CONFERENCE SUMMARY

PAC’s 2022 Annual Professional Accounting Futures Conference On

The Impact of Macroeconomic Challenges on Professional Accountants and Investors

Held virtually by Zoom on the afternoons of November 10, 11, 2022 from the Institute for Management & Innovation
University of Toronto Mississauga, Mississauga, Ontario

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2022 PAC Conference Summary: Professional Accounting Futures
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The seventh Professional Accounting Centre’s 2022 Annual Futures Conference was held on the afternoons of November 10 & 11, 2022. Each afternoon featured two talks and a panel of discussants who each gave a short preamble.

Day 1 examined the impact of macroeconomic challenges for professional accountants.

- Professor Lakshmanan Shivakumar (London Business School), looked at how managers and analysts deal (or not) with macroeconomic information, particularly inflation. He described the phenomenon of post-earnings-announcement drift and its chimeric potential for abnormal profits.

- Professor emeritus Dan Simunic (University of British Columbia) described the nature of current macroeconomic uncertainties. He foresees increased government intervention and regulation and lessening intergovernmental cooperation as states focus on their own citizen’s needs. This is a theme repeated on Day 2 by Anup Srivastava (University of Calgary). For accountants and auditors, Dan sees a heightened need for professional skepticism and increased audit time and cost.

- Panel 1’s four speakers/discussants reiterated the need for auditors and accountants to understand how macroeconomic challenges affect a company’s • business • industry, and • control environment, and to pay particular attention to management’s • assumptions and estimates • non-GAAP earnings metrics, and • inconsistencies between commentaries and financial statements/other disclosures.

“Fraud causes significant losses to investors each year...[through] asset misappropriation, financial reporting misconduct, or, more generally, corruption... Independent auditors play an important gatekeeper role in supporting high-quality financial reporting and the protection of investors...A critical aspect of this role is...the auditor’s use of the fraud lens.”

Paul Munter, Acting Chief Accountant, SEC (Munter, 2022)

Day 2 examined challenges of macroeconomic uncertainties for investors.

- Speaker Nick Anderson of the International Accounting Standards Board (IASB), in an interview with PAC Director Len Brooks, described • the standard-setting process • the IASB mission to bring transparency, accountability, and efficiency to capital markets, and • examples of current projects.

Anup Srivastava, professor and Canada Research Chair (University of Calgary) explained why the global economy should prepare for long-run inflation. He described events that have spawned current macroeconomic uncertainties and how the U.S. Federal Reserve, in pursuing its dual mandate of maximizing employment and reducing inflation for U.S. citizens, may cause global recession. Just when the world needs international cooperation to combat climate change and hunger, he showed that countries are becoming more protectionist and less cooperative.

Panel 2 discussed investors’ use of information during macroeconomic uncertainty. Panelists agreed that the demand for information by investors increases during periods of uncertainty, but point out that today’s uncertainties of high inflation, high employment, disrupted supply chains, etc., are unprecedented. As with Panel 1, discussants warned of non-GAAP earnings metrics that generally favour companies’ narratives at the expense of transparency; not neglecting to look beyond the income statement to understand a company’s capital costs; ability (or not) of raising prices; after-tax, after-inflation rates of return; incentives for fraud.

Speakers and panelists described this period of macroeconomic uncertainty in bleak terms. All concurred that uncertainty is only getting worse, not better, and that accountants, auditors, and investors need to be vigilant.

“There is an inverse relationship between interest rates and dishonesty.”

Carson Block

Visit the PAC website for full conference coverage

Readers are reminded that the Conference Summary provides just thumbnail sketches of selected highlights of the speakers’ information-packed presentations and Q&A. To learn more, visit the full conference — videos, PowerPoint slides, and Q&A — at PAC 2022 Annual Conference on Professional Accounting Futures – November 10 & 11, 2022. Speaker biographies can be found in the Expanded Agenda.

Len Brooks, Professor of Business Ethics & Accounting
Director, Professional Accounting Centre (PAC)

2 Economist. (November 11, 2022). A sleuth’s guide to the coming wave of corporate fraud: Mischief is cyclical—it is bred in good times and uncovered in bad times.
CONFERENCE SUMMARY INTRODUCTION

The seventh annual Public Accounting Centre (PAC) Professional Accounting Futures conference was held virtually at the Institute for Management & Innovation (IMI) and the University of Toronto Mississauga (UTM) on the afternoons of November 10 & 11, 2022. Leading standard setters, auditors, regulators, practitioners, and researchers came together to discuss the impact of macroeconomic challenges on professional accountants and investors.

