

# PAC ANNUAL CONFERENCE

November 10 & 11, 2022

## PROFESSIONAL ACCOUNTING FUTURES



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November 11, 2022

Standard Setting under Macro-economic Uncertainty

**Nick Anderson**

Board Member, International Accounting Standards Board (IASB)



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# Questions for Nick Anderson, IASB

## *Standard Setting under Macro-economic Uncertainty.*

Recent months have witnessed huge macroeconomic challenges on multiple fronts – uncertainty about pandemic recovery, inflation, supply chain challenges, the effects of war, and the dramatic manifestation of climate risk events.

- Q: We are entering a more challenging phase for many economies around the world, how does the IASB respond under these circumstances?

# Questions for Nick Anderson, IASB, continued

- Q: Is it fair then to describe the IASB as being indifferent to prevailing economic conditions?
- Q: What are recent examples of the IASB responding to urgent issues, and how long did the response to each take?
- Q: More broadly, how does the economy influence the work of the IASB?

# Questions for Nick Anderson, IASB, continued

- Q: What projects on the Board current work plan support long-term economic growth and, perhaps, help mitigate against cyclical downturns?
- Q: Given it can take several years for the IASB to develop a new standard, can any of the Board's current projects help improve financial reporting in the near term?
- Q: It's been 2 years since the IASB published its educational material on climate-related risks – what impact has there been on reporting by corporates?

# Questions for Nick Anderson, IASB, continued

- Q: The IASB is one of two standard setting boards of the IFRS Foundation, the other being the International Sustainability Standards Board (ISSB). Could you comment on the work of the ISSB and its Task Force for Climate-Related Financial Disclosures, and on how their work will affect corporate reporting?
- Q: How will the work of the ISSB and the TCFD be taken into account in developing financial reporting standards by the IASB?

# Questions for Nick Anderson, IASB, continued

- The IFRS Foundation currently oversees the work of the IASB, the ISSB, as well as the Integrated Reporting and Connectivity Council. Do you foresee the establishment of other reporting vector initiatives that might further disclosures of additional macroeconomic challenge factors?
- Q: The IASB maintains a research project pipeline, a maintenance project pipeline and a reserve list of projects. Which of the items in these pipelines do you see making a significant impact on the disclosure of macroeconomic challenges for investors?

# Questions for Nick Anderson, IASB, continued

- Q: Can the FASB be more responsive to the economic cycle than the international board?
- Q: You mentioned that economic conditions influence standard setting. Is there a risk of making standard setting too cyclical?

For example, after the GFC, both the FASB and IASB have issued new expected credit loss recognition standards that require significant forward-looking estimation. In times of macro-uncertainty such as this, is there a buyer's remorse of some sort -- is there a sense of nostalgia for the good old incurred loss model? Similarly, goodwill impairment involves a lot of judgment -- can the current uncertain environment reinvigorate demands for going back to deterministic amortization schedules as we had earlier?



# Questions for Nick Anderson, IASB, continued

- Q: You mentioned principle-based standards earlier. Could you comment on the concern that principle-based standards give managers too much discretion, especially when the economy is not doing well?
- Q: Finally, could you comment on how the Harmonization Model is working out? By that I mean, are you satisfied that IASB member organizations are harmonizing their standards ethical, accounting and auditing standards to new IASB pronouncements within a reasonable timeframe?

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November 11, 2022

Preparing for Long-run Inflation and Investing  
During Downturns

Anup Srivastava, BTech, MBA, PhD

Professor and Canada Research Chair in Accounting,  
Haskayne School of Business, University of Calgary



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# Inflation

**Anup Srivastava**

**Professor and Canada Research Chair  
Haskayne School of Business  
University of Calgary**

# Economics is often confusing

At the moment, it's downright counter-intuitive.

- Inflation is at its highest in decades,
- And unemployment is its lowest in half a century,
  - But we're feeling the pain of the lower real wages that brings.
- Interest rates are climbing sharply. And home prices are sliding,
  - Yet rents are taking off.

# Inflation

- Definition
- Severity
- Causes
- Government response
- Problems from governments' responses
- What can companies do about it

# Definition and Measurement

## A general increase in prices

- And the resulting decline in the purchasing power of money.

## Measurement:

Statistics Canada constructs the Consumer Price Index (CPI)

## Process:

- **Collect over million prices**
  - Prices that change quickly like food or gasoline are collected more frequently
  - University tuition or insurance rates every year.
- **Weigh each item's price change**
  - By its share of total consumer spending.
  - Shares updated to reflect changes in consumer spending patterns.

# What causes inflation?

**Too much money chasing too little goods**

**Quantity theory of money,**

$$(M) \times (V) = (P) \times (T)$$

M=Money Supply

V=Velocity of circulation

P=Average Price Level

T=Volume of transactions of goods and services

# What causes inflation?

## Quantity theory of money,

$$(P) = (M) \times (V) / (T)$$

Prices increase when

M=Money Supply 

V=Velocity of circulation 

T=Volume of transactions of goods and services 





# Context of High Inflation

# Covid—early days

## When Covid hit, most economies went into a recession

- Economic activity came to a standstill
- Recession was sharp
- Danger of defaults on mortgages, loan repayments
- Likelihood of housing market and real estate collapse.
- Social unrest

# Covid-early days

## The second quarter of 2020

- Canada's GDP fell by 11 per cent in April 2020, the deepest plunge since the Great Depression.
- businesses suspended regular activity
- workers lost their jobs
- unemployment rate hit double digits.

Governments put one of the largest fiscal and monetary support programs ever.

# Covid Response

- Renters were offered eviction moratoria.
- Mortgage forbearance was employed during the pandemic to help prevent a housing market crash.

## Government of Canada

- Boosted Canada Child Benefit payments
- Goods and services tax credit
- Old Age Security and Guaranteed Income Supplement for seniors.
- Emergency Response Benefit for workers who lost significant income during the pandemic,
- Liberalized eligibility rules for Employment Insurance

