaluated including reassessment of the constraint. Examples of variable consideration estimates that might have changed include expectations about returns of goods, contract volumes and whether an entity will meet contractual conditions for performance bonuses or penalties. Estimates made at contract inception are required to be updated throughout the term of the contract to depict conditions that exist at each reporting date, including any amounts that are constrained, to reflect revised expectations about the amount of consideration to which it expects to be entitled.

Changes to the transaction price that relate to a change in estimates of variable consideration (and are not a result of contract modifications, which are discussed below) are generally allocated to the performance obligations in the contract on the same basis as their initial allocation. This could result in either an increase or decrease in revenue in relation to a satisfied performance obligation or in cumulative revenue recognised for a partially satisfied over-time performance obligation. The standard provides an exception which requires variable consideration to be allocated entirely to a specific part of a contract (such as one or more (but not all) performance obligations in the contract or one or more (but not all) distinct goods or services promised in a series of distinct goods or services that form part of a single performance obligation) if certain criteria are met. Entities using this allocation exception should also consider whether they can continue to apply this exception.

Uncertainty might prompt entities to modify contracts with customers. Customers and entities might be more likely to terminate contracts, which is also a form of contract modification under IFRS 15. A contract modification is a change in the scope or price (or both) of a contract, such as revising payment terms, providing discounts, or introducing variable consideration in a previously fixed-price contract. Identifying whether a modification has occurred (whether explicit or implied by customary business practice) and determining how to account for it might require significant judgement. When an IFRS 15 contract is modified, an entity might also need to reassess the contract criteria in paragraph 9 of IFRS 15 for the modified contract, as well as the contract's duration (i.e., the period in which parties to the contract have present enforceable rights and obligations). A contract modification could also change the timing or amount of revenue recognised for a contract. For example, some modifications are accounted for on a prospective basis and others on a cumulative catch-up basis depending on the facts and circumstances.

The effect of inflation, rising commodity prices and foreign exchange rates can affect the measure of progress for performance obligations satisfied over time that apply a cost-based input method. If the volatility in prices is not passed along to the customer, entities need to ensure that the measure of progress appropriately reflects their performance in transferring control of the promised good or service to the customer, which could require judgement. For example, exchange rates and commodity prices are subject to changes in market activity and often drive a degree of mismatch between expected costs and market prices. In some cases, entities might conclude that the use of a cost-based input method is no longer appropriate if the costs it will incur will be subject to significant market volatility. As a result, entities will need to monitor their total expected contract costs and make timely updates to their measure of progress. In addition, entities might need to consider whether they have onerous contracts, which would require them to recognise the present obligation under the contract as a provision under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. For example, after entities measure progress in satisfying each performance obligation over time by applying IFRS 15 and account for the related costs in accordance with the applicable standards, they might need to assess whether the remaining contract as a whole is onerous in accordance with IAS 37 (i.e., considering whether the revenue still to be recognised is less than the costs yet to be incurred). Onerous contracts are discussed in Section 11 Provisions below.

Another impact entities might need to consider is customers' ability and intent to pay, and/or whether entities might be more willing to accept partial payment or extend payment terms. Entities will need to determine how to account for these circumstances. Specifically, entities will need to consider the effects on their IFRS 15 collectability assessments, estimates of variable consideration made at contract inception, the subsequent impairment measurement of any contract assets or trade receivables under the expected credit loss model in IFRS 9, as well as impairment of related contract cost assets and identification of significant financing components. In addition, entities entering into new contracts with customers will need to carefully consider their customers' ability and intent to pay.

Entities should consider whether uncertainty or changes in business practices require their revenue disclosures to be enhanced. For example, if an entity estimates variable consideration (including application of the constraint), it is required to disclose information about the methods, inputs and assumptions used. Entities also need to disclose certain information about their performance obligations, including when performance obligations are satisfied in a bill-and-hold arrangement, and significant payment terms. Entities should also consider the requirements to disclose the judgements, and changes in judgements, that significantly affect the determination of the amount and timing of revenue. Further information on revenue is available in Chapter 27 of the 2023 edition of *International GAAP®*.

7. Fair value measurement

IFRS 13 provides a definition of fair value and guidance that applies in all circumstances. Importantly, fair value is a market-based measurement, not an entity-specific measurement. Therefore, the reporting entity's intentions (e.g., to hold an asset or liability in a market downturn) or assumptions are not considered and instead market participants assumptions must be used.

IFRS 13's fair value hierarchy requires valuation techniques to maximise the use of observable inputs from orderly transactions and minimise the use of unobservable inputs. Consequently, even if the market for an asset has become less liquid (that is, less active), relevant prices or inputs observed from orderly transactions in these markets must still be considered.

