Impacts of Rising Inflation and the Economic Environment on Financial Reporting

Extract, PSA Discussion Group Report on the Public Meeting – June 8, 2023

The submission asked the Group to consider some of the key financial reporting areas that may be impacted by adverse economic conditions.

Group members were asked to share their views regarding measurement uncertainty and other disclosures, asset impairment, liability measurement, going concern, financial self-sufficiency of government business enterprises, and other matters outlined in the submission by considering the following:

- **Potential issues faced by public sector entities because of the current economic climate.**
- **Financial and economic consequences that may need to be considered in financial reporting and disclosures of public sector entities.**
- **Topics that may require new or updated non-authoritative guidance or may suggest a possible future Public Sector Accounting Discussion Group topic.**

One Group member noted that impacts of uncertainty are often reflected in budgets and annual reports (e.g., in the Financial Statement Discussion and Analysis) rather than the financial statements.

Group members discussed whether certain measurement attributes may not appropriately capture certain economic consequences, such as inflation. They shared the following:

- Replacement cost of infrastructure may need to be explored as a possible measurement attribute. Changes in inflation and economic circumstances accentuate the need to have a measurement attribute that may better reflect what it will cost to replace the service potential of significant infrastructure.
- Using historical costs in an inflationary environment may not accurately reflect current economic circumstances.
- Using replacement cost for key operational assets may require further guidance. A Group member noted PORTFOLIO INVESTMENTS, Section PS 3041, is clear in establishing loss in value and other than temporary decline requires a write-down of the assets. Other Group members noted that current economic conditions make it difficult to establish what may be deemed temporary versus permanent.

Some Group members remarked that the current inflationary projections remain mild when compared to the period of high inflation experienced in the 1980s, citing Craig Lord's article for *Global News*, "Inflation in Canada soared 40 years ago. Is today's price surge any different?" The Group discussed the following when contemplating the severity of the current economic climate:

- To avoid a panic reaction, the Group proposes not modifying or revising existing Public Sector Accounting Standards (PSAS). It remains important to monitor how standards are being applied in reflecting the financial position and results of public sector entities.

- Conditions may require organizations to apply or reassess the applicability of certain standards. The economic decline may still be in its infancy and organizations need to be proactive in appropriately reporting its financial risks.
- Relevant guidance already exists. The Group sees no glaring gaps in existing guidance.

The Group noted that government business enterprises (GBEs) may be the most vulnerable to the impacts of high inflation:

- GBEs are more susceptible to consequences resulting from challenging economic conditions.
- The economic downturn may impair the viability of some GBEs, and/or their financial self-sufficiency from revenue outside their controlling government's reporting entity .
- Some GBEs have not recovered from economic consequences suffered from the COVID-19 pandemic. The current economic climate may further accentuate financial challenges many GBEs experienced. Drawing attention to current guidance is important.
- The Group reflected on its discussions in November 2019 and November 2018 involving the assessment of GBEs' financial self-sufficiency. They noted that the guidance provided in addressing the effects of the COVID-19 pandemic would still apply to the current economic climate.

Most Group members indicated that many public sector organizations will need to assess how current economic conditions affect asset impairment. The Group discussed:

- Deferred maintenance is more prevalent during challenging economic times. Important infrastructure initiatives may be delayed or cancelled to the detriment of the service life of assets and needed replacements to deliver services.
- Impairment is primarily based on the service potential of assets. Government-owned or -leased buildings and other tangible capital assets may need to be reviewed for impairment. The Group discussed the need for disclosures should an asset be unlikely to meet its expected service potential.

Many Group members noted challenges in applying an appropriate measurement attribute to reflect ongoing economic consequences and shared the following:

- Historical cost may need to be re-assessed as the required measurement attribute, especially for infrastructure assets.
- Measurement uncertainty is appropriately addressed in financial instruments. Disclosure requirements around liquidity, credit, and other risks are defined in existing PSAS. Public sector entities have improved their disclosures on adoption of the new financial instruments standard.
- Assumptions involved in measurement estimates may need to be reviewed. Changes in circumstances and uncertainty surrounding many economic factors may necessitate this review.

Some Group members noted that challenging economic conditions lead to difficulties in managing and maintaining infrastructure assets:

- Deferred maintenance should be tracked. Many organizations have delayed or deferred maintenance, which may not serve the public interest.

- Infrastructure deficits will become more pronounced under poor economic conditions. A few Group members noted that further disclosure should be provided in such instances, adding that such deficits risk becoming liabilities. Statement of Recommended Practice (SORP) 3, Assessment of Tangible Capital Assets, relates to reporting outside of financial statements, but applying it could provide useful disclosures about the condition of an entity's assets.
- Many organizations are attempting to also address climate change in their asset management plans. Green infrastructure remains an area where further guidance is needed as organizations plan for addressing climate-related risks.
- Some assets can hold value or even be repurposed, in contrast with depreciated assets that are no longer of use. Public sector organizations may need to be creative in the future use of underutilized assets.

The Group discussed that public sector entities have social obligations in serving the public interest. In the absence of legal obligations, the public sector may still have social and ethical obligations to consider. Service levels may need to be upheld despite challenges posed by the economy. Note disclosures on programs and commitments that may not meet service requirements should be provided.

The Group discussed whether broader reporting would be beneficial in improving the stewardship of public sector organizations:

- One Group member noted that stewardship disclosures may be important to consider as the management of resources varies across organizations. Establishing key performance indicators would prove helpful in disclosing how organizations manage funds and plan, use, and track resources. SORP-2, Public Performance Reporting, relates to reporting outside of financial statements, but applying it could provide useful disclosures about key performance indicators of an entity.
- A Group member shared that Municipal Benchmarking Network Canada is an example of how funds may be managed differently across municipalities. Some organizations are already tracking performance and are integrating key performance indicators as part of their annual reports.
- Debt has become more expensive, and performance indicators around areas such as cash management would be of public interest. Some Group members reflected that such reporting be the responsibility of management and is unlikely to fit within the confines of accounting standards. However, the cash flow statement and the extent to which interest costs affect spending on programs provide good financial statement information relevant to cash management.

Ultimately, Group members concluded that existing accounting standards and guidance are adequate for considering the current economic conditions. While existing PSAS are sufficient, the application of existing standards may require further guidance. Reference could be made to the reporting and disclosure requirements of the subtopics from this discussion to highlight the issues public sector organizations face given the challenging economic outlook.The Group encouraged PSAB to consider issuing updated non-authoritative guidance to reflect the current economic environment, such as:

- the guidance issued in response to the economic impacts of COVID-19 in 2020; and
- the guidance on the financial self-sufficiency of GBEs.