The Horizons of Financial Reporting – Part 2

Investor perspectives and measurement uncertainty

2024 Edition.

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Table of contents

Executive summary 1

Introduction 2

The financial reporting pyramid: A recap 3

Research approach and data 4

Investor perspectives: Intangibles 5

Challenges to broader recognition and measurement of intangibles 5

Rebuttal and insights for reporting 6

Policy implications and issues 7

Investor perspectives: Sustainability-related financial reporting 8

Challenges to financial reporting in relation to climate risk 9

Rebuttals and insights 9

Policy implications and issues 11

Other insights about investors and measurement uncertainty 12

Conclusion: The future of financial reporting 13

References 14

Research team 15

Executive summary

We report on investor perspectives regarding the potential expansion of recognition and measurement of intangible assets and climate-related risk in financial reporting. We focus on these items as they are timely and topical issues, and current reporting practices are challenged by the measurement uncertainty they entail. To develop insights, we conducted interviews with a broad range of investors. Consistent with the first report, **The Horizons of Financial Reporting - Part 1 - Preparer Perspectives (Part 1 report)** in the series, we place recognition and measurement as the apex of the financial reporting pyramid, representing the highest quality of financial reporting.

We address several challenges to expanded recognition of intangible assets: lack of relevance, subjectivity of measurement and proprietary costs. Our findings indicate that investors support expanded reporting of intangibles, including wider recognition of intangible assets in general-purpose financial statements, provided standardised (i.e., comparable and auditable) measurement techniques can be established and transparently communicated via note disclosures.

We also identify and counter several challenges to expanded reporting of sustainability matters, including climate-related risk: lack of controllability, lack of comparability, and greenwashing concerns. Investors expressed strong support for expanded reporting of climate-related risks, particularly through climate scenario analysis. However, at present, investors prefer this disclosure to be included in a separate sustainability report. There remains, however, a significant gap in the clear articulation of the reporting of climate-related risks to the financial impact of these risks within financial reports.

We conclude by identifying key implications for policymakers in this space. We particularly emphasise the importance of considering expanded reporting, including wider recognition, of intangibles, and better explication of materiality and connectivity in sustainability reporting.

Introduction

This report is the second in a series of reports focusing on the horizons of financial reporting, with a focus on exploring opportunities to clarify the scope of financial reporting. The series originated from the ongoing debate around the relevance of general-purpose financial reports in their current form, including the content within, and questioning whether they can continue to meet the evolving information needs of investors in an increasingly complex business environment (Davern et al. 2022)[1].

In exploring how financial reporting can continue to meet the changing information needs of investors, in this report we provide guidance to help future-proof general-purpose financial reporting as user needs continue to evolve in an increasingly complex business and social context. By doing so, the aim is not necessarily to extend the scope of financial reporting, but rather to help in re-positioning the financial reporting function to ensure it remains an effective communication tool to 'tell the story' about an entity's performance.

Building on the first report in this series (**Part 1 report**) which focused on the preparer perspective, in this report we explore investor perspectives on the horizons of financial reporting. We specifically examine the role of measurement uncertainty in determining what warrants recognition and measurement in a preparer's general-purpose financial statements. Following the financial reporting pyramid introduced in Part 1 (Davern et al. 2022), we consider recognition and measurement as the pinnacle of financial reporting. We acknowledge that measurement uncertainty presents challenges to full recognition and measurement as highlighted in our previous report.

… measurement uncertainty is not necessarily a challenge that policymakers must resolve by providing explicit guidance or standards on measurement techniques. Rather, what is required is clarity about the issues that drive ranges and sources of measurement uncertainty, perhaps through relevant disclosures in the notes. This can inform users as they seek to learn how much uncertainty is typically associated with different reported items and how they should incorporate that into their models. Decision-useful reporting, and interpretation of financial reports does, and always should, require the exercise of judgment. (Davern et al. 2022)

Consequently, in this report, we explore investor perspectives on the challenges and enablers of reporting on items that fall within the scope of financial reporting but often, for various reasons including concerns over measurement uncertainty, are not currently recognised in financial reports prepared in accordance with IFRS Accounting Standards. This research report builds on earlier research undertaken by Davern et al. (2018a, 2019a) which focused on **the decision usefulness of general-purpose financial reports of Australian listed companies**. This prior work found that despite the criticism often aimed at financial reporting, the decision usefulness of financial reporting has endured.