# Money Supply

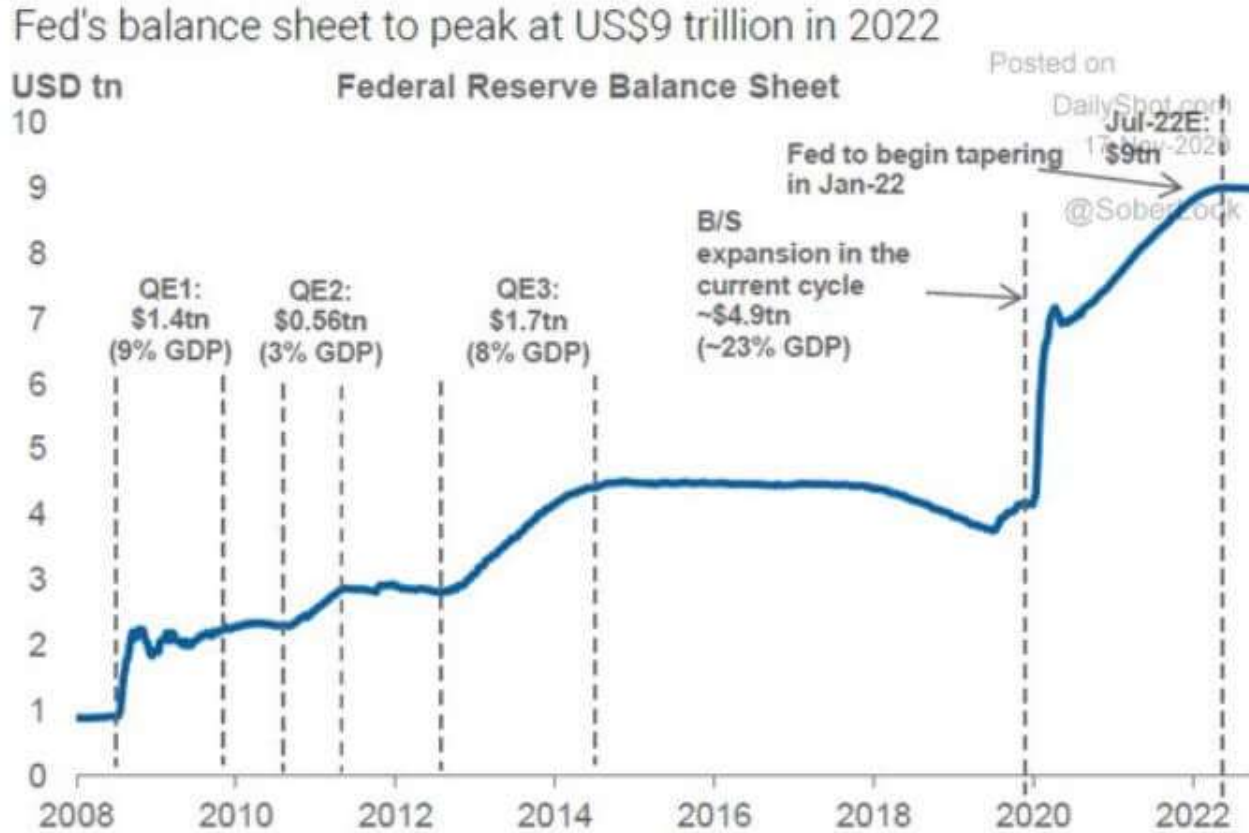
## Quantitative Easing (QE)

The Fed began experimenting in 2008 with a QE

- In essence, printing money - to buy debt
- Effectively, to loan money to banks, households, corporation
- To prevent financial meltdown

