Executives ignore SEC legal requirements to warn investors about inflation risk, new research finds

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Inflation is back with a vengeance. Prices of goods and services have risen at rates not seen since the 1980s, slamming households, small businesses, corporations, and governments at all levels. But new research coauthored by Berkeley Haas Associate Professor Yaniv Konchitchki finds that most corporations that face significant risk from inflation have failed to disclose it, causing trillions of dollars in shareholder stock price loss damages thus far and threatening major additional losses for shareholders.

In a paper published in the *Journal of Monetary Economics* and coauthored with Jin Xie of Peking University's HSBC Business School, the authors show that when it comes to inflation, companies widely ignore U.S. Securities and Exchange Commission (SEC) legal rules requiring them to disclose important risks to their business. The authors developed a novel approach to extracting the attitudes and beliefs of corporate managers toward inflation risk from SEC reports, by examining over 65,000 10-K annual reports filed by major corporations with the SEC from January 2005 to April 2021. They discovered that, despite SEC legal requirements to disclose risk factors, more than 61% of the companies at high risk when prices rise never mentioned inflation or used inflation-related words in the risk disclosure section of those reports.

The failure of exposed companies to disclose inflation risk is not a trivial matter. Securities laws require public companies to disclose risks to their business in order to protect investors. "Corporate executives do not follow the legal requirement to warn shareholders about inflation risk," said Konchitchki, an expert on the interface between capital markets, corporate financial reporting, and macroeconomics. "Several trillions of dollars in shareholders wealth have been damaged, and more are at stake."

Consider the losses on stocks over the past one-to-two years of rising

inflation. Any individual or institutional investor who holds shares in companies, directly or indirectly—such as through retirement accounts—has suffered losses, Konchitchki said.

"Our textual analysis of corporate reports filed with the SEC reveal that executives in many of these companies *never* mentioned—even once over the past several years of our sample period—the word inflation, inflation-related phrases, or that the companies are highly exposed to inflation risk," he added. "Diligent investors, plaintiff attorneys, and regulators should ask, and will probably be asking, 'Why didn't you tell us?'"

The paper's findings and framework enable the identification and evaluation of shareholder damages—especially for firms with inadequate risk disclosures—and could transform corporate disclosure practices, inflation expectations, and monetary policy, Konchitchki said.

The risks of inflation

Inflation can hurt companies in a variety of ways. For example, companies currently hold in total hundreds of billions of dollars in cash on their balance sheets. "Inflation erodes the purchasing power of these cash amounts, generating massive losses that are not shown in their financial statements because the U.S. financial reporting regime is nominal—i.e., it ignores inflation effects," Konchitchki said.

Furthermore, the authors show that inflation risk exposure is common across almost all industries. Restaurant chains that can't raise menu prices as fast as the soaring costs of food see their profit margins squeezed—imagine a burrito and the avocados that go into it. Utility companies that need a regulator's approval to raise prices when costs rise are also highly exposed to inflation shocks. Silicon Valley Bank collapsed recently because it was holding billions of dollars in long-term

government bonds that plunged in value as the Federal Reserve raised interest rates to combat inflation.

Given inflation's increasing prevalence, there are emerging examples across many industries that Konchitchki said he is monitoring to study the macroeconomic effects of inflation.

Damages to shareholders

Konchitchki and Xie identified companies highly vulnerable to inflation by looking for those that had seen their share prices drop following inflation shocks, that is, when inflation data was released showing prices had risen more than had been forecasted. "We developed a measure to determine the extent to which shareholder value was damaged by unexpected inflation," Konchitchki explained. The authors found that 14-18% of the companies in their sample, calculated across all industries, are exposed to rising prices.

The failure to be warned about inflation risk could be devastating for shareholders. Konchitchki and Xie created a model to simulate stock price losses if inflation shocks occurred in a 2-6% range over three years. The model projected total shareholder damages of $0.9 trillion to $2.8 trillion for shareholders of inflation-exposed companies.

One thing did seem to change the practices of corporate executives: getting sued. Companies exposed to inflation that had been targets of shareholders' securities class action lawsuits were more likely to begin disclosing inflation risk, the authors discovered. In contrast, companies that were not exposed to inflation risk did not change their reporting practices following such class action lawsuits.

'Rational inattention'

Why would companies not discuss inflation dangers in their annual reports? Konchitchki doesn't believe that executives are trying to pull the wool over investors' eyes. After all, a failure to provide adequate disclosure puts executives and their companies in jeopardy of legal action and regulatory sanctions.

The most probable explanation, Konchitchki said, is "rational inattention"—the economic theory that decisionmakers can't process all available information but can rationally choose which pieces of information to pay attention to. The potential damage from rising prices just isn't on the corporate radar screen—perhaps especially among Gen X and Millennial managers who have never experienced periods of runaway prices. "Because inflation has been relatively low over the past decades and/or identifying the damages from inflation might have been too costly, executives haven't been attuned to it," he suggests. He predicts that in coming years executives will be more liable, and thus will pay more attention to inflation if they wish to reduce their legal liability and excel in their jobs.

This lack of attention is also a problem for Federal Reserve policymakers who have been loudly warning about inflation and its risks in a bid to manage expectations of corporations and other players in the economy. Konchitchki's and Xie's research shows that many executives aren't getting the message.

Larger lesson

As a founder of a new research area that he termed macro-accounting, Konchitchki pioneered the examination of linkages between accounting data, capital markets, and the macroeconomy. He believes there's a larger lesson in the failure to recognize the threat of rising prices in financial reports.

"There is a disconnect between executives and an understanding of the macroeconomy," he said. "We've seen shortcomings in appreciation of how inflation can be disruptive. It's important that corporate managers become more familiar with macroeconomic and accounting research and take a more holistic approach, considering how economic turbulence will affect the financial performance of their businesses."

Going forward, given the increase in the level and fluctuations of inflation, the effects analyzed in the paper will be even more critical for executives, shareholders, attorneys, and the macroeconomy, he said. And the methodology developed in the paper can be generalized to other macroeconomic risks. "Executives can improve their companies' performance and risk management by adopting a macro-accounting, research-based approach, which focuses on assessing the effects of current and forecasted macroeconomic fluctuations—such as inflation, recessions, wars, and other economic uncertainties—on their accounting performance metrics."

More information: Yaniv Konchitchki et al, Undisclosed Material Inflation Risk, *Journal of Monetary Economics* (2023). DOI: 10.1016/j.jmoneco.2023.03.004

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