



2022 AASB RESEARCH FORUM

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Exploring the Horizons of Financial Reporting*

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The Horizons Project & Sustainability

The Challenge:

How can ***Financial Reporting*** continue to meet the evolving needs of investors in an increasingly complex business and social context?

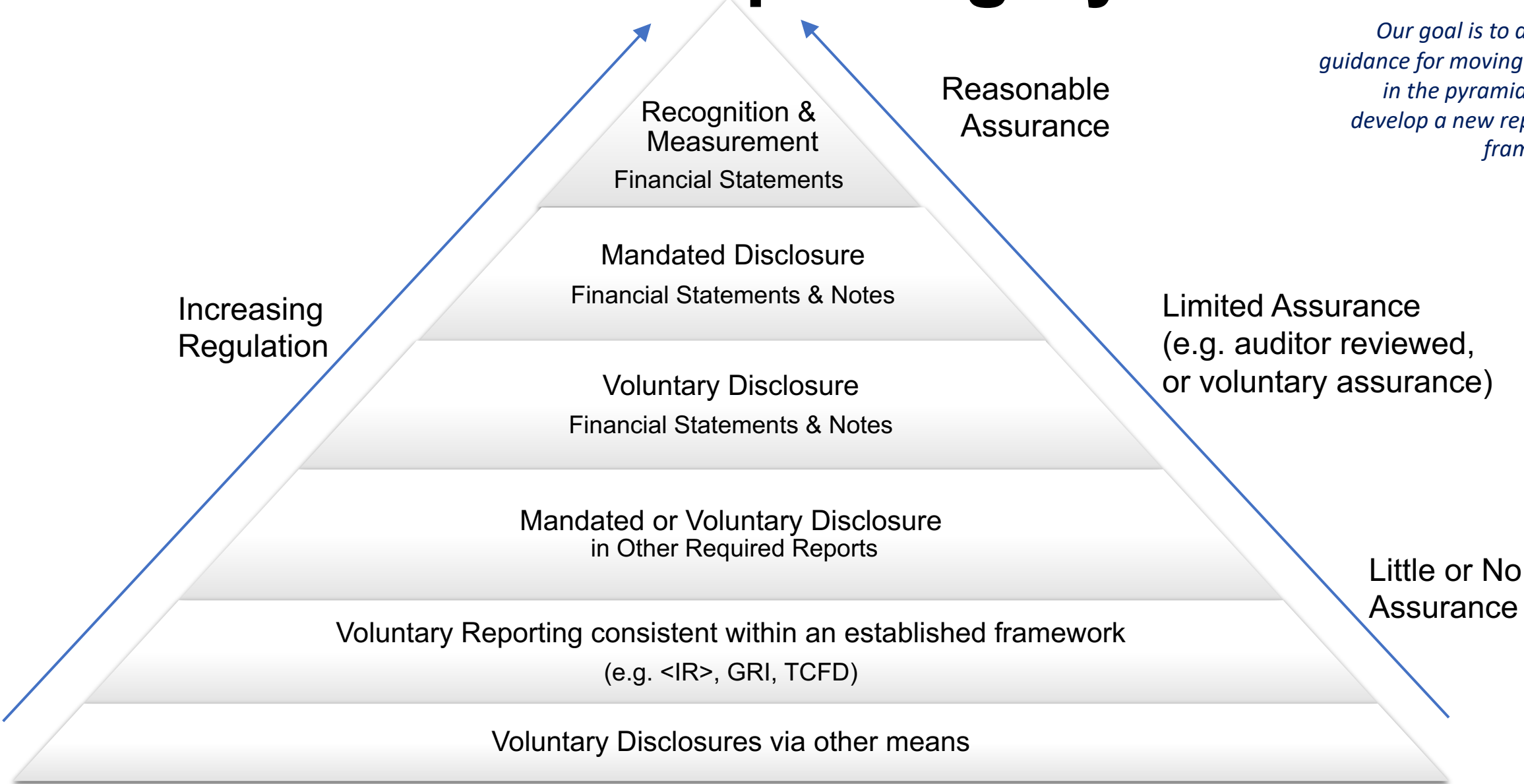
Premises:

- The competitive advantage of financial reporting as an information source for capital markets is its credibility.
- Recognition & Measurement (R&M) is the “gold standard” for investors. (AASB Research forum 2017)
- R&M (with assurance) drives **data quality**. (AASB Research Forum 2020)
- Investors are demanding more information in three key interrelated thematic areas: ***sustainability***, intangibles, and risk/forward-looking information.

Our Approach:

- Interviews/focus groups with preparers (& investors) in the three thematic areas.

The Financial Reporting Pyramid



Our goal is to develop guidance for moving higher in the pyramid not to develop a new reporting framework

Recognition vs. Disclosure: What we know

- Investors “trust” audited numbers.
- Measurement uncertainty often drives the choice between recognition & disclosure.
 - Typically, disclose so investors can make their own measurement assumptions
 - Exception: the leases standard which values leases rather than providing inputs to investors' valuation models
- Financial reports already vary greatly in “hard” vs. “Soft” numbers in the financials.
 - We already add “apples” and “oranges” in terms of the uncertainty or “fuzziness” of measures
 - The precision with which some items (currently not reported) can be measured far outweighs the precision with which we measure some items currently in financial reports

- Emissions reporting: Scope 1 to Scope 2 to Scope 3

... The focus has been around energy use in terms of contribution to climate change, the very basic level of consideration of the financial implication of climate disclosure.