Following the themes of the Part 1 report, we focus on the reporting issues relating to intangibles and sustainability, two items typically involving greater measurement uncertainty. We aim to understand the challenges in advancing reporting up the pyramid to provide recognition and measurement in light of this inherent uncertainty. Specifically, we explore, from an investor perspective, the question: *what are the challenges and opportunities for expanding recognition and measurement to items where current standards deem measurement uncertainty as problematic?*

[1] Financial reports are generally accepted as the primary means by which companies communicate information to investors, emphasising their financial performance and position (CPA Australia 2019). However, some prior research suggests the overall relevance of accounting information, most notably periodic earnings, has declined in relevance for securities markets. More recent research by Barth et al. (2023) argue that rather than 'declining', the relationship between share prices and accounting information appears to have evolved, to become more 'nuanced'.

The financial reporting pyramid: A recap

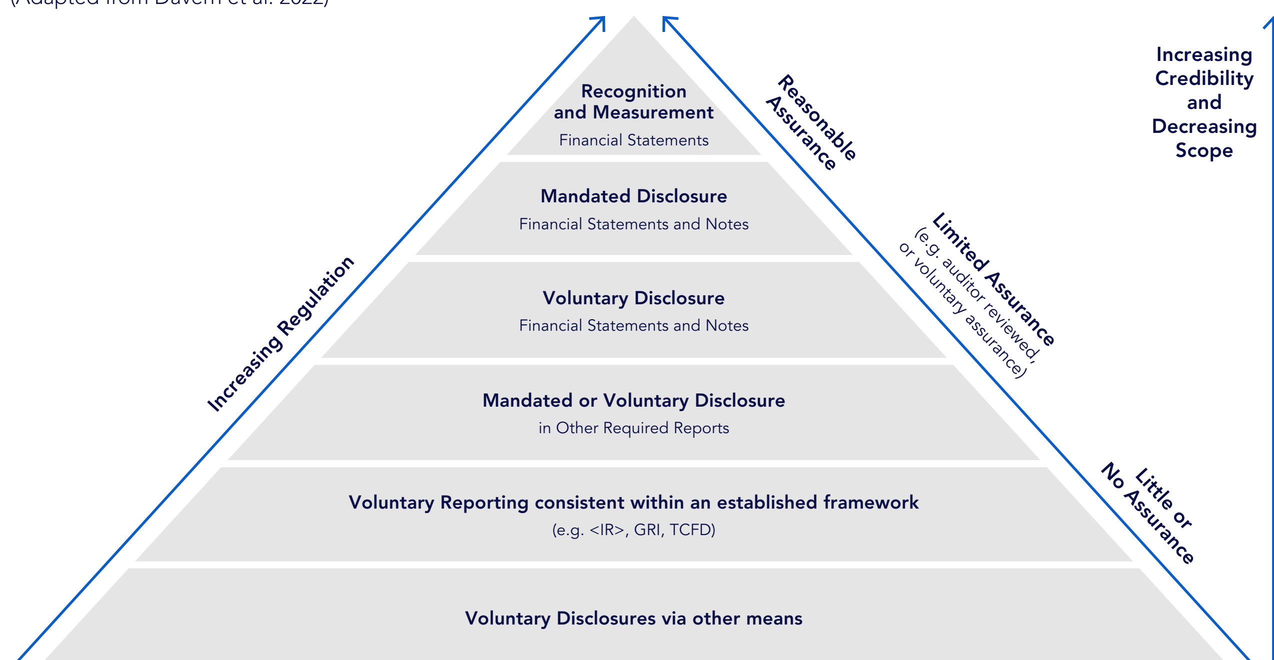
The Part 1 report introduced the 'Financial Reporting Pyramid' (reproduced in Figure 1 below) as a framework for identifying the increasing quality of reported information as it moves from broad voluntary disclosure to recognition and measurement in accordance with IFRS Accounting Standards. The apex of the pyramid represents the 'gold standard' of recognition and measurement, which is consistent with the findings of prior studies that recognition and measurement lead to higher quality underlying data (Davern et al. 2019b). This result may be attributed to increased management and auditor attention to items for which a higher level of reporting and scrutiny is required.

