Renewables: 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 — 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 renewables companies

A big topic across the renewables sector is the lingering effect of global supply chain disruption. The renewables sector just received substantial tax incentives through the Inflation Reduction Act of 2022. However, energy producers are facing challenges in taking advantage of these incentives because of supply chain constraints, inflation and an uncharacteristically high cost to finance new projects. This means that they cannot effectively monetize the Inflation Reduction Act's new and existing production tax credits.

Some offshore wind producers, for example, lack the barges they need to install wind towers. They also grapple with rising raw material costs, such as steel for wind turbines and other commodities used in interconnection transmission lines. In addition, higher interest rates mean certain projects can no longer be financed at the prices originally contemplated in long-term power purchase agreements. These are compounding issues leading to even higher project costs.

As a result of these and other constraints, we are seeing companies delay, or in some cases cancel, new renewables projects. This becomes a risk for impairment. And it's an area that management and the board need to be keeping a close eye on. If management concludes that project delays, supply chain disruption, increasing costs and other factors do not indicate an impairment, it is up to the board to determine whether it feels comfortable with that conclusion or whether it sees real evidence of a decline in value.

"The high costs to finance large capital projects, coupled with the impacts of inflation on investment returns, mean that renewable energy companies face a very real risk of impairments," said **Todd Fowler**, National Audit Industry Leader – Power & Utilities.

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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.

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