**QE => Increase Money Supply**

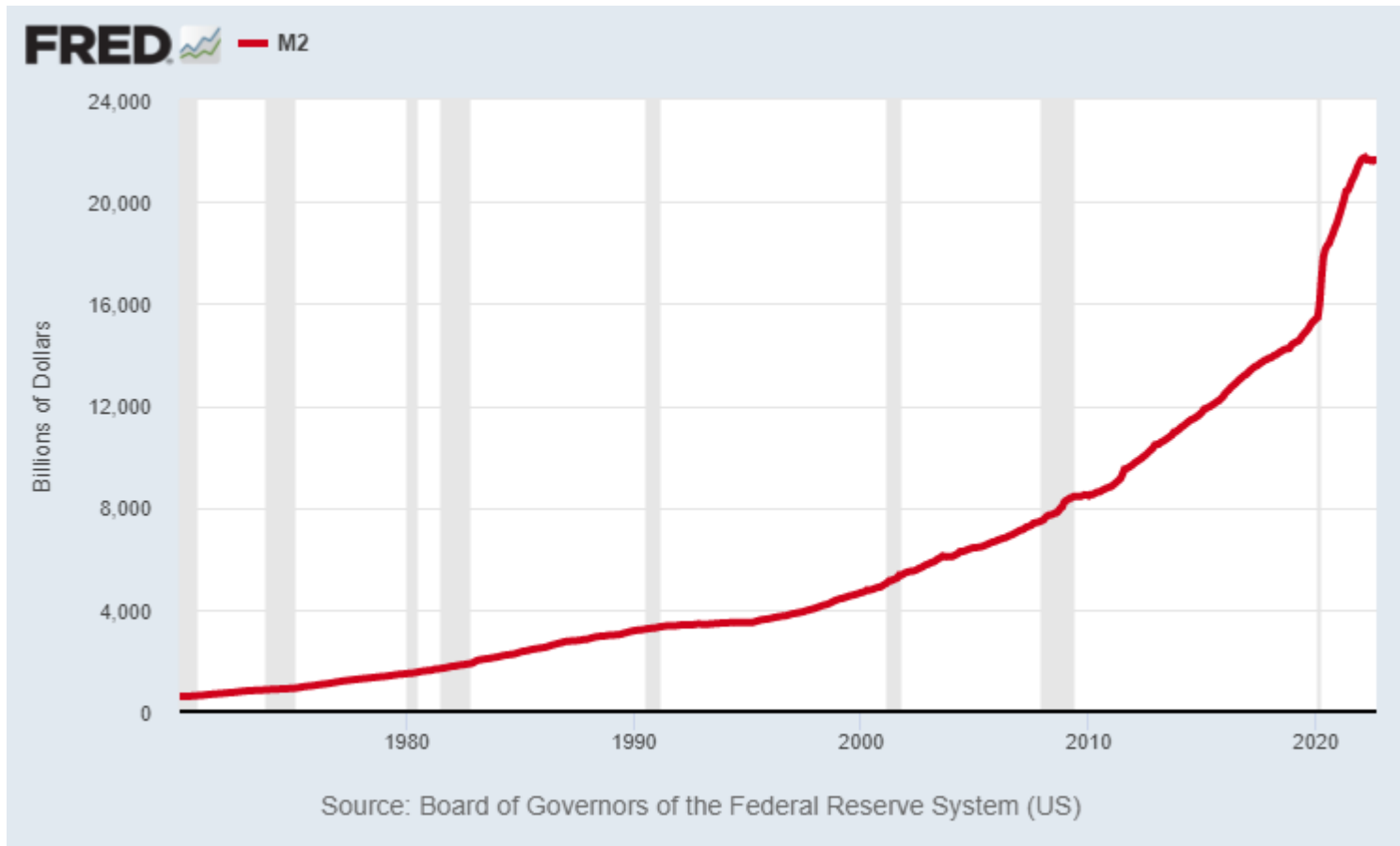
# QE During Covid



Source: Federal Reserve, BEA, Haver Analytics, Morgan Stanley Research forecasts

It reached a high of US\$9 trillion in April 2022

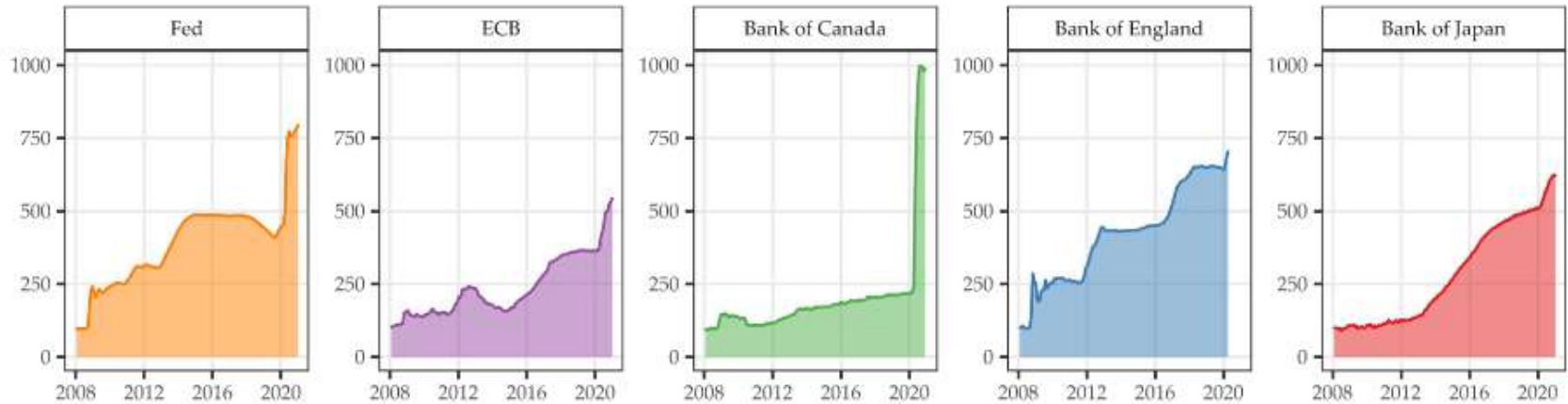
# M2: Money Supply



# Governments Around The World

G.S. Cortes, G.P. Gao, Felipe B. G. Silva et al.

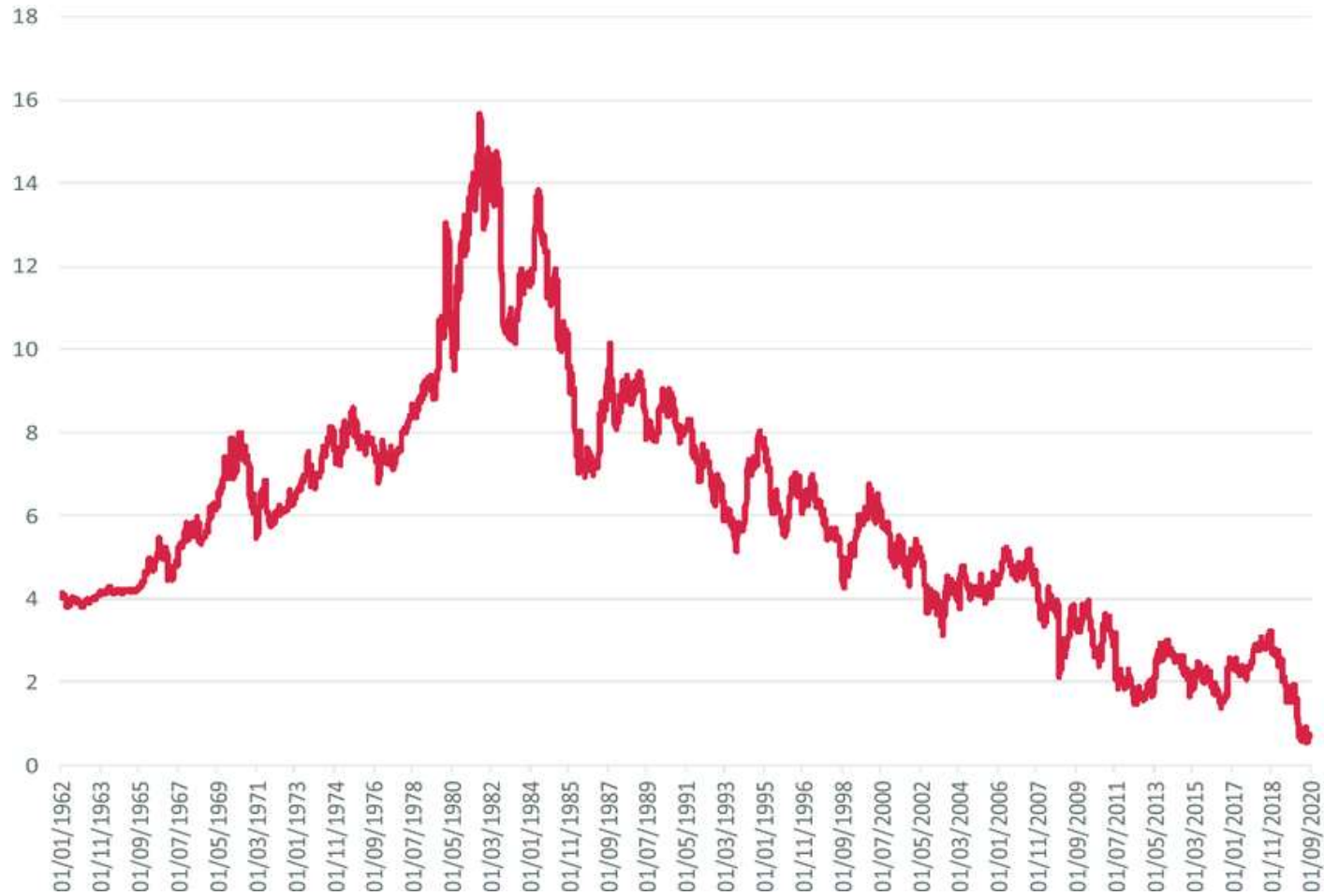
*Journal of International Money and Finance* 122 (2022) 102543



**Fig. 1.** Balance Sheet Expansion of Major Central Banks. This graph shows the expansion in the balance sheet of each major central bank from January 2008 to May 2021. The size of the balance sheet is measured by total assets, normalized to 100 in January 2008 to facilitate time-series comparisons around the main periods of interest (i.e., 2008 and 2020). The data are from each central bank's website.