We argue that descent from the apex of the pyramid is, in part, because of the challenges of measurement uncertainty. Failure to satisfy the criteria for general-purpose financial statement recognition due to uncertainty in the measurement of the underlying phenomena, or the ascription of a dollar value to that phenomenon, will likely result in disclosure in the notes that accompany general-purpose financial statements.

As discussed in the Part 1 report, *ceteris paribus*, more credible reporting of an individual item results in more informative reporting of that item. In other words, as the reporting of an individual item higher up the pyramid is more credible, the financial reporting of that item is more informative. However, as reporting moves up the pyramid it becomes more constrained in scope and, thus, provides a countervailing force that may reduce the overall informativeness of financial reporting. This creates a tension between a desire to report individual items higher up the pyramid to enhance informativeness, and the fact that the requirements for that higher level reporting may result in excluding the reporting of relevant items, thereby undermining the overall informativeness of the financial report. Accordingly, in the context of intangibles and sustainability reporting, the aim of this Report is to examine the potential for reporting items with greater measurement uncertainty higher toward the apex of the Financial Reporting Pyramid.

Figure 1. The financial reporting pyramid

(Adapted from Davern et al. 2022)



Research approach and data

To explore the key research question, we conducted semi-structured interviews with a diverse cross-section of investors. The interview protocol covered a broad range of topics, from understanding of the role of audited general-purpose financial statements in investor decision-making through to issues of trustworthiness, informativeness and measurement uncertainty, in the context of intangibles and sustainability reporting. Interviewees included investors with the following positions/backgrounds:

- Sophisticated retail investors
- Private investment managers
- Boutique investment management firm
- Large wealth management funds
- Short-term quantitative/algorithmic traders

All interviews were conducted over Zoom in the first half of 2023, recorded, and professionally transcribed. The interviews generated over 40,000 words (79 pages) of transcripts for coding and analysis.

The selection of investors for the interviews is intentionally diverse, spanning retail investors and sophisticated professional investors. Although the term 'investor' is often used generically when referencing users of financial statements and financial information, the profile and information needs of retail and professional investors differ in terms of purpose and investment time horizons – that is, 'one size does not fit all' for investors (Chenhall & Juchau 1977). As part of the current report, these differences are highlighted and form part of the narrative around investor views.

In the following sections, we organise our analysis based on two key thematic areas; (i) sustainability-related financial reporting (and, in particular, climate risk); and (ii) intangibles. There are two primary reasons for focussing on these areas; (i) each area is currently on the work agenda of standard setters both nationally and internationally;[2] and (ii) both issues present challenges to the boundaries of financial reporting as currently stated (Barth, 2022), with challenges particularly arising due to inherent measurement uncertainty.

The interconnectedness of the above issues has also been noted by researchers, practitioners and standard setters, including the European Financial Advisory Group (EFRAG), which explicitly noted the need for taking into account the borders between financial reporting and sustainability reporting and the interconnection between the two dimensions.' (EFRAG, 2023)

We synthesise our findings into insights to inform future policy guidance on enabling reporting that incorporates these thematic areas and potentially allow for greater measurement uncertainty towards the apex of the pyramid.

[2] For further information on the work plans of relevant standard setting bodies, please refer: https://www.ifrs.org/projects/work-plan/ (IASB); https://www.iasplus.com/en/news/2023/07/iasb-issb-work-plan (ISSB); and https://aasb.gov.au/media/vsamzkcm/workprogrammarch2023.pdf (AASB).

Investor perspectives: Intangibles

A key purpose of the interviews was to explore investor perspectives on recognition and measurement, which included seeking insights into conceptual or other matters that, from the interviewees' perspectives, drive the debate on the recognition and measurement of intangible assets. Generally, speaking, investors expressed diverse views on this issue and how best to communicate information about intangible assets to investors.

A central debate about how to communicate information to investors about intangible assets is whether this is communication best achieved through recognition and measurement or note disclosure. This is particularly relevant in the context of internally generated intangible assets, which (aside from some limited exceptions, such as development costs) are not generally recognised in an entity's statement of financial position, in part because they do not have a cost that is reliably measurable given they do not result from an exchange transaction. Specifically, para. 51 of AASB 138 *Intangible Assets* (AASB 138) notes that:

It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition because of problems in:

(a) identifying whether and when there is an identifiable asset that will generate expected future economic benefits; and

(b) determining the cost of the asset reliably. In some cases, the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the entity's internally generated goodwill or of running day-to-day operations.