7.1. Orderly transactions

The definition of fair value contemplates an orderly transaction. While volatility in the financial markets may suggest that the prices are aberrations and do not reflect fair value, it would not be appropriate for an entity to disregard market prices at the measurement date, unless those prices are from transactions that are not orderly. While market factors such as an imbalance in supply and demand and liquidity constraints can affect the prices at which transactions occur in a given market, such an imbalance does not automatically indicate that the parties to a transaction were not knowledgeable and willing market participants or that a transaction was not orderly.

The determination of whether a transaction is orderly is made at the individual transaction level and requires the use of judgement based on the available evidence from all relevant factors. Evidence of whether a transaction is orderly must be evaluated when deciding the weight to place on the transaction price when estimating fair value. If the observed price is based on a transaction that is determined to be forced or disorderly, little, if any, weight should be placed on it compared with other indications of value. Judgement is required in assessing the relevance of observable market data and whether they reflect orderly transactions, particularly in situations when there has been a significant decrease in market activity for an asset or liability.

7.2. Active markets

A significant decrease in the volume of transactions in a market does not automatically imply that a market is no longer active. However, it can influence which valuation technique(s) are used, how those techniques are applied and whether inputs are observable at the measurement date. Similarly, increased complexity and judgement in measuring fair value does not automatically imply that fair value can no longer be reliably measured.

It would be inappropriate for an entity to default solely to unobservable inputs, such as an entity's own inputs, when observable information is available, for instance recent transacted prices.

Further information on measuring fair value under IFRS 13 is available in [Chapter 14 of the 2023 edition of *International GAAP®*].

8. Leases

Entities account for lease contracts in accordance with IFRS 16 *Leases*. Increased interest rates may affect lease accounting because they increase a lessee's incremental borrowing rate, which is used to measure the lease liability for new leases, certain lease modifications and other events that require remeasurement (see below). An increase in the lessee's incremental borrowing rate will result in the recognition of a lower lease liability if all other variables are constant. As the incremental borrowing rate is lease specific, each lease and entity may be impacted by increased interest rates differently.

Lessees are required to reassess the lease term and, therefore, the lease liability, upon the occurrence of either a significant event or a significant change in circumstances that is within the control of the lessee (e.g., a business decision to substantially curtail or exit operations in a leased facility).

Economic conditions may also result in right-of-use assets becoming impaired (see section 3).

Further information on lease accounting under IFRS 16 is available in Chapter 23 of the 2023 edition of *International GAAP®*.

9. Employee benefits

The effects of high inflation and interest rates may also impact the recognition and measurement of employee benefits in accordance with IAS 19 *Employee Benefits*. For example, higher bond yields used to determine discount rates may result in a decrease in pension benefit obligations.

9.1. Recognition of termination benefits

Due to the economic conditions, an entity may need to terminate employees' employment before the normal retirement date. In that case, an entity should recognise termination benefits as a liability and an expense at the earlier of the following dates: when it can no longer withdraw the offer of those benefits; or when it recognises costs for a restructuring that is within the scope of IAS 37 (see 10 below) and involves the payment of termination benefits. The standard notes that when an entity recognises termination benefits, it may also have to account for a plan amendment or a curtailment of other employee benefits.

Strong market volatility may result in significant actuarial gains and losses when accounting for defined benefit plans.

9.2. Measurement of defined benefit plans

IAS 19 requires that the present value of defined benefit obligations and the fair value of plan assets are determined frequently enough to ensure that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the end of the reporting period. Much could depend on what is considered to be a 'material change'. However, this value is expressly intended to include changes in market prices (hence, requiring asset values to be those at the end of the reporting period) and interest rates, as well as financial actuarial assumptions. It is particularly important when preparing interim reports that entities consider whether it is appropriate to apply the values of the last actuarial valuation for the key assumptions (such as the discount rate).

Further information on accounting for employee benefits is available in Chapter 30 of the 2023 edition of *International GAAP*®.

10. Foreign currency movements and hyperinflation

Given the high inflation rates, entities with foreign operations should monitor inflation rates in the foreign countries in which they operate. If a foreign entity's local economy becomes hyperinflationary, the entity will need to apply IAS 29 *Financial Reporting in Hyperinflationary Economies*.

EY publication *IFRS Developments Issue 215: Hyperinflationary economies (Updated April 2023)* contains a list of countries with economies that are considered hyperinflationary for IFRS purposes as of 30 June 2023, as well as economies that are not currently hyperinflationary for IFRS purposes but should be monitored.