This Conference Summary document provides thumbnail sketches of the two talks and panel session held each day. Of necessity, we provide only selected highlights here, but videos of the presentations, Q&A sessions, and PowerPoint slides are available free of charge at PAC 2022 Annual Conference on Professional Accounting Futures – November 10 & 11, 2022. Speaker biographies can be found in the Expanded Agenda.

Day 1, November 10, 2022

Challenges for Professional Accountants

1:00 Introductory Remarks: Len Brooks, Director PAC; Soo Min Toh, Acting Director, IMI; and Craig Smith, EVP, Member & Student Services, CPA Ontario.

1:15 Macroeconomic Developments and Accounting Estimates: Lakshmanan Shivakumar, Professor, London Business School

2:15 Global Uncertainties and their Implications for Accounting, Auditing, and Financial Reporting: Dan Simunic, Professor Emeritus, University of British Columbia (UBC)

3:15 Break

3:30 Panel: Impact of Macroeconomic Developments on the Accounting Profession – Accounting Standards, Estimates, Auditing and the Profession in General

- Tom Lanoue, Partner, Deloitte
- Cameron McInnis, Chief Accountant, Ontario Securities Commission
- Brad Owen, Partner-in-Charge, Department of Professional Practice, KPMG
- Dan Simunic, Professor Emeritus, UBC (for the Q&A)
Day 2, November 11, 2022

Challenges for Investors

1:00 Introductory Remarks: Len Brooks, Director PAC; Dushyant Vyas, Associate Director, PAC

1:15 Standard Setting under Macroeconomic Uncertainty: Nick Anderson, IASB Board Member

2:15 Preparing for Long-run Inflation and Investing During Downturns: Anup Srivastava, Professor & Canada Research Chair, University of Calgary

3:15 Break

3:30 Panel: Investors’ Use of Accounting Estimates During Macroeconomic Uncertainty

- Maria Ogneva, Professor, University of Southern California, Marshall
- David Milstead, Journalist, The Globe and Mail
- Anish Chopra, Portfolio Management Corp
- John Aiken, Head of Research (Canada) and Senior Analyst at Barclays

The PAC is pleased to acknowledge the support of the University of Toronto Mississauga (UTM) and CPA Ontario for establishing and maintaining the PAC, and CPA Ontario for funding this conference.

We invite readers to visit the PAC website for past conferences, research projects, and two case collections that will be available in 2023: one on professional skepticism; the other on equality, diversity, and inclusion (EDI).

Special thanks go to • Martina Simmonds, Allison Dias, Clerissa Albores, Abdullah Qaisar, and Lee Benson for help with the conference and conference materials and • conference moderators Minlei Ye, Dushyant Vyas, and Michael Marin.

The views and opinions expressed in this paper are those of the speakers and do not necessarily reflect those of their respective organizations, CPA Ontario, or the PAC.

Len Brooks, Professor of Business Ethics & Accounting
Director, Professional Accounting Centre (PAC)
University of Toronto
November 2022
Speaker 1: Lakshmanan (Shiva) Shivakumar, Professor, London Business School

Earnings and the Macroeconomy

“Sadly, the academic literature has only just recently picked up on a newer approach to earnings, which is to link earnings numbers to the macroeconomy.”

Shiva Shivakumar

Lakshmanan (Shiva) Shivakumar compared two views of company earnings and a phenomenon called post-earnings announcement drift³ that illustrates a puzzling way in which investors react to some accounting information. Shiva posited a reason for the phenomenon that has been known since the 1960s. His slides can be found here.

Earnings: internal and external views

Most of the time when we talk about a manager’s role within a company in terms of improving earnings, we have a very internal view of the things that manager is aiming to do; that is, to increase revenues and to reduce costs, said Shiva. This is the typical income-statement perspective.

An alternative view is an external view, through which managers aim to take advantage of external forces — macroeconomic factors — in the firm’s environment and strategically change exposure to them. These macroeconomic factors could include • inflation • real GDP growth and employment • population growth and demographic changes • regulatory effects, etc.

Earnings prediction models

The internal-view prediction model is the predominant approach in academic studies. Why? It is linear and simple. The external-view prediction model is more complicated but is the predominant approach in practice (analysts’ reports).

Post earnings-announcement drift

Post earnings-announcement drift is an anomaly in the accounting and finance literature where investors ignore some information about accounting numbers.

Prices of stocks that have positive earnings announcements continue to drift upwards. Similarly, returns on stocks that reported bad earnings news continue to drift downwards (Figure 1). The underreaction persists for up to nine months.