It is important to note that the Conceptual Framework for Financial Reporting addresses measurement uncertainty and acknowledges that:

… the use of reasonable estimates is an essential part of the preparation of financial information and does not undermine the usefulness of the information if the estimates are clearly and accurately described and explained. Even a high level of measurement uncertainty does not necessarily prevent such an estimate from providing useful information. (para. 5.19)

Despite this, the comfort with uncertainty expressed in the Conceptual Framework does not translate directly to standards such as AASB 138 in relation to the recognition of internally generated intangible assets, nor does it translate into disclosure practices, as evidenced by the lack of voluntary disclosures of unrecognized intangibles (Davern et al. 2021).

Challenges to broader recognition and measurement of intangibles

The interview data reveal several challenges related to recognition and measurement of intangible assets beyond the current requirements (i.e., externally acquired intangible assets and some internally generated intangible development assets). These challenges can be identified as follows:

(a) Relevance of a broader assessment beyond the financial statements:

… the numbers in the financial statements regarding intangibles … really, if you're trying to understand a far-dated business's prospects, [I] really don't look to the balance sheet, you really have to do a broad assessment, you need to speak with the company, you need to speak with competitors. And you actually come up with a soft estimate yourself. (Investor 1)

(b) Relevance given the nature of the entity:

There are relatively few businesses for which, for us, for which the book value of intangibles would make a difference to our investment decision (Investor 3)

(c) Subjectivity of measurement favours disclosure rather than recognition and measurement:

… when you're valuing these things, it's … not a quantitative skill, it's more of a qualitative perception. So, I'd be interested in notes on those sorts of things. Probably not on the balance sheet, though …. (Investor 4)

(d) The proprietary costs of reporting commercially sensitive information:

They want to encourage investors, but they don't want to give away every single detail about the opportunities and their businesses. And they might have some secret or undisclosed patents or something that they're working on. You know if it's pharmaceuticals and things like that, I don't know a lot about that kind of business, but I can imagine where new product launches that they don't want to put on there …. (Investor 9)

Rebuttal and insights for reporting

Most of these challenges to broader recognition and measurement of intangible assets can readily be rebutted, as demonstrated below:

(a) Financial statements are a complement to other information sources. A broader recognition and measurement of intangible assets provides a comparison point for investor-generated "soft estimates", enabling both a clearer valuation of the intangibles (i.e., a confirmatory role) and an assessment of management's credibility in reporting (i.e., a credibility role):

Having that to support how much credence and credibility you place on those statements. (Investor 2)

INSIGHT

There is a need to consider the dual complementary roles of broader recognition and measurement as both confirmation and credibility checks on valuations.

(b) The varying relevance of intangible assets for different entities is not an argument against their broader recognition and measurement, but rather an argument for an appropriately scoped standard. As one investor noted:

I could imagine potentially some big expansion of the way in which R&D might be reported or something might have an effect for pharmaceutical companies in their research phases and things like that … and that could have profound effects on their financial position …, there might be some brand names as well, that could get quoted on there. But I think for a lot of those intangibles, particularly on the brand side of things far more than the pharmaceutical side of things, I think the outcomes of the brand are very evident from the financial metrics that are otherwise put out by the firm and therefore get valued by people anyway. (Investor 3)

INSIGHT

A deciding factor in the recognition and measurement debate is the extent to which investors are valuing currently unrecognised items already – whether through "soft estimates" or evident in existing financial metrics. The key question is one of information asymmetry: To what extent does entity management have unique information that is material to the valuation of the item in question?