11. Provisions

11.1. Measurement

The amount recognised as a provision is the best estimate of the expenditure required to settle the present obligation at the end of the reporting period, which could be a higher amount than previously expected as a result of inflation and rising costs.

A provision is measured at the present value of the expected outflow when the effect of the time value of money is material. Higher interest rates could lead to more provisions that are subject to discounting as the effect of interest rate increases would more likely be material (especially those of long-term nature).

The higher the discount rate, the lower the discounted amount. However, there may be compensating effects due to increased inflation resulting in increased costs to settle obligations.

11.2. Discount rate

The highly volatile inflation environment impacts the accuracy of forecasts of estimates of the expenditure required to settle the present obligation. Therefore, the amount of any provision may significantly vary from one reporting date to another with the impact of the change being reflected in the income statement.

Entities may need to consider the effects of high inflation and interest rates on the measurement of provisions with regards to the discount rate used. IAS 37 requires risks and uncertainties to be taken into account in reaching the best estimate of a provision. This can be achieved by using a risk-adjusted discount rate or by adjusting the estimated future cash flows, although the discount rate must not reflect risks for which the estimated future cash flows have already been adjusted. If a risk-adjusted discounted rate is used, this will be a lower rate than the unadjusted (risk-free) discount rate. This may seem counter-intuitive, however, in the case of a provision, a risk premium is being suffered to eliminate the possibility of the actual cost being higher.

The discount rate to be used depends on whether:

(a) The future cash flows are expressed in current prices, in which case, a real discount rate (which excludes the effects of general inflation) is used

Or

(b) The future cash flows are expressed in expected future prices, in which case, a nominal discount rate (which includes a return to cover expected inflation) is used

Either alternative is acceptable, and these methods should produce the same figure for the initial present value of the provision. However, applying inflation to the estimated cash flows incorporating the effect of inflation may involve less complexity (approach (b)) as:

- The determination of the real interest rates may be difficult due to a lack of observable data and would involve the entity's own estimation of the effect of inflation

  And

- The use of a real interest rate would assume that prices rise evenly over the forecast period, what may not be true in times of economic volatility

Therefore, the incorporation of observable and published inflation rates into the estimation of future cash flows needed to settle the present obligation, as well as using a published nominal discount rate, may provide more transparent information for the users of financial statements, especially if those are supported by the relevant disclosures on the assumptions made and related sensitivities.

It is worth pointing out that whilst these two alternative approaches would be expected to yield the same value for the provision in the balance sheet, the profile of charges over time in the income statement for the unwinding of the discount could be different in each case, because of the different discount rates used (real or nominal).

In addition, a more significant difference will arise where the recognition of the original provision is included as part of the cost of property, plant or equipment, rather than as an expense, such as when a decommissioning provision is recognised. In that case, using a real discount rate will result initially in a lower charge to the income statement, since under IFRS IC 1 any revision to the estimate of the provision is not taken to the income statement but is treated as an adjustment to the carrying value of the related asset, which is then depreciated prospectively over the remaining life of the asset.

11.3. Onerous contracts

When there is high inflation, entities that have not fixed their costs to fulfil their obligations under contracts or are not able to pass on the effects of price increases to their customers may need to consider the existence of an onerous contract provision. This may be the case in relation to long-term fixed fee revenue contracts when the cost of inputs continues to rise and there is no possibility to adjust the transaction price. The assessment of the existence of an onerous contract should be performed at each individual contract level.

Provisions are measured at the present value of the obligation under an onerous contract, which is the lower of the cost of terminating the contract and the net cost of fulfilling the contract, regardless of the action expected to be taken by the entity. The cost of fulfilling a contract comprises the costs that relate directly to the contract and consists of both the incremental costs of fulfilling the contract and an allocation of other costs that relate directly to fulfilling contracts.

11.4. Restructuring provisions

Restructuring actives are more common in times of economic uncertainty involving high inflation and interest rates. That period, especially if prolonged, may force entities to reorganise their operations or scale down or even discontinue part of their business. IAS 37 provides strict criteria for when a restructuring provision is recognised; a management decision alone is not sufficient. In addition, IAS 37 provides guidance on the type of costs that are eligible for inclusion in such a provision, stating that it should include only direct costs arising from the restructuring, such as employee termination benefits that relate directly to the restructuring (treated under IAS 19), contract termination costs, etc. Costs related to preparing the business to operate after the restructuring are not eligible for inclusion in any provision.

11.5. Future operating losses

IAS 37 prohibits recognition of provisions for future operating costs or future business recovery costs. As entities may anticipate future operating losses stemming from the impact of inflation, they cannot be provided for in advance of the transactions having taken place. Entities need to be mindful of the difference between an onerous contract and a future operating loss. For example, a change to more environmentally friendly materials or processes because of increased stakeholder interest in climate change could mean that contracts previously expected to be profitable are now expected to be loss making.