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How drift is studied

The change in earnings, divided by a standard deviation of that change in earnings, is called standardized unexpected earnings (SUE) in academic literature. At the time the company makes its earnings announcements, the change in the earnings is compared to the earnings four quarters ago, or in the same quarter in the previous year.

In a sense, it is a measure of how much surprise investors see in the announced earnings. The “surprise” can be a positive increase or a negative one. The proxy is a very simplistic one, but it works very well, explained Shiva. For example, if stocks were divided into portfolios based on their SUE categories (Figure 1), stocks with the highest positive earnings would be in portfolio 10 (P10); stocks with the lowest earnings announcements would be in P1.

Given that P10 stock prices will increase over time and P stock prices will decline over time, increasing the stocks in P10 and selling those in P1 would result in a hedge portfolio that yields significant profits, in the range of 12% to 25% annualized returns, from an investment strategy that requires no capital investment. Traders call it an earnings momentum strategy.

“For academics, the phenomenon is puzzling, because this is a very easy way for investors to make money if they can predict how the prices are going to change in the future,” said Shiva. “Why is it that people aren’t taking advantage of this simple trading strategy? Why is it that investors are always under-reacting to earnings information?”

Shiva and others investigating this phenomenon found that it cannot be explained by risk exposure alone. Instead, they hypothesized that inflation exposure is primarily responsible, for example, through companies’ • bargaining power with customers and suppliers • fixed or floating prices in customer and supplier contracts • elasticity of labour supply • fixed or floating interest rates • hedging contracts.

Post-earnings announcement drift persists because of these and other reasons, on which Shiva elaborated:

• Inflation exposure is extremely hard to predict at the firm level.
• Analysts ignore inflation exposures in their forecasts.
• Trading based on inflation exposures is unprofitable for illiquid stocks.

Questions from Lakshmanan Shivakumar Q&A

For the verbatim answer to the following questions, and more, listen to the Lakshmanan Shivakumar Q&A at the end of his talk.

- **Q:** Your model assumes positive inflation. Could it function equally well with negative inflation or deflation?
- **Q:** Inflation is prevalent in the news, and investors seem to be paying more attention. Do you expect hedge returns to go down to or even disappear in today’s environment?
- **Q:** What percentage of the drift is explained by inflation exposure?

Hear why paying attention to inflation and understanding inflation exposure of individual firms are quite different things.

- **Q:** What percentage of the drift is explained by inflation exposure?

Hear why inflation is the biggest factor, but it can vary for several reasons.

**Speaker 2: Dan Simunic, Professor Emeritus, University of British Columbia (UBC)**

*Global Uncertainties and their Implications for Accounting, Auditing, and Financial Reporting*

“I’ve never seen the world in quite the state of turmoil, if you will, than it is in currently.”

Dan Simunic

**Introduction**

In this talk, Dan Simunic took a high-level view of global problems and their uncertainties and their possible impacts on financial reporting and accountants and auditors. His slides can be found [here](#).

From the start, Dan asserted that the problems we face are not new; we just haven’t done a very good job at solving them. For that reason, Dan referred to academic papers in his talk, written decades ago, that still provide insights to the current and future problems he discussed.

**Global uncertainties / Main economic problems**

Dan identified what he believes to be society’s largest existential problems that generate global uncertainties. All endogenous — of humans’ own making — the problems and their possible solutions have economic implications:

- **Climate change/global warming** in all its manifestations is a fundamental economic problem, Dan said, and it occurs because of our economic behaviour. It is an extreme case of negative externalities — both production externalities and consumption externalities —
when firms and individuals do not internalize all the costs of their economic decisions (transactions), and do not calculate marginal costs correctly. 4

“We are on a highway to climate hell with our foot still on the accelerator.”
UN Secretary-General Antonio Guterres, UN Climate Change Conference (COP27), November 2022.

Externalities, unless they can somehow be solved, destroy the Pareto-efficiency/optimality of a competitive market solution, which says, “no one can be made better off by allocating resources except by making someone else worse off.” In other words, externalities destroy the intellectual basis for the organization of our free-market economy if everyone is worse off.

- Wars and trade wars are political problems with strong economic implications. International investment and trade relationships are changing.
- Global diseases are social problems with lesser, but still large economic implications. For example, supply chains see continued disruption from the COVID-19 pandemic.

Solutions?

Dan predicts that serious solutions to global warming are incompatible with democracies, where people largely vote their self-interest. He expects to see more government intrusion into the economy and society, more laws and regulations, and more outright prohibitions of certain actions and choices. All three problem types — pure economic, political, and social — lead in this direction, he said.