(c) Regarding measurement challenges and subjectivity driving a shift down the reporting pyramid to disclosure rather than recognition and measurement, investor views are mixed. While Investor (4) was pushing for disclosure in the notes, Investor (1) held a contrary view, remarking:

I don't think that's a reason to demote the presentation or the representation of the number. (Investor 1)

The underlying basis for these mixed views is an empirical question, but it is notable that Investor (4) generally held a more traditional, narrow-scope view of financial reporting, and Investor (1) displayed greater comfort for subjectivity in financial reporting noting that of "softer" numbers in general:

[Financial Reporting is]… an information access point that has rules around it, where you understand the subjectivity that goes into all of it in varying amounts. (Investor 1)

While there are mixed views and debate, one investor who saw both competing perspectives commented on the recognition and measurement of intangibles:

So I think it would be good to have it, but then you'd have to have all the assumptions laid out in a way that people could look at it and go, I feel it's less than that, or I feel it's more than that. (Investor 2)

Transparency around assumptions was a common theme, and the important role of assurance was also highlighted by other investors:

I would want the assumptions, I would want some sort of note to say that it's subjective. And if there's an external body that has validated the information … your auditor or someone external. (Investor 9)

INSIGHT

Uncertainty and subjectivity in recognition and measurement can be addressed through assurance and appropriate transparency of the assumptions and the manner in which value is determined. Transparency needs to be meaningful, unlike some of the current examples we see with input ranges for level 3 fair values. Arguably assurance needs to consider whether transparency is sufficient to allow meaningful interpretation of an uncertain or subject measurement.

(d) The issue of proprietary costs was not seen as problematic when the level of aggregation and the broader information environment were considered:

I actually don't think that's a massive risk for a collection of reasons … even if we were to expand the disclosure of intangibles, the way in which businesses would aggregate that information would heavily minimise the extent to which there was competitive disadvantage.

I think there's already a wealth of information about the material things out there, so that disclosing an aggregated figure of value, whether it's at cost or fair value probably doesn't make a massive difference to the competitive environment. (Investor 3)

INSIGHT

Proprietary costs are likely given too much weight in the case against recognition and measurement, or even disclosure. Key here is determining an appropriate level of aggregation that provides meaningful information to investors without unduly incurring proprietary costs.

Policy implications and issues

While expanding the reporting of intangibles is not without debate from an investor perspective, it is nonetheless clear that many of the challenges can be rebutted. With appropriate scope, a standard mandating an expansion to the recognition of intangibles could enhance the relevance of general-purpose financial statements to investors. The appropriate scope would need to consider the above challenges and rebuttals – ensuring relevance by addressing information asymmetries, handling subjectivity through transparency in valuation, and managing proprietary costs by mandating reporting at a sufficiently high level of aggregation while remaining informative.

An important caveat here is that not all investors are alike, not just with respect to information needs, but also with respect to the ability to interpret financial reports. As one investor commented:

I think certainly in an Australian market, where the retail investor is reasonably prominent … adding in an intangible factor that could potentially mislead those investors, I think would likely be problematic. And you could imagine sort of a delay in impairing brand value or something that led some people to think that there was value in businesses where that brand was eroding quite quickly. (Investor 3)

Nonetheless, retail investors themselves see value in expanding the recognition of intangibles, as one noted:

I think it just quantifies because then it's something that you can then measure if I'm considering to invest in two similar businesses. That way, I can actually make a direct comparison of I should you invest in Company A versus Company B, it's a lot easier to compare, like, similar to I don't know, using a metric, like earnings per share. (Investor 6)

In short, the International Accounting Standards Board's (IASB)'s recent launch of a comprehensive review of accounting for intangibles is much needed (IASB, 2024). The evidence above suggests that the review should give substantive consideration to expanding the balance sheet recognition of, and in turn addressing the measurement challenges relating to, intangibles.

Investor perspectives: Sustainability-related financial reporting

Since the establishment of the International Sustainability Standards Board (ISSB) in November 2021, international developments in sustainability have moved at pace. The ISSB was tasked with developing a global baseline for sustainability reporting[3], which it delivered in June 2023 with the release of IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* (S1) and IFRS S2 *Climate-related Disclosures* (S2). In December 2022, the Australian Federal Treasury followed suit and released a consultation proposing that climate reporting become mandatory for Australian entities to be phased-in over three years[4]. At the time of writing, the current proposal is that the phase-in will begin for Group 1 entities for annual reporting periods beginning on or after 1 January 2025, with the adoption of the Australian-equivalent of S2 (subject to some transitional relief) mandatory for Group 2 entities from 1 July 2026 and Group 3 entities from 1 July 2027.