- Asset valuation and impairment?

- Where are the firms assets? Where are the firms suppliers and customers?

.. the whole idea of valuing assets and taking carbon into account, leadership teams [Boards and management] aren't even really on that page yet that they even need to do that

- Can we trust the numbers: Assurance?

.. reasonable assurance of carbon data sets has been happening for a while for some and it takes time, there's many inputs...

I'm not sure that that level of assurance is uniform across the market because they're doing it voluntarily... I would worry about what reasonable assurance over carbon disclosures actually means.

Why Mandate Reporting?

- Remember our premises:
 - Credibility of Financial Reporting
 - Gold Standard of Recognition and Measurement
 - Recognition and Measurement drives data quality

Why not
Voluntary?

- Consistency and Comparability

... we've got those robust reporting systems and processes in the financial space ... and it's consistent and it can be relied upon. But in this space, we've not got consistency and I think that needs to be mandated to achieve it.

Not A Plethora of Metrics!!!

- A principles-based approach: allowing **judgment** but with transparency

... when we're talking about ... the needs of users, there is that room for interpretation of principles of reporting ...to tell the story

... pulling it back to what's material whilst maintaining transparency

... but it's a new area, absolutely, and mistakes will be made.

Materiality?
Proprietary
Costs?

What Should We Report?

- The impact of climate risk on Asset Valuations?
 - As an impairment?
 - As a contra-asset provision?
 - What about the upside of the risk?
- An intangible liability for climate risk?
- Impacts on earnings or other comprehensive income?



Climate Risk Reporting: Looking Forward

- Financial Reporting is already forward looking!

...we've always looked at future information when we've been calculating the valuation of assets and ... trying to determine future cashflows. ... I know a lot of people are pushing back on future-orientated information because we have been comforted in the past that we've been reporting and auditing past, historic information

- The “Problem” of Measurement Uncertainty

... I think the only part that I find a huge uncertainty is about government action and government regulation

... I deal a lot with the scientific community for of course eliminating measurement uncertainty is their MO and yet investors are just saying look, within cooee is pretty good

.... So I'm not too worried about measurement uncertainty, I think what we're going to do is we're to have rapidly improving models and rapidly improving measurements to resolve that...

- The uncertainty is in the valuation not in the science
 - E.g. biological characteristics of assets (e.g. carbon sequestration)

“ISSB confirms requirement to use climate-related scenario analysis”, 1/11/2022

So, it's almost very basic, the recognition by the reporting entities actually needs work. Very few that I work with have done good scenario modelling around adaptation to climate change risk.

... they've almost got to get to the point of A, realising they need to do that kind of scenario modelling and B, then applying it to their own portfolio and ... bringing in people with the right expertise to say well in that case how does that impact the value of the assets in the portfolio?

- Modelling to inform measurement, involves modelling:

1. Climate Change


- E.g., IPCC

2. Entity specific financial impact of climate change

- Somewhat akin to impairment modelling.

3. The financial effectiveness of the entity's response to the expected impacts

- In essence a statement of managerial intent



Decreasing
Credibility

Measurement Uncertainty Revisited

- Modelling financial impacts of climate change

Where are our assets? What is a scenario modelling around climate change and therefore if sea level rises by this amount ... are we going to lose assets? Are assets going to be reduced in value? So playing it through.

- Shifting from Measuring Cost (with impairment) to Measuring Value.

- Bringing back professional judgment to accounting!

- Measurement uncertainty should not prevent recognition
- Need to communicate uncertainty appropriately.

... we're going to have to accept measurement uncertainty like we're going to have to accept [change]. I think what we're going to have to agree on is different levels of accuracy, probably depending on the amount of risk, financial or otherwise, related to the measurement



Making dreams come true!

I used to have this dream of a transparency balance sheet where you imagine clear plastic film so on the first layer is your paper where you write your hard and fast numbers so you got your cash and your receivables and then you might layer another transparency over it where you put some softer numbers and then you might have a third layer where there's even softer numbers again.



Policy Implications & Unanswered Questions

Policy Implications

- Climate Risk impacts should be a part of *financial reporting*
 - More than just asset impairment.
- Measurement uncertainty should not negate R&M. Scenario analysis informs measurement:
 - Mandate a climate change model (*stage 1 model*)
 - Report and assure financial impacts of climate change (*stage 2 model*)
 - Constrain disclosures about responses to climate change (*stage 3 Model*)
- Empower preparers & auditors to use professional judgment to enhance reporting quality.
 - Mistakes will be made!

Unanswered Questions

- Cost/benefits of reporting?
- How do we communicate measurement uncertainty to users?
 - Disclose ranges? confidence intervals?
- Which scenario to use in measurement (worst, best or most likely case).
- How many scenarios should be disclosed?
- How much “fuzzy” measurement can investors bear? (pun intended 😊)



Image source: Wikipedia

**Check out our report
published by CPA Australia:**

<https://go.unimelb.edu.au/i8de>

The Horizons of Financial
Reporting – Part 1
Preparer Perspectives