# 10-Yr Treasury Yields aka Interest Rates



# Shift in demand patterns, and Bubbles

- **Households spent less**
  - On services, international travel, dining out, travels
- (Rich) Households awash with cash
  - Interest rates reached close to zero=> No point in holding cash
  - Money found its way to financial assets and real estate

**Asset bubbles: Stocks, Housing, Crypto**

# Post-pandemic recovery

- **Demand for goods increased, but**
  - Bullwhip effect
  - Supply chain disruptions
  - Shipping bottlenecks, shipping rates skyrocketed
  - Ports could not get functional
- **Demand for services came back**
  - Workers nowhere to be found
  - Restaurants, airports, hotels
  - Truck drivers

# Post-pandemic recovery

- Post-Covid **demand for goods and services higher** than pre-Covid days.
- Households still sitting on **larger cash than before.**
- But **supply disrupted.**

**Simply speaking**

**Too much money chasing too little goods**

**=> Inflation**

# Dual punch on supply side-1

## Russian attack on Ukraine

- West's subsequent sanctioning of Russian goods and trade.
- Russia an important supplier of oil, gas, and coal to European factories.
- **Ukraine and Russia combined**
  - the world's largest exporters of grains, feed crops for cattle, and fertilizers for growing crops.

## China's Zero Covid Policy

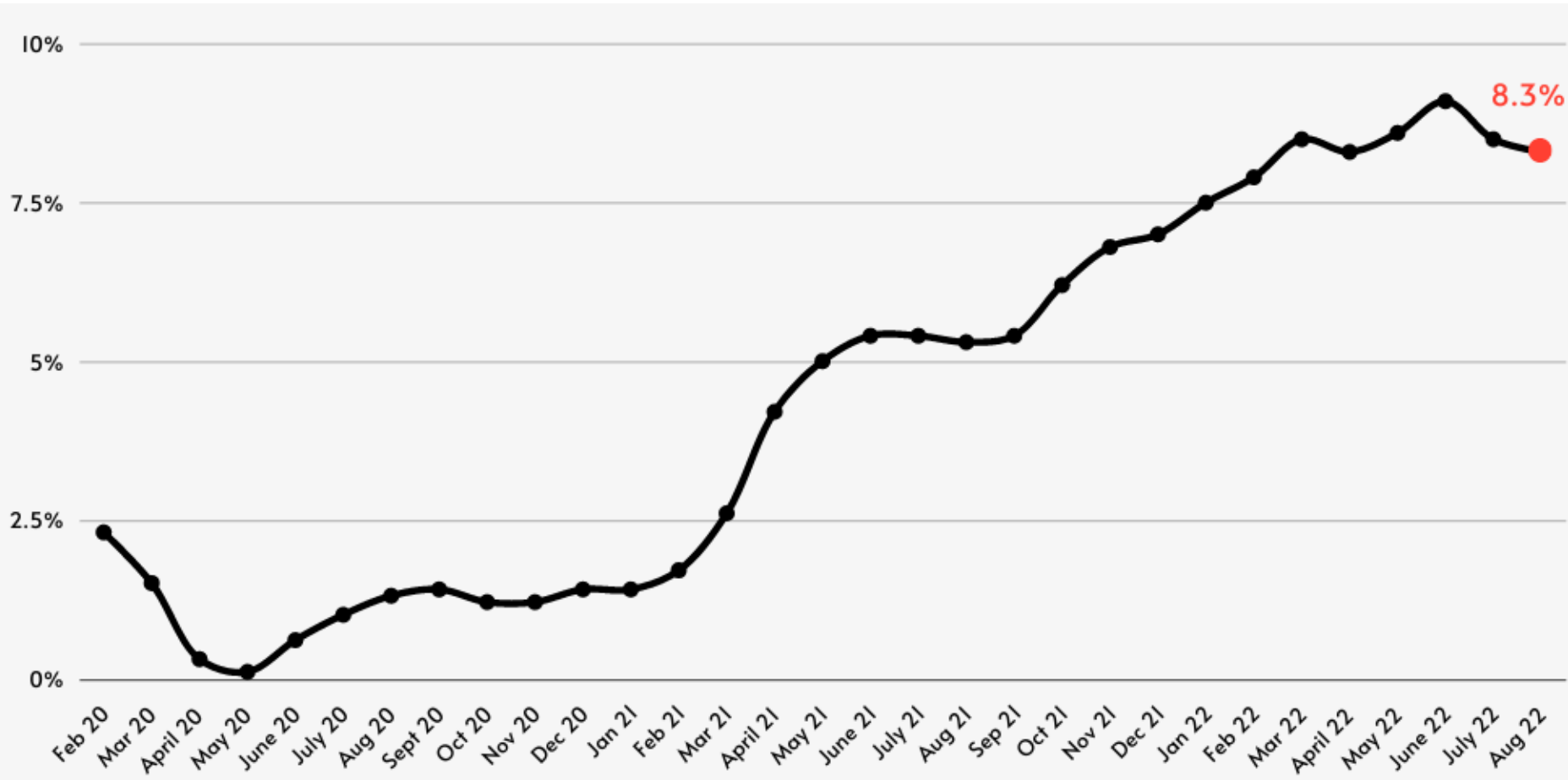
- China is world's factory.
- Lockdowns and closures of the world's most important manufacturing.