Analogous to the wild west of financial reporting and compliant auditors before passage of the U.S. Sarbanes-Osley Act of 2002, we now have a wild west of global individualism, freedom, consumerism, and social media, Dan said.

Implications for financial reporting? 5

- Increased prior uncertainty over financial-statement (FS) amounts can be expected to motivate a more intensive audit.
- Increased posterior uncertainty over FS amounts can be expected to result in more material misstatements in the FS when point estimates are reported.

Implications for accountants and auditors?

In a more uncertain world, auditors should:

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4 For more information, see Bator, Francis. (March 1957). *The simple analytics of welfare maximization*, American Economic Review, pp. 22-57. The paper describes basic concepts and welfare economics. Germane to Dan’s talk is how welfare economics can collapse and what factors might cause the collapse.

• provide more information to shareholders, etc., about FS amounts to reduce the likelihood of being sued.
• perform more intensive and costly audits, though technological innovations may help control costs.

**Conclusion**

More and more onerous laws and regulations designed to ameliorate climate change, or shape industrial policy and trading relationships, will require different types of information (e.g., ESG) about firm performance and compliance, all of which have implications for financial reporting — both accounting and assurance.

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**For the verbatim answers to these questions and more, see the Q&A following Dan’s talk:**

- **Q:** How can accountants develop useful, measurable, comparable, reliable measures of environmental impact? How can we start to think about this issue?
  
  Dan discussed a paper by Ronald Coase.  

- **Q:** We see climate-related court cases increasing, where public entities are suing big polluters to extract money for climate remediation. Is this an example of a Coase solution? And how will it impact disclosure?

- **Q:** Is any academic research currently being done on developing alternative systems of economic measurement that move away from growth and our obsession with growth?

  Dan discussed taxation by governments to discourage externalities (e.g., a carbon tax), a solution stemming from the writings of A.C. Pigou, so it is sometimes called a **Pigovian tax**.

- **Q:** How could we go about a global measurement / standard enforcement / distribution of a carbon tax? How would we think about getting everybody on the same page?

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7 For more information, see, Kaga, J. (May 12, 2022). *Pigovian Tax: Definition, Purpose, Calculation, and Examples*, *Investopedia*. 
**Panel 1: Impact of Macroeconomic Developments on the Accounting Profession – Accounting Standards, Estimates, Auditing and the Profession in General**

**Tom Lanoue, Partner, Deloitte**

“*When I think about the macroeconomic impact on the accounting profession, I really think about the impact it’s had on financial reporting, but also on the control environment.*”

Tom Lanoue’s talk and slides described numerous audit and accounting impacts and events that can trigger testing on companies because of macroeconomic uncertainties. Many businesses have been forced to address new issues that had not affected them in the past, such as supply chain disruptions, inventory shortages, and renegotiated contracts. Tom said auditors’ professional skepticism is even more critical in downturns. Auditors must also understand management’s control environment and the business, particularly because accounting and auditing standards being applied in these difficult times require team understanding of not just the historical business practice, but management’s plans going forward.

**Cameron McInnis, Chief Accountant, OSC**

“As a securities regulator, I find myself dusting off the playbook of downturns. Each downturn presents something new, but all downturns seem to have a few things in common.”

Escalating energy shortages, labour shortages, inflationary pressures, and other factors impact economic uncertainty. Under these circumstances, said Cameron McInnis, high quality, transparent disclosure becomes especially important. For example, management’s significant judgments and the key assumptions going into measurements for financial reporting should be clearly explained. Cameron said that the security regulator must often remind issuers that disclosure of assumptions and estimation uncertainty is required under IFRS. (View Cameron's slides [here](#).)

What do downturns have in common? Cameron provided examples of areas to which securities regulators will pay particular attention:

- increasing estimation uncertainty
- going concern
- subsequent events [after reporting]
The OSC wants to see entities demonstrate good faith and reasonable assumptions that attempt to take into consideration the current economic environment.

**Brad Owen, Partner-in-Charge, Department of Professional Practice, KPMG**

*The current geopolitical and economic soup has created economic uncertainty that not only impacts getting estimates right, but also making sure disclosures in financial statements or MD&A are robust enough for users to understand some of the more significant judgments that went into some of the accounting estimates...and the uncertainty is only getting worse as opposed to better.*

*Brad Owen*

**Brad Owen** targeted the accounting concept of *fair value measurement*, specifically around impairment. He warned that the likelihood of impairment events and triggering events increases significantly in times of market uncertainty, and that uncertainty is only growing. (View his slides [here](#).)