The Australian Federal Treasury confirmed in a subsequent consultation in June 2023[5] that:

The Government has committed to … provide Australians and investors with greater transparency and accountability when it comes to their climate related plans, financial risks, and opportunities. As part of this commitment, the Government will introduce standardised, internationally-aligned reporting requirements for businesses to make disclosures regarding governance, strategy, risk management, targets and metrics – including greenhouse gasses.

Concurrently, the IASB added a project to its work agenda in March 2023 on climate-related risks in financial statements[6]. Accordingly, the role of sustainability reporting is at the forefront of many investors' decision-making. Consistent with our first report, we focus on climate risk, following the ISSB's and the Australian Federal Treasury's climate-first approach and the recent IASB project developments. We focus on the financial reporting aspects of climate risk, as the issues of connectivity between the financial reports and sustainability reports is very much an open question. S1 already states that, in their sustainability reports, entities are to make disclosures that enable financial statement users to understand how sustainability-related risks and opportunities are linked to information reported in the financial statements (Barckow & Faber, 2023; ISSB, 2023a, para. 21). How then should financial reports endeavour to connect to sustainability reports?

[3] aasb-auasb_sustainabilityreporting_12-21.pdf (accessed 1 August 2023).

[4] Climate-related financial disclosure - Consultation paper (treasury.gov.au) (accessed 1 August 2023).

[5] Climate-related financial disclosure - Consultation paper (treasury.gov.au) (accessed 1 August 2023).

[6] IFRS - Climate-related and Other Uncertainties in the Financial Statements (accessed 1 October 2023).

Challenges to financial reporting in relation to climate risk

In exploring how climate risks should be reflected in financial reporting, we discussed multiple approaches with investors, ranging from qualitative to quantitative disclosures and to the extreme case of recognition and measurement of a provision or intangible liability for climate risk in the financial statements. Our interviewees raised several challenges to the factoring of climate risk in financial reports, including in the financial statements themselves. We detail those challenges below:

(a) Financial reporting about climate risk introduces noise, and it is insufficiently within management's control to be relevant:

Why would I not necessarily want to see it on the face the financials, I think it will create a lot of noise as to what is controllable by management. I think the extent to which management has the ability to avoid some of those costs might be relatively low, and I suspect in a number of businesses is relatively low. Additionally, there are so many outside influences that affect that. That would be potentially something that sort of mismatches management's accountability with what we're seeing on the financials and the extent to which that would filter into the income statement or into comprehensive income …

I don't believe the financial statements need to be this one-stop shop for every possible estimate of everything. (Investor 3)

In a similar vein, investors queried whether it was meaningfully possible to quantify climate risk:

How do you account accurately for it? … climate risk is tricky, because it's near impossible to quantify, except in obvious operations, such as burning of fossil fuels. (Investor 8)

(b) The investors interviewed also raised concerns about comparability of reporting in the context of climate:

So, for example, I think that {company} in their annual report, they had disclosed a reduction in carbon emissions year on year. But I don't understand what that impact has, from an Australian perspective and an industry perspective. So are they market leaders or still laggards … (Investor 6)

(c) Climate-related reporting can be a distraction and obscure 'real' financial performance:

… it's just window dressing to try and appease, unfortunately, large institutional and institutional investors who are getting a lot of pressure from retail investors … But functionally, the retail investor doesn't actually know how this operates. It's just, it's the popular thing to do right now. (Investor 5)

I do get caught up in some of the infographics. Which can create a bit of noise and distraction to the body of the information. (Investor 6)

Rebuttals and insights

Underlying the different views of our investors it was clear that much of the debate was due to the relative infancy of reporting in this domain, with investors largely only having experience with unstandardised voluntary reporting. Consequently, we found our investors had difficulty imagining how financial reporting could look in this space in the future. This was in stark contrast to their experience with reporting about intangibles. Nonetheless, rebuttals to the challenges identified in sustainability reporting (both within financial reports and separately) bring some insight to the picture:

(a) The issues of noise and controllability may be valid, but it is arguably true of many of the items on which we already include in general-purpose financial reporting[7]. Already we see investors demanding climate-related information, even if noisy measures or "fuzzy" estimates are involved:

I wouldn't want both {quantitative and qualitative information}, I would have to provide some context and colour around the numbers. [I]think if you knew what the assumptions were, that would provide comfort of a fuzzy number. (Investor 6)

[7] For example, income taxes are reported, but are largely not controllable, and we report on fair values with only level 3 inputs.