**Throws a wrench in a well-functioning global supply chain**

# Inflation over time



# US inflation over time





# US Fed Mandate

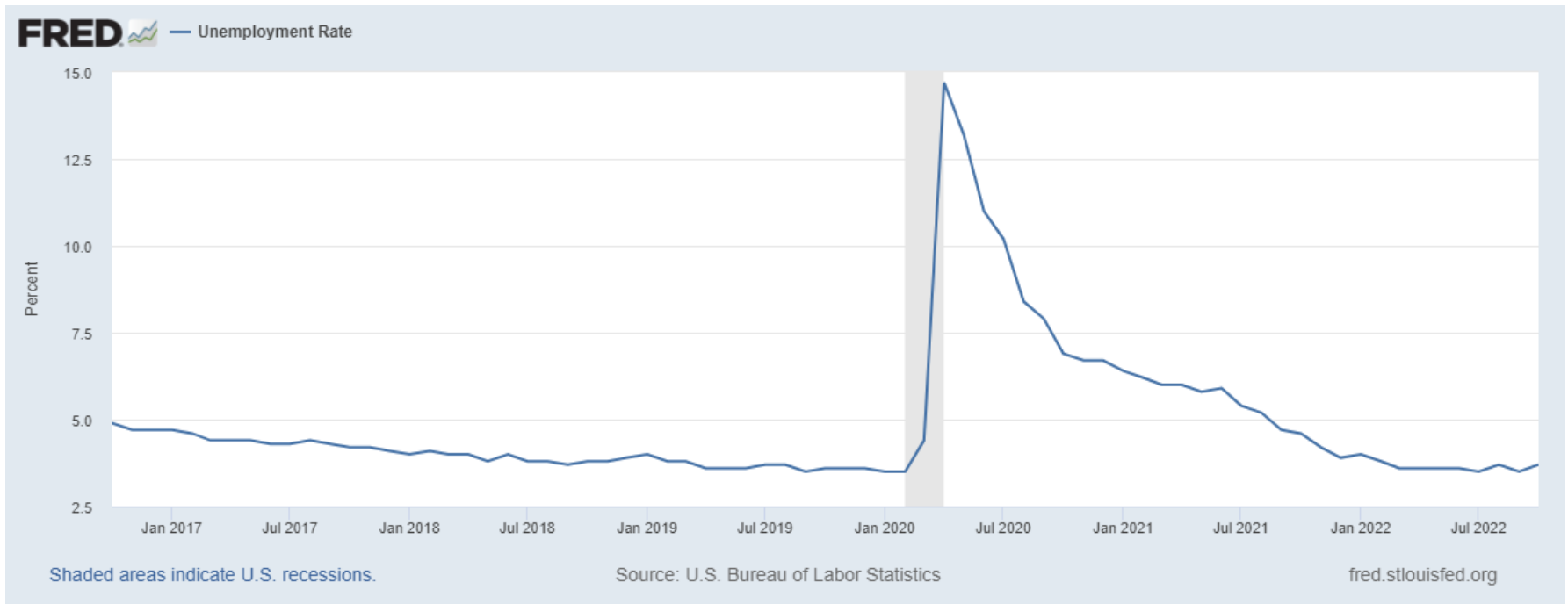
Keeping **our** economy healthy is one of the most important jobs of the Federal Reserve.

- The Federal Reserve System has been given a **dual mandate**—pursuing the economic goals of **maximum employment** and **price stability** (aka 2% inflation).
- It does this by using a **variety of policy tools** to manage financial conditions that encourage progress toward its dual mandate objectives—in other words, conducting **monetary policy**.

# Inflation superhigh, and unemployment super low



# Inflation superhigh, unemployment super low



# Why Fed cares about inflation

## Start with food insecurity

Swelling of grocery bills swell, pose enormous burden on low-income households.

Poor families spend a much larger share of their income on food

**In 2020,**

- The average family spent 12% of its earnings on food.
- **poor households** spent **27% on food** that year.

They have **little discretionary spending they can pare back to free up funds for food.**

**They are particularly vulnerable to spikes in food costs.**



# Why care about inflation—poor households

**An estimated 38 million Americans are food insecure,**

- they have insufficient means
- unsure where their next meal is coming from

**In addition to food insecurity**

↑ Fuel

↑ Rent.

**Importantly, no commensurate increase in wages at the lowest levels.**

**Federal minimum wage practically unchanged.**



# Canada

**25 per cent of the population can not afford food, rent, and utilities.**

# Previously, Fed had goofed up!

## It expected

- In December 2020 that prices would rise by **less than 2%** in each of the following two years.
- in December 2021, it reckoned that inflation in 2022 would be just **2.6%**

## **Now a Knee-jerk reaction**

**Pressed gas too long, now apply brakes, suddenly.**

# Fed applies brakes

## Two things

### 1. Reversal of QE:

- Target one trillion reduction in money supply this year.

### 2. Increase interest rates

- On Nov. 2, 2022, lifted borrowing costs by **0.75 percentage point**-
- its **fourth straight hike** of that size,
- brings its benchmark rate **to as high as 4%**



Is Fed overdoing it now?

With inflation rampant, Volcker raised rates to over 15% in 1980 - and then 20% in 1981.

# Comparing the Speed of U.S. Interest Rate Hikes

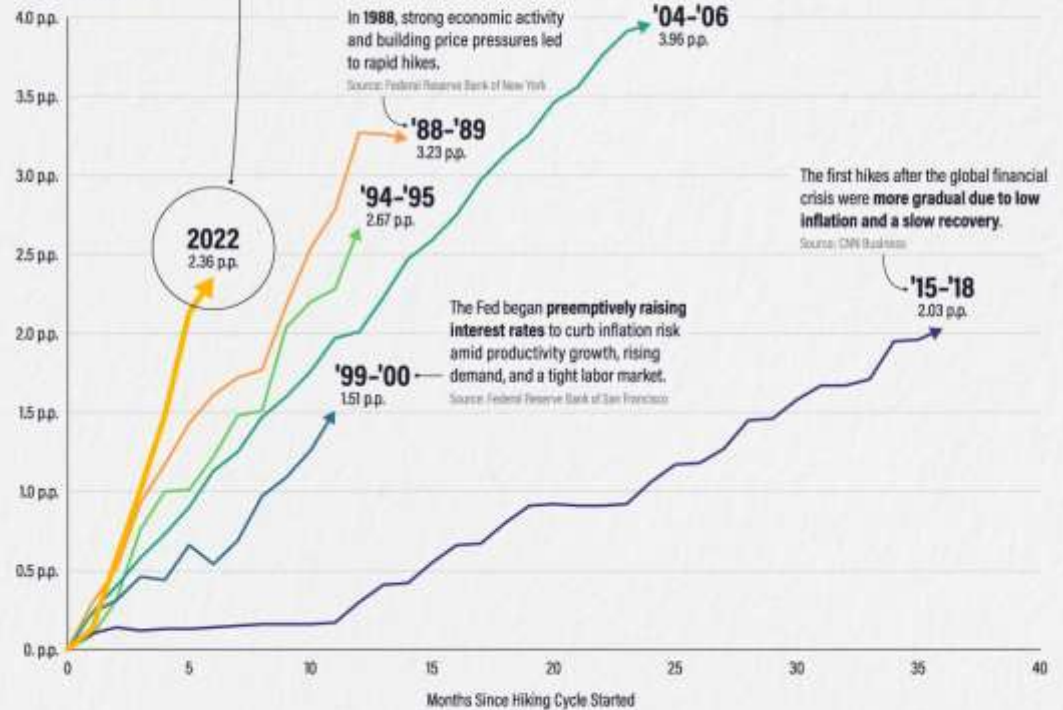
Rates are rising faster than any other time in recent history.

The Federal Reserve is aggressively raising rates as high inflation continues. In just six months, the effective federal funds rate has risen by more than 2 percentage points.

How does this compare to other periods of interest rate hikes over the past 35 years?

The effective federal funds rate is a weighted average of the rate banks use to lend money to each other overnight. It is determined by the market, but is influenced by the Federal Reserve's target.

