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Rising Interest Rate A&A Considerations

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Interest rates are rising dramatically, and many economists expect rates to continue to climb as the Federal Reserve tries to stamp out stubborn inflation. Rising interest rates are a major financial consideration of many entities across industries. Small- and medium-sized entities can be more vulnerable to escalating interest rates, as they often lack the financial flexibility that larger entities possess. Interest rates have been historically low for a long time and management of many entities, as well as practitioners, may be unfamiliar with the business impacts, challenges, and audit risks that rising rates present.

This report provides an overview of certain impacts and audit risks related to rising interest rates. Practitioners may benefit from considering these impacts and risks during engagement planning and risk assessment procedures. Consideration of the ways a client is affected by external forces, like rising interest rates, is part of obtaining an understanding of the entity and its environment and will allow the practitioner to plan and perform the engagement to address those risks.

Debt

Naturally when interest rates increase, the cost of debt increases. Entities with floating rate debt may be challenged to service that debt, as their interest costs rise, and cash flow is squeezed. Entities seeking new borrowings will see the cost of capital rise. Practitioners should be alert to the impact that rising interest rates are having on an entity's debt and its ability to obtain financing.

Valuations and Impairment

Rising interest rates may increase risk related to valuation of investments and derivatives. Depending on the nature of an entity's investments and derivatives, practitioners may need to determine that higher interest rates are properly reflected in the measurement of those instruments. Instruments measured at fair value may be based on discounted cash flows (e.g., a derivative measured using the income approach which involves a discounted cash-flow analysis). In those cases, a risk may exist that the discount rate being used is unreasonable given the current environment. In addition, rising interest rates may affect hedge effectiveness assessments.

Impairment tests of assets may require the use of discounted cash flows. Practitioners should be alert for the use of appropriate discount rates. Assumptions related to the determination of discount rates should be consistent with underlying economic factors and reflect the interest rate environment.

Revenue Recognition – Significant Financing Component

As interest rates continue to rise, management and practitioners may need to consider any impacts on contracts with customers and the presence of a significant financing component in contacts. As indicated in FASB *Accounting Standards Codification* (FASB ASC) 606, *Revenue from Contracts with Customers*, specifically FASB ASC 606-10-32-16, when assessing whether a contract contains a financing component and whether that financing component is significant to the contract, one of the factors to be considered is the prevailing interest rates in the relevant market. Practitioners should be alert to the fact that current determinations about the significance of a financing component may differ from past determinations, given the rapid increase in interest rates.

As indicated in FASB ASC 606-10-32-19, when adjusting the promised amount of consideration for a significant financing component, an entity should use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. Practitioners should be alert to contractual interest rates in a contract (explicit financing component) that may not reflect current market rates and, as such, the financing component of the consideration would be based on a more appropriate interest rate (See FASB ASC 606-10-55-238 for an example).

Practice Note: As indicated in FASB ASC 606-10-32-19, after contract inception, an entity should not update the discount rate for changes in interest rates.

Defined Benefit Plans

Interest rates factor into a number of calculations and amounts related to the accounting for defined benefit plans. When interest rates rise, defined benefit plan obligations are reduced. Practitioners should stay alert to the use of appropriate interest (discount) rates in the measurements of defined benefit plan amounts.

Leases

Increases in interest rates may affect an entity's accounting for leases under FASB ASC 842, *Leases*. The discount rate used to initially measure a lease may need to be updated if there is a remeasurement of the lease liability (FASB ASC 842-20-35-5). If remeasurements occur, practitioners should be alert to the use of an appropriate discount rate that is reflective of the interest rate environment at the remeasurement date. Higher interest rates translate into higher discount rates, which lower lease liabilities and right-of-use assets.

Overall Accounting Estimates

The assumptions and data supporting certain accounting estimates may be affected by rising interest rates. Practitioners should evaluate whether judgments and decisions made by management in making accounting estimates remain reasonable, in light of the current interest rate environment. AU-C 540, *Auditing Accounting Estimates and Related Disclosures*, addresses auditor responsibilities related to accounting estimates and disclosures in financial statement audits.

Fraud

Rising interest rates may threaten an entity's financial stability and profitability, resulting in an increase in pressure to commit fraudulent financial reporting. Auditors are responsible for obtaining reasonable assurance that client financial statements are free of material misstatement due to error or fraud under paragraph .05 of AU-C 240, *Consideration of Fraud in a Financial Statement Audit*. Practitioners should be alert to whether the current interest rate environment is negatively impacting an entity's business and financial condition to the point where the issue is identified as a fraud risk factor, requiring an appropriate response.

Going Concern

Higher and rising interest rates can negatively affect an entities' business in a variety of ways. For example, product demand may suffer if customers find the increased costs of financing too expensive. Such business impacts, reduced cash flow, higher borrowing costs, and less access to financing can become burdensome strains on many entities. Loan covenants may be breached in the current interest rate environment as well. The challenges and pressures created by increasing interest rates may cause management or practitioners to conclude that substantial doubt about an entity's ability to continue as a going concern exists.

An auditor's responsibilities related to going concern are included in AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern.* For review engagements, the accountant's responsibilities related to going concern are included in AR-C 90, *Review of Financial Statements*. Accountants performing compilations can refer to paragraph A20 of AR-C 80, *Compilation Engagements*, for considerations about going concern issues. U.S. Generally Accepted Accounting Principles guidance is contained in FASB ASC 205-40, *Presentation of Financial Statements - Going Concern.*

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