Along with current examples of factors affecting fair value estimates, Brad warned auditors to pay increased attention to contradictory evidence, consistency of assumptions, and management’s changes to strategic plans.

**Questions from the Panel 1 Q&A**

Hear the Panel’s discussion of the following questions at Panel 1 Q&A:

- Q: Will we see more and more intrusion of government into the economy, our lives, and society?
- Q: Will auditors be required to play a bigger role in assessing compliance with / detecting violations of standards, laws, and regulations?

Hear the panelists’ opinions on • why Canada is slow at adopting international standards such as non-compliance with laws and regulations (NOCLAR), • why younger generations seem less hesitant about whistleblowing than those past, • how the past wave of deregulation in the U.S. is being reversed, and • why audit standards around fraud and/or illegal acts will likely change over the next ten years.

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8 For more information, see IFRS. (2022). [IFRS 13 Fair Value Measurement](#) [Webpage].
For the verbatim answers to the following questions and more, see the Panel 1 Q&A:

- **For Cameron McInnis:** Is the OSC paying particular attention to disclosures about the impact of inflation risk in the MD&A? If so, how will it monitor the credibility of such disclosures, because in uncertain times management can support almost any assumption?
  
  Hear Cameron McInnis’s answer about what the OSC questions. Hear what Brad Owen flags as deferred impairment and how it can be harmful to investors.

- **For Brad Owen and Cameron McInnis:** We saw 2021 was a record M&A year in volume, deal counts, and for multiples. Do you expect a lot of goodwill impairment to come through in 2022, given what is going on in the world?
  
  Hear why Brad Owen emphasizes the necessity of information through disclosure. Hear why Cameron McInnis sees the accumulation of goodwill as a problem for the past 12 years and what initiatives are being explored to deal with it.

- **For Tom Lenoue and Brad Owen:** If the propensity to commit fraud increases during times of uncertainty, how have you communicated this possibility to your auditors?
  
  See the importance of the fraud triangle and the need for auditors to understand a business, its industry, and the current environment.

- **For Tom Lenoue and Brad Owen:** Do you have a perspective on the recent auditor reporting standards that require auditors to report key audit matters?

- **For Cameron McInnis:** What is the most common fraud seen in times of uncertainty or expected in times of uncertainty? Does the OSC have the resources to detect it?
  
  See why changes in an entity that result in internal control changes could increase risk of fraud.

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9 Auditing and Assurance Standards Board (AASB). (n.d.). Auditor Reporting – Key Audit Matter Reporting and Other Considerations, Canadian Auditing Standards [Webpage].
**Speaker 1: Nick Anderson, IASB Board Member**

**Standard Setting under Macroeconomic Uncertainty**

“The IASB writes principle-based standards. The objective of those standards is to provide useful information to our primary users, investors, creditors, and other lenders, but by design our requirements are intended for all seasons. So, they’re for the economic winters as well as for the warmer months, if you like.”

Nick Anderson

In an interview-style exchange, PAC Director Len Brooks posed questions to International Accounting Standards Board (IASB) board member, Nick Anderson on the workings of the IASB and on a range of macroeconomic topics.

For a full list of questions, see the PowerPoint slides. For verbatim information on the topics below and more, see Nick Anderson Q&A at the end of his talk.

**IASB overview**

The IASB is responsible for the development and publication of IFRS Accounting Standards. It is a not-for-profit, non-treaty international organization entirely dependent on the continuous support of its stakeholders. Its mission through its standards is to bring transparency, accountability, and efficiency to capital markets around the world; to work in the public interest, to foster trust, growth, and long-term stability to the global economy. That said, enforcement of the standards is up to each country’s regulators, not the IASB or IFRS.

**Current IASB projects**

Nick provided examples of current projects concerning, including these:

- **Goodwill.** Users are much more interested in the economics of the transaction rather than goodwill, Nick said. For example, how much capital has been deployed? What is the likely return on that capital? Goodwill is an essence an accounting construct, which is necessary, he said, but it doesn’t drive the economics. The IASB is doing work that would require companies to provide some information, not just to what’s happening to goodwill, but to the subsequent performance of businesses they acquired and whether these businesses are significant.

- **Cash flows.** Cash is the life blood of all entities and without it companies run into trouble. Work has been done to improve the transparency of cash flows and transactions which investors regard as economically equivalent to cash flows that aren’t actually cash flows (e.g., how debt moves from one period to another). ¹⁰

¹⁰ For more information, see IFRS. (2022). *IAS 7 Statement of Cash Flows*. 