Further information on accounting for provisions is available in Chapter 26 of the 2023 edition of *International GAAP*®.

12. Share-based payments

12.1. Valuation of share-based payment awards

IFRS 2 *Share-based Payment* require entities that grant equity-settled share-based payment awards to employees and others providing similar services, to be measured based on the fair value of the equity instruments at grant date.

Fair value is based on market prices if available. In the absence of market prices, a valuation technique (e.g., option pricing model to value options granted) should be used to estimate what the market price is on the measurement date in an arm's length transaction between informed and willing parties. The current economic environment may impact inputs to a valuation technique, such as the risk-free interest rate and expected volatility of the share price, that may require more judgement to determine, and have a greater impact on the fair value than in periods of stable economic environment. Appendix B to IFRS 2 contains detailed guidance on estimating the fair value of equity instruments granted.

12.2. Modification and cancellation of awards

Entities may amend the terms and conditions of share-based payment arrangements to keep employees and others providing similar services incentivised in the current economic environment. If amendments (e.g., a change in the earnings target for performance-based awards or the exercise price) to the terms and conditions of an award change the fair value, vesting conditions or classification of an award, the entity must apply modification accounting.

For equity-settled share-based payment awards, paragraph 27 of IFRS 2 requires that, at a minimum, the entity must recognise the services received measured at grant date fair value (i.e., based on the original terms) unless those equity-instruments do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. When the effect of the modification increases the value of the award to an employee (e.g., by increasing the number of equity instruments subject to the award or, in the case of an option, by reducing the exercise price), the incremental fair value must be recognised as a cost. The incremental fair value is the difference between the fair value of the original award and that of the modified award, both measured at the date of modification. If entities or employees cancel any equity-settled share-based payment arrangements during the vesting period, the cancellation should be accounted for as an acceleration of vesting and the entities must, therefore, recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period. However, if a new equity instrument is granted and identified as a replacement for the cancelled award, the entity accounts for the granting of the replacement equity instruments in the same way as a modification of the original grant of equity instruments.

For cash-settled share-based payment awards, IFRS 2 provides guidance for modifications that change the classification of an award from cash-settled to equity-settled. The standard provides no specific guidance on other modification or cancellation of cash-settled awards because cash-settled awards are accounted for using a full fair value model. When modifications occur, the liability recognised at and after the point of modification will be based on its new fair value, with the effect of any movement in the liability recognised immediately. Similarly, if an award is settled, the liability will be derecognised, and any gain or loss on settlement is recognised immediately in profit or loss. When an award is cancelled, the liability will be derecognised, with a credit immediately recognised in profit or loss.

Modifying or cancelling equity-settled or cash-settled share-based payment awards may have tax consequences.

Further information on accounting for share-based payments is available in Chapter 29 of the 2023 edition of *International GAAP®*.

13. Other financial statement presentation and disclosure requirements

13.1. Classification of liabilities with covenants

The effects of high inflation and volatile interest rates may indirectly impact an entity's ability to meet the covenant requirements included in long-term loan arrangements. IAS 1 requires that, when an entity breaches a covenant on or before the period end, with the effect that the liability becomes payable on demand, it is classified as a current liability. Some long-term arrangements include covenants that the lender requires the entity to monitor and ensure that they are met more frequently than annually. In such cases, entities must carefully consider if a waiver obtained before period end is, in effect, rectifying the breach permanently, or if it only provides a period of grace until the next scheduled covenant testing date. In the former case, the liability would be considered non-current, while in the latter case, the liability would have to be reclassified to current. Furthermore, entities need to consider providing disclosures about covenants and their impact on classification.

13.2. The impact of events after the reporting period

Events after the reporting period are those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue. In times of high economic volatility, the chance of subsequent events impacting financial measures increases. IAS 10 *Events after the Reporting Period* makes a distinction between adjusting and non-adjusting events after the reporting period. The principal issues are how to determine which events after the reporting period are to be reflected in the financial statements as adjusting events and, for non-adjusting events, what additional disclosures need to be provided.

For example, declines in the fair value of investments after the reporting period do not normally relate to the condition of the investment at the end of the reporting period, but instead reflect circumstances that arose subsequently. However, if entities get information about a customer's bankruptcy after the reporting period, this may confirm that the customer was credit-impaired at the end of the reporting period and indicates that the assets were impaired at the of the reporting period or that the impairment loss amounts recognised at the end of the reporting period need to be adjusted. In addition, when a covenant of a loan liability that is subject to complying with on or before the end of the reporting period is breached at the end of the reporting period, the liability cannot be reclassified as a non-current liability, even if subsequent to the reporting date, the lender provides a waiver for the liability as it is not an adjusting event.