Change in Effective Federal Funds Rate  
Percentage Points



Source: Federal Reserve. Chart inspired by Charts. Month 0 is the month when the first interest rate hike in the cycle occurred. The 2022 cycle reflects the change in the effective federal funds rate up to September 2022. We considered an interest rate hike cycle to be any time period when the Federal Reserve raised rates at two or more consecutive meetings.

# Consequences of sudden brakes

- Endangering **recession**
- **Uncertainty** for corporate investments
- **Killing the startup** activity and tech sector
- Reducing **household wealth**
- Risk of **housing crisis**
- Rising **cost of debt servicing**
  - Variable interest mortgages
  - Student loans
  - New vehicle loans
  - Zombie companies, at best can pay interest

# An example of looming housing crisis

## Interest payments on a 30-year loan of \$400,000

- @3%: \$ 12,000 p.a.
- @7%: \$ 28,000 p.a.

Imagine a household barely able to pay its interest.

To maintain the same level of affordability, housing prices must fall by about 50%

Housing, the single largest saving for North American households.

# Tech stocks this year

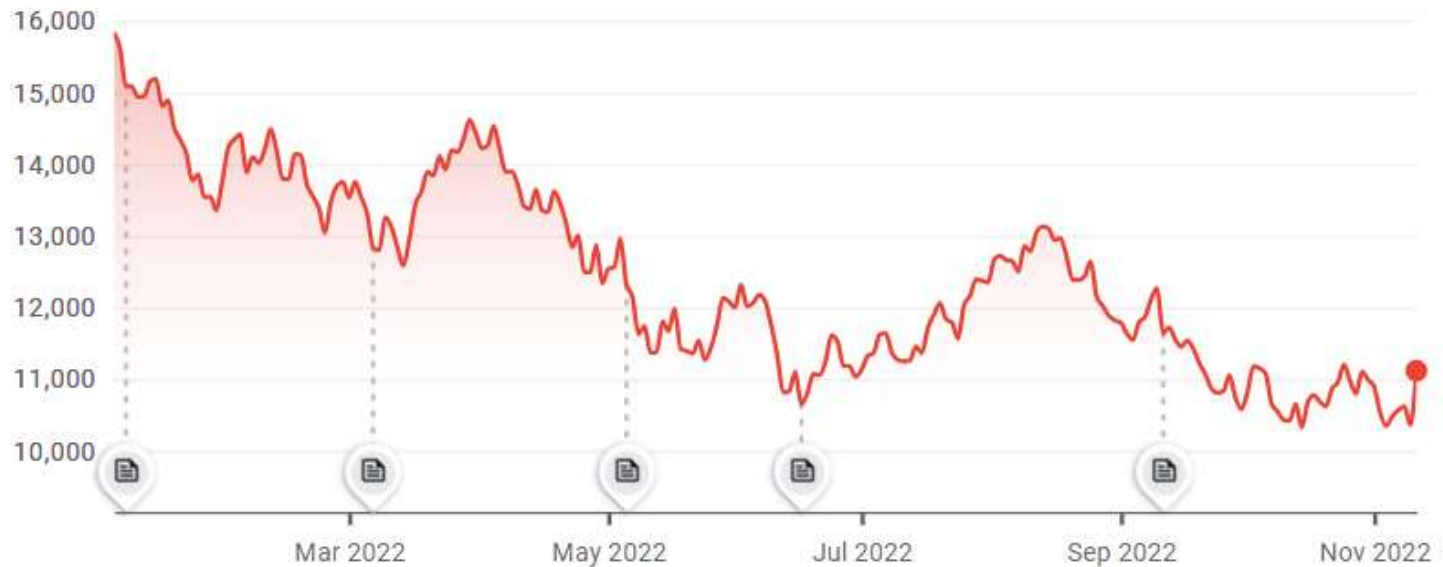
## Nasdaq Composite

11,114.15 ↓ 29.80% -4,718.65 YTD

Nov 10, 5:15:59 PM UTC-5 · INDEXNASDAQ · Disclaimer

1D 5D 1M 6M YTD 1Y 5Y MAX

[Key events](#)



# Fed knows the tradeoffs

- **Food and Rent Insecurity for the poorest**

versus

- **Destruction of wealth for the not-so-poor**

**Fact:** About **one-quarter** of Americans have essentially **no wealth** or even a **negative net worth**

# Consequences for **other** countries

- With rising US interest rates
  - US Dollar strengthens (15%+ this year)
- **Other currencies weaken,**
- But,
  - Commodities denominated in USD (most)
  - Most foreign debts in USD (50%+)
  - Global foreign reserves (60%+)
  - Trade invoices (70%+)
  - Foreign exchange transactions (80%+)

# Other countries act along with Fed

- Other countries (including Canada) must raise interest rates following Fed hikes
  - To prevent capital outflows.
  - To avoid devaluation of currencies.
- **Increases the cost of capital** in their countries
  - Amplify a potential global recession.

# Consequences for **other** countries

- Consequences of Currency **devaluations**:
  - Import costs rise, food, oil, minerals
  - Can't service or repay debts,
  - Exacerbate inflation troubles
  - Recession, unemployment, social unrest, law and order problems
- **Exodus of capital** from risky countries

Look at Pakistan, Sri Lanka, Ghana.....



# Consequences for **other** countries

They turn to

- **IMF**

- Comes with stringent conditions, to lower government subsidies on fuel and food at a time when prices are increasing.

- **Bank loans**

- Short term
- Higher interest rates

- **Borrow from China and Oil-rich states.**

# Can international concerns be ignored?

## Debt problems are contagious,

- the Latin American debt crises of the 1980s,
- the Asian financial crises of the 1990s,
- and the Eurozone debt crises of the 2010s.

# Should Fed Care?

**Recall:** The Federal Reserve System has been given a **dual mandate**—pursuing the economic goals of **maximum employment** and **price stability** (aka 2% inflation).

- Its mandate is for the **US domestic economy**.
- It operates mostly independently of the federal government.

# EU considering

- A tax of at least 33 percent on oil and gas companies
- Redistribute extraordinary profits from energy companies to poor households and vulnerable firms.
- Non-gas electricity companies would face a levy
- A threshold electricity price at less than half the current market rates.

# European Wages

- **60% workers** have collective-bargaining agreements,
- Tend to run for a year or more
- **It takes time** for economic conditions to influence their pay.
- Germany's public-sector unions will enter forthcoming negotiations seeking **a raise of 10.5%**

**Furtherance of wage-price spiral**

# What can companies do about it?

Harvard  
Business  
Review

[Diversity](#) [Latest](#) [Magazine](#) [Ascend](#) [Topics](#) [Podcasts](#) [Video](#) [Store](#) [The Big Idea](#)

Business And Society

## How Companies Can Prepare for a Long Run of High Inflation

by Vijay Govindarajan, Hassan Ilyas, Felipe B. G. Silva, Anup Srivastava, and Luminita Enache

May 02, 2022



# Suggestion-1

**Understand your entire value chain and its exposure to supply chain shocks.**

- go beyond learning about just your immediate supplier — figure out the supplier behind your supplier, and so on.
- Even a minor subcomponent criss-crosses the world at various manufacturing stages.
- Assess the **risk of disruption** at each stage,
- Develop alternative sources of supply, and keep sufficient inventory.