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2022 PAC Conference Summary: Professional Accounting Futures
Standard-development process

Developing a new standard takes several years. It involves: • two rounds of consultation, • the publishing of a discussion paper, • evaluation of the initial reaction to IASB proposals, • publishing of an exposure draft (a clear draft standard), • further consultation, • feedback evaluation, and • further outreach.

Other tools

Other tools help improve financial reporting in the near term. For instance, the IFRS Interpretations Committee answers questions about applying standards issued by the IASB, and IFRS Foundation publishes educational materials to highlight particular areas of standards, and to ensure common understanding of their requirements. For example, the IASB’s educational material on climate-related risks\(^{11}\) was intended to remind stakeholders that IFRS standards require companies to consider climate-related matters when their effect is material to the financial statements, even if the standard or the Due Process Handbook does not include the word “climate.”

“We do live in a complex world, but I’m always looking to how we can bring simplicity to our requirements. You can’t always get away from complexity. Often companies are operating with complex instruments, complex structures, and so on. But making sure our requirements are as understandable and accessible as possible can only help to support that consistent application...I think it’s a kind of ongoing quest rather than something which we will ever consider to be finished.”

Nick Anderson

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**Speaker 2: Anup Srivastava, Professor & Canada Research Chair, University of Calgary**

**Preparing for Long-run Inflation and Investing During Downturns\(^{12}\)**

“I often say economics is confusing. At the moment, it’s downright counterintuitive. Inflation is at its highest in almost forty years. And while unemployment is at its lowest, we are feeling the pain of the lower real wages that this inflation brings. Interest rates are climbing sharply. Home prices have started sliding, yet rents continue to increase. It’s a combination very difficult to explain using simple economics.”

Anup Srivastava

Anup Srivastava, in his talk and slides, explained the causes of global high inflation and outlined the actions of central banks — particularly the U.S. Federal Reserve. He described government

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\(^{11}\) For more information, see IFRS. (November 20, 2022). Educational material: the effects of climate-related matters on financial statements prepared applying IFRS Standards.

responses, problems associated with them, and actions companies can take to prepare for what he sees as a future of long-run inflation.

**Inflation: context and current causes**

“What causes inflation? Simply speaking, it is too much money chasing too few goods.”

*Anup Srivastava*

**The COVID context.** To understand today’s high inflation, we need to remember that between 2020 and 2022, because of the COVID-19 pandemic, governments around the world implemented huge fiscal and monetary programs to support workers who lost jobs or suffered significant income loss when businesses suspended regular activity.

**Quantitative easing.** Central banks around the world, in coordination, implemented quantitative easing (QE), a monetary policy through which money is loaned to banks, households, and corporations at very low interest rates to prevent financial meltdown. The U.S. Federal Reserve (the Fed) first experimented with QE during the financial crisis of 2008. Put simply, Anup said, “Quantitative easing is printing money to buy debt.”

Between 2008 and January 2022, because of QE, the Fed’s balance sheet climbed. It peaked at US$9 trillion in 2022.

**Asset bubbles in the making.** Through the pandemic, shutdowns and restrictions resulted in households spending less and amassing cash. Because of near-zero interest rates — the lowest in most peoples’ lifetimes — money found its way to what we see as asset bubbles today: stocks, housing, and cryptocurrency.

**Post-pandemic recovery.** From the second half of 2021, demand for services rebounded, but workers were, and are still, nowhere to be found. Demand for goods increased, but supply chain disruptions started by the pandemic continued. They were exacerbated by:

- Russia’s 2022 attack of Ukraine and western sanctions of Russian goods, particularly oil, gas, and coal to Europe. Combined, Ukraine and Russia are the world’s largest exporters of grains, feed crops for cattle, and fertilizers for growing crops.

- China’s zero-covid policy, which shut down the world’s most important manufacturing country. No matter what the product, asserted Anup, the likelihood is high that at least one part comes from China.

**Consequences of increased demand and reduced supply?**

- **Dramatic inflation.** U.S. inflation hit 8.3% in April 2022, the highest in 40 years (Figure 2). Put into context, the increase is even more dramatic: at the beginning of 2020, inflation was under 2.5%; by April, it had jumped suddenly to over 8% (Figure 3).
Reaction of the U.S. Federal Reserve. Given its dual mandate to use monetary policy tools to pursue the economic goals of • maximum employment and • price stability (i.e., by targeting inflation of 2%), in late 2020, the Fed tried to curb inflation. Why? To reduce food insecurity for the poorest of American citizens — an estimated 38 million people — who have little discretionary spending to pare back to free up funds for food. Fuel and rent costs increase without commensurate increases in wages at the lowest levels.