Determining whether events are adjusting or non-adjusting depends on the nature of the subsequent event and the accounting topic. This assessment will in, many cases, be highly judgemental; entities need to consider whether disclosures about the judgement are required.

The going concern assessment needs to be performed up to the date on which the financial statements are issued.

14. Going concern

IAS 1 requires management, when preparing financial statements, to assess an entity's ability to continue as a going concern, and whether the going concern assumption is appropriate. Furthermore, disclosures are required when the going concern basis is not used or when management is aware, in making the assessment, of material uncertainty related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern. Disclosure is also required when the judgement applied in determining the existence of a material uncertainty is significant.

In assessing whether the going concern assumption is appropriate, the standard requires that all available information about the future, which is at least, but not limited to, twelve months from the end of the reporting period, should be taken into account. This assessment needs to be performed up to the date on which the financial statements are issued.

14.1. Judgement

In making the going concern assessment, management may need to consider factors that relate to the entity's current and expected profitability, the timing of repayment of existing financing facilities and the potential sources of replacement financing.

Management takes into consideration the existing and anticipated effects of the current economic situation on the entity's activities in its assessment of the appropriateness of the use of the going concern basis, reflecting higher inflation, interest rates and volatile commodity prices.

Management should consider all available information about the future which was obtained after the reporting period up to the date that the financial statements are authorised for issue. That is, the financial statements must not be prepared on a going-concern basis if, before they are authorised for issue, circumstances were to change such that management no longer has a realistic alternative to ceasing trading or liquidating the entity, even if the assessment at the end of the reporting period supported the application of the going concern basis.

14.2. Disclosure

There may be material uncertainty that casts significant doubt on the entity's ability to operate under the going concern basis. When an entity prepares financial statements, it is required to disclose this material uncertainty in the financial statements in order to make clear to readers that the going-concern assumption used by management is subject to such material uncertainty.

In January 2021, the IFRS Foundation released an education document, *Going concern – a focus on disclosure* highlighting some of the points mentioned above regarding the requirements in IFRS that are relevant to an entity's assessment of its ability to continue as a going concern and the respective disclosures. The educational document is a helpful reminder about challenging which assessments that management needs to make and key disclosures that may apply.

15. Interim reporting considerations

In accordance with IAS 34, an entity is required to include in its interim financial report, an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period.

In accordance with IAS 34 *Interim Financial Statements*, an entity is required to include in its interim financial report, an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period. In times of economic volatility, the chance of significant developments having occurred since the end of the last annual reporting period increases accordingly. An entity is required to include explanations regarding the nature and amount of items affecting assets, liabilities, equity, net income and cash flows that are unusual because of their nature, size, or incidence. Information disclosed in relation to those events and transactions in the most recent annual financial report will also need to be updated in the interim financial report.

IAS 34 sets out several required disclosures as well as a non-exhaustive list of events and transactions for which disclosures would be required if they are significant. For example, when significant, an entity needs to disclose changes in the business or economic circumstances that affect the fair value of its financial assets and financial liabilities, whether those assets or liabilities are recognised at fair value or amortised cost. In addition, an entity is also required to disclose any loan default or breach of a loan agreement that has not been remedied on or before the end of the reporting period and transfers of financial instruments between levels of the fair value hierarchy used in measuring the fair value when significant.

Furthermore, although IAS 34 does not contain a detailed requirement to include sensitivity disclosures, if the range of reasonably possible changes in key assumptions has significantly changed since the end of the last annual reporting period, an update of relevant sensitivity disclosures may be required.

The standard presumes a user of an entity's interim financial report will have access to the most recent annual financial report of that entity. Therefore, it is unnecessary for the notes to an interim financial report to provide relatively insignificant updates to the information that was reported in the notes to the most recent annual financial report. However, if the information included in the last annual financial report is no longer relevant, entities may have to provide updated disclosures or to add information on topics discussed in this publication for interim financial reporting purposes.

While other standards specify disclosures required in a complete set of financial statements, if an entity's interim financial report includes only condensed financial statements, as described in IAS 34, then the disclosures required by those other standards are not mandatory. However, if disclosure is considered necessary in the context of an interim report, those other standards provide guidance on the appropriate disclosures for many of these items. Considering these requirements and depending on the entity-specific facts and circumstances, higher-level disclosures may be sufficient in condensed interim financial statements.

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