**Those days of keeping lean, just-in-time inventories are gone.**

# Suggestion-2

## Understand your capital structure:

- Your mix of equity shares, preferred shares, bank loans, short-term credit, supplier credit, and convertible debt.
- See which ones need to be repaid and when, which are affected by interest rate increases, and which could bring your business down if you default.
- Financial plans that worked during the last decade may be too risky for the coming years.

Restructure your loans, obtain new lines of credit, **and maintain enough cushion.**



# Suggestion-3

Pay extra attention to global developments, realignment of countries' alliances, and changing policies of international suppliers.

- These factors can no longer be taken for granted.
- **Short-term factor loom large.** You can't expect that countries will act rationally in their long-term economic interests.
- Politics, international pressures, and **national fervor could dominate rational economic thinking**, leading to rapid changes in business policies.

# Suggestion-4

**An important challenge in the midst of the exodus of people from the job market is to keep morale high and prevent attrition.**

- Losing a key employee means months of lost productivity and expenditure of additional efforts to find and train a replacement.
- Constant communication with employees and at least be aware of their plans for switching jobs.
- Be more flexible in accommodating their personal needs, such as letting them work from home, which may boost employee productivity.



Some recent layoffs (% of workforce):

Seagate: 8%  
DocuSign: 9%  
Shopify: 10%  
Twilio: 11%  
GoFundMe: 12%  
Chime: 12%  
Meta: 13%  
Redfin: 13%  
Lyft: 13%  
Stripe: 14%  
Patreon: 17%  
Coinbase: 18%  
Opendoor: 18%  
Flipboard: 21%  
Intel: 20%  
Snap: 20%  
Dapper: 22%  
Robinhood: 23%  
Twitter: 40-50%

# Suggestion-5

**The luxury of pursuing risky, nonremunerative ideas is now gone.**

- It's time to **rationalize** activities, customers, businesses, brands, segments, suppliers, manufacturing sites, and product lines,
- **Short-term survival takes precedence over long-term growth.**
- Go back to the drawing board
- Identify core areas and focus on those that provide the best returns for finite resources while holding the most promise for future.

# Suggestion-6

**Yet, do not** apply a **universal axe** and order **an across-the-board cut** of salaries, expenditures, and headcount.

- Would lead to low morale and further attrition of talented employees.
- Don't be tempted to start cutting forward-looking expenditures like R&D, employee training, and advertising.

## **Use a finer scalpel.**

- Design a new scorecard to rank-order activities and business lines in terms of retention priorities.
- The scorecard must consider the current organizational priorities, while leaving scope for growth and future profitability.



thank you 😊

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# BREAK



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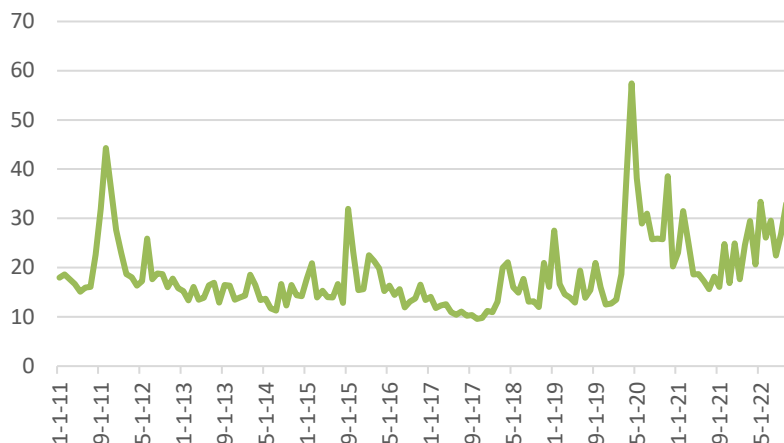
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# Macroeconomic Uncertainty

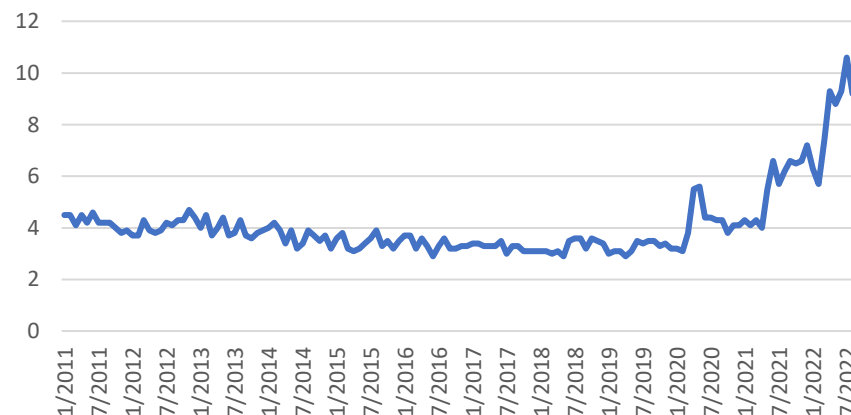
## Aggregate Market Uncertainty (VIX)

Source: Chicago Board of Exchange.



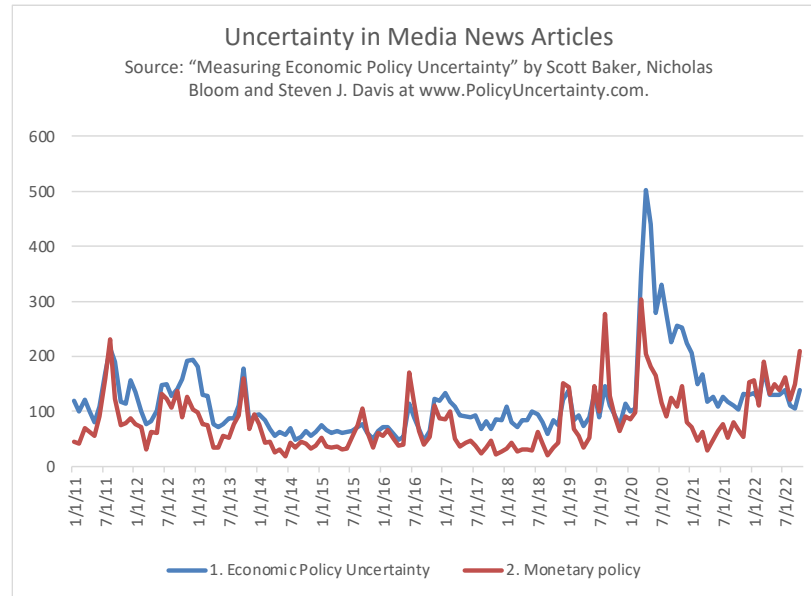
## Michigan Consumer Survey Inflation Uncertainty