Brakes applied! By December 2021, continued upward inflation indicated to the Fed that it should correct its actions. It then • reversed QE and targeted a US$1 trillion reduction in money supply over 2022, and • increased interest rates four times by November 2022, bringing its benchmark rate to as high as 4% — the fastest interest-rate increase in recent history\(^{13}\).

Consequences of the Fed’s braking actions?

What are the consequences of this sudden applying of brakes to the economy? See Figure 4.

For the U.S. economy, the Fed’s actions lead to destruction of wealth for the not-so-poor through a decline in housing and stock prices in order to ensure food and rent security for the poor.

For other countries, rising US interest rates mean the US dollar strengthens, but other currencies weaken and their cost of capital increases. Other countries, including Canada, • must raise interest rates to prevent capital outflows and reduce currency devaluation • pay more for commodities and imports • experience increased likelihood of higher inflation, unemployment, recession, and social unrest, and • risk borrowing from and buying from

China and oil-rich states risk defaulting on debt repayments, which amplifies the likelihood of global recession.

“Why should we care about global problems? Why should we care about those countries? Because economies, the global economy, are integrated, and debt problems are contagious...Expect global realignments of country alliances...Expect countries to be more protectionist and less cooperative in nature. Expect policy changes by international suppliers...The days of keeping just-in-time inventory are gone.”

Anup Srivastava

For the fight against climate change, the near future is bleak. Europe faces energy shortages by losing Russian oil and gas, so all energy sources will be considered in the short term. India must buy oil from Russia because it cannot afford other sources. The payback time for green technologies is too slow for the current high-cost-of-capital environment. Countries will focus on their own needs, become protectionist and less cooperative.

For companies, essential is understanding your entire value chain and its exposure to supply chain shocks to avoid disruptions. The days of keeping just-in-time inventory are gone. Understanding your capital structure, because financial plans that worked over the last decade may be too risky for the foreseeable future in a high-cost-of-capital environment. Rationalizing activities, customers, businesses, brands, segments, suppliers, manufacturing sites, and product lines. Identifying core areas that provide the best returns for finite resources, while holding the most promise for the future. In short, Anup said, “Short-term survival is taking precedence over long-term growth.”

Conclusions

Anup and co-authors see a future of long-run inflation. They foresee real economic realignments happening and more protectionist policies, as the U.S. Federal Reserve has demonstrated. Just when the world needs lesser import duties, so that goods and food can flow more freely, countries are imposing export quotas to protect their own populations. “So, I think the days when you could expect the whole world to come together and act like a big family are long gone,” said Anup.

Panel 2: Investors’ Use of Accounting Estimates During Macroeconomic Uncertainty

Maria Ogneva, Professor, University of Southern California, Marshall
David Milstead, Journalist, The Globe and Mail
Anish Chopra, Portfolio Management Corp
John Aiken, Head of Research (Canada) and Senior Analyst at Barclays

Maria Ogneva, Professor, University of Southern California, Marshall

Govindarajan, V., et al. Ibid.
Analysts actually do spend more time and expend more effort during the high uncertainty times to produce research. Even the length of the reports goes up.

*Maria Ogneva*

Maria Ogneva’s recent research concentrates on the role that accounting information plays in macroeconomic forecasting.

In her talk and slides, she described earlier research in periods of high macroeconomic uncertainty. The research generally shows that macroeconomic uncertainty:

- spurs demand for financial information by investors, and the value of research to investors goes up.
- increases the supply of information from financial intermediaries, including analysts, sell side analysts, and journalists.
- increases concentration by journalists on earnings announcements (possibly at the expense of coverage of other important corporate events), who also give more coverage to bell-weather companies.

However, macroeconomic uncertainty now differs from that described by prior research, because of today’s concomitant uncertainty about high inflation. That means that little prior research is exists for today’s conditions.

Adjusting financial statements for inflation effects is complicated, Maria said. Even during low inflationary periods, only inefficient or incomplete adjustments are made by investors and analysts.

The big question is whether or not the research produced in low-inflationary periods will carry over to the current, highly volatile, higher inflation environment.

**David Milstead, Journalist, The Globe and Mail**

“Journalists are sort of sucked into the quarterly earnings game that companies and Wall Street and Bay Street play, whether we like it or not.”

*David Milstead*

David Milstead explained how journalists approach earnings results and provided examples. He spoke about the proliferation of non-GAAP measures that companies release to create “the best possible conclusion for themselves.”