(Standard Deviation in Next-Year Inflation Expectations)



- **Macroeconomic uncertainty spurs the demand for financial information:**
  - A greater demand for timely financial information from the investors affects information production by the intermediaries (analysts, journalists)
- **Macro uncertainty today differs from prior periods of high uncertainty:**
  - Research on the effects of inflation on the acquisition and processing of financial information is very sparse

# Uncertainty and Supply of Information Media



- **High economic uncertainty increases concentration of media coverage on earnings announcements (Bonsall, Green, Muller 2020)**
  - Crowding out the coverage of non-earnings news (including material events in 8-Ks)
  - Increased coverage of bellwether stocks or early-season announcers
- **The expanded media coverage reduces investors' information acquisition and processing costs**

# Uncertainty and Supply of Information

## Sell-Side Analysts

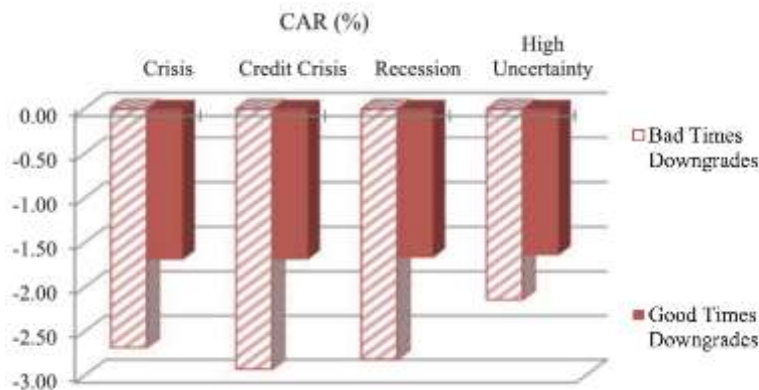
### ■ A more complicated task,

- Difficulty incorporating negative macroeconomic news in the forecasts (Hann, Ogneva, Sapriza 2012), mitigated by access to in-house economists (Hugon, Kumar, Lin 2016)

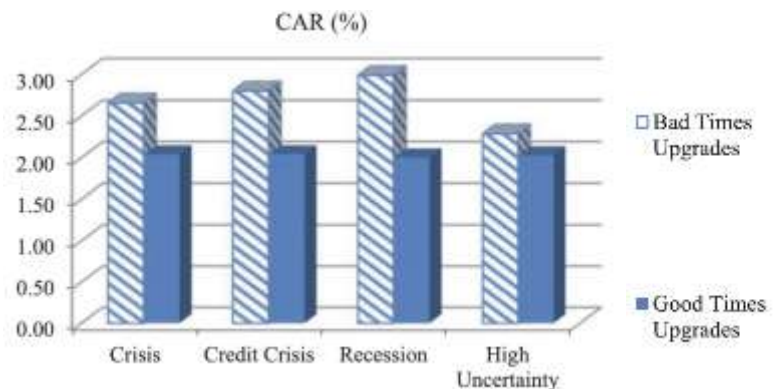
### ■ but a greater impact of research

- Recommendation changes generate a larger stock reaction when the uncertainty is high (Loh and Stulz 2018)
- Analysts better than managers at impounding macro info into forecasts (Hutton, Li, Shu 2012); more detailed reports in downturns (Loh and Stulz 2018)

Panel A: Downgrades



Panel B: Upgrades



# Inflation Uncertainty

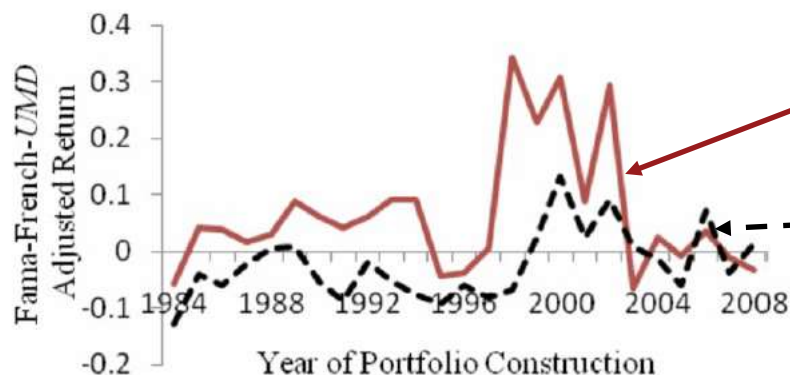
## ■ Research focus on the nominal accounting effects:

- No recognition for inflation-driven gains & losses (e.g., inventory asset)
- These gains & losses materialize in future cash flows (when inventory sells)

## ■ Adjusting financial statements for inflation is costly:

- inefficient or incomplete adjustments made by investors (Konchitchki 2011) and analysts (Basu, Markov, Shivakumar 2010)

## ■ Which results carry over to the high and volatile inflationary environments, where economic agents pay more attention to inflation effects (Candia, Coibion, Gorodnichenko 2022)?



**Inflation-adjusted earnings < Nominal earnings  
(investors over-estimating inflationary losses)**

**Inflation-adjusted earnings > Nominal earnings  
(investors over-estimating inflationary gains)**

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# Economic Uncertainty and Financial Reporting

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## A User's Perspective – Sell-Side Equity Research

- **Economic uncertainty leads to lower confidence in outlook**
  - Management teams are more reluctant to provide guidance
  - Negatively impacts investor sentiment
  - Raises corporate's cost of capital
- **From a financial reporting perspective, uncertainty reduces the utility of historical financial statements**
  - Prior period not an accurate reflection of the anticipated future economic conditions
- **An Example – Impact of inflation on outlook:**
  - More difficult to forecast
  - Wider dispersion of estimates
  - Less certainty
  - Lower multiples: Empirical evidence of a negative correlation between P/E's and (expected) inflation



# Economic Uncertainty and Financial Reporting

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## What Can Professional Accountants Do to Alleviate Banking Scandals?

- **Capital Markets/Banking Sector Has Been Rife with Scandals**
  - The Financial Crisis was not the end of scandals in the world of banking
  - Current predicament of Credit Suisse highlights the ongoing issues
    - ◆ I fully admit that Barclays has hardly been a paragon of virtue
- **Accountants Need to Retain a High Degree of Skepticism**
  - Accountants and Auditors need to use judgement
  - Users of financial statements must put reporting in context
    - ◆ Be aware of underlying motives and incentives

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