With examples of non-GAAP measures such as • Earnings before interest, taxes, depreciation, and amortization (EBITDA) • adjusted EBITDA • funds from operations • operating funds from operations • distributable earnings, and • distributable earnings before realization, David illustrated why investors, journalists, analysts, and even people with a fair amount of financial sophistication have difficulty evaluating or challenging company narratives.

Canadian regulators have instituted regulations on non-GAAP measures that are in place this year. As a result, a requirement in Canadian companies’ press releases is an explanation of non-GAAP measures and why they were used.
David said, “If companies follow through and do that with the fear of enforcement behind them, all of us can see if the macroeconomic challenges that we’re facing right now are driving some of the tweaks and adjustments and prettying up of financial results we see.”

**Anish Chopra, Portfolio Management Corp**

“Once you have high rates of inflation embedded in an economy, it becomes very difficult to take it away. That’s the reason that central bankers have become very, very vigilant, and very, very, active, in trying to get the inflation numbers down.”

Anish Chopra

Using a buy-side perspective, Anish Chopra illustrated why, in an inflationary environment, two things are very important for a business:

- not having a lot of capital employed
- being able to increase pricing.

Inflation increases the cost of capital as interest rates rise to offset it, and inflation affects input costs. If a company can’t increase its pricing at the rate its input costs go up, costs will just constantly eat away at profitability.

For an investor in an inflationary environment, two things are very important:

- looking beyond the income statement to the balance sheet to see capital costs. In a period of high inflation, historical financial statements will not give an understanding of the capital employed in property, planned equipment, inventory, and other asset areas.
- understanding after-tax, after-inflation, rates of return.

Historically, high inflation rates take some time to come down. Commodity prices might come down, but wages, for example, may not. That’s because negotiated increases for labour contracts effectively embed inflation in wages for a number of years.

**John Aiken, Head of Research (Canada) and Senior Analyst at Barclays**

“It’s not just the fact that there’s uncertainty, but it compounds on itself.”

John Aiken

Providing views on economic uncertainty from a sell-side user’s perspective, John Aiken now places less confidence in corporate outlooks, because management teams are even more reluctant to risk swings in share price and valuation — and increased borrowing costs — if they fail to meet earnings expectations. (His slides can be viewed [here](#).)

The impacts of inflation on outlook result in • less forecast certainty • wider dispersion of forecast estimates between companies, and • empirical evidence for lower price to earnings (P/E) multiples with (expected) inflation.

While many argue that financial reporting becomes less relevant in times of uncertainty, John said, “I have been railing against non-GAAP earnings metrics for my entire career. There are a ton of flaws with accrual earnings. However, the comparability [and] consistency of financial statements cannot be beat when trying to analyze not only a company but [that company] against its peers.”
Auditors and accountants must exercise a very high degree of skepticism, particularly in high-risk areas, such as capital markets, John warned. Fraud is difficult to detect, but accountants should ask themselves: • does what I’m seeing make sense? • what are the incentives for the management team? • what are the incentives for fraud?

Questions from the Panel 2 Q&A

From the Panel 2 Q&A:

☐ For Maria Ogneva: Why is there little research on the impact of inflation?

Research is a publishing business at the end of the day, said Maria. So, topics that are not top of mind for the public are also not top of mind to researchers, because they’d be difficult to publish. That’s one of the reasons there’s so little research on the effects of inflation and inflation uncertainty.

☐ From Maria Ogneva to all: Do you see firms or management discussing the financial results in light of inflation?

Panelists discussed the balancing act between executives talking about pricing power and stewardship of capital, but appearing in stories that challenge them for harm to society by passing costs on to their customers. The Canadian grocery companies over the past year was an example used.15

As a company, “you want to show the investor that you’ve got costs under control. At the same time, you want to say, yes, we could pass price increases on, but you have to balance that against the company [appearing to] say we’re effectively gouging our customers.”

Anish Chopra

For the verbatim answers to the following questions, see the Panel 2Q&A:

☐ For all panelists: What do you think about the Canadian Government’s reaction to the current economy? Are they on the right track?

☐ For all panelists: The papers have been recommending a windfall tax. Comments?

☐ For all panelists: What do you see that tells you about inflation risk for companies? What would you like to see?

☐ For all panelists: We all hear the negative impacts from uncertainty. Are there any positive effects?

We look forward to seeing you in 2023 for the eighth annual Professional Accounting Futures conference.

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15 Toronto Star. (July 9, 2022). Cheated at the checkout? A star investigation suggests Canada’s largest supermarket chains are hiking prices faster than necessary and profiting from inflation. They say attributing gains to increased markups is ‘simply inaccurate’. Toronto Star.