While it was recognised that getting quantitative information wrong may engender a risk of litigation, this did not rule out the value of quantification:

… if it had a, obviously, with the litigation costs, that would have an impact on the bottom line. So yes, that would be a concern. But I think … I would sway more towards that I'd have more comfort that they've attempted to identify key risks in their business. And, you know, if they had put clear assumptions in place, if there's particular outliers that have played out, I think I would be more understanding of that flow on effect. (Investor 6)

Notably here, the investor is referring to climate scenario analysis within the sustainability report – there was little appetite for quantification in monetary terms of climate risk in the financial statements.

INSIGHT

Difficulties in quantification can be addressed by the transparency of assumptions, but at present investors would prefer that information on climate-related risks and opportunities be presented separately in a sustainability report and not within the financial statements. However, there was acknowledgement that there may be issues, such as asset impairments, that will feed from climate scenario analyses in a sustainability report to line items within the financial statements. Connectivity is clearly a nuanced area that is not yet well understood.

(b) Comparability is arguably why we need standards, and investors were keen to see developments progress in this space, particularly regarding information within sustainability reports:

… it comes back to being able to compare to peers. I'm not particularly concerned from an investment manager's perspective, what the ESG score of a mining company is versus a bank, it's an irrelevant data point, and probably still will be irrelevant at the 10 year mark. However, I'm going to be interested in between the difference between one mining company and the next. That's going to be useful information. (Investor 8)

… if it isn't standardised, and you can't compare. (Investor 8)

I think, where it can be quantified, we'd like to see some sort of standard procedure on it. If there's a regulator that has a standard for, okay, environmental impact is going to be assessed on a scale of one to whatever, one being great, whatever being horrible, and then you have that consistently across the board. (Investor 5)

INSIGHT

While there was an appetite for standards to enhance comparability, caution is still required. There is a risk of creating a plethora of metrics (see, for example, the cross-industry and industry-specific metrics within IFRS S2), that makes comparability a challenging multi-dimensional problem. Some metrics will be industry-specific, again challenging comparability (and somewhat akin to the issue of industry-specific non-GAAP measures in financial reporting (see Davern et al. 2018b, 2019a). There are also concerns about data quality. Reporting on climate-related risks will increasingly rely on data from outside the entity (e.g., Scope 3 emissions upstream in the supply chain), where data quality may be difficult to assure. There is also prior evidence broadly suggesting that financial reporting disclosures, as opposed to recognition and measurement, are based on lower-quality data. (Davern et al. 2019b)

(c) Greenwashing and window-dressing in sustainability reporting, while a legitimate concern, is exacerbated by the relative infancy of reporting in this domain. As standards develop and investors have access to an entity's history of reporting on climate-related risks and opportunities, there will be fewer occasions for greenwashing. Given their forward-looking nature (and, hence, potential for strategic presentation of information), investors were keenly interested in being able to, over time, undertake longitudinal analysis of reported climate scenarios:

I think that the scenarios is a good way to do it and say that with these assumptions, and we've got various examples in the past of using scenarios within the accounts, where it points out to the variability of things that can influence the outcome, so might be currency, you know, but even currency. (Investor 2)

These scenarios may connect to the financial statements, as they inform impairment judgments:

Yeah, I think … a note with the general assumptions is … good? Yeah, it just says, you know, it's on the balance sheet and it has, you know, see note three or something. And you got to note three and it says, we've used the whatever the standard climate change scenario is, or we've assumed this. And this is our range or something like that wouldn't need to be too long. But just like a few percentages and ranges and things like that. (Investor 9)

As to whether a climate risk provision or liability should be recognised, the consensus was against such reporting – unless it met the already established recognition criteria, including reliable measurement:

Is the climate liability, suggesting that the business itself would have this obligation if legislation was ever passed that would make them responsible for this obligation? Or is it saying that as a result of their operations, there is this obligation that somebody else is going to end up paying largely future generations and governments and what have you? And I think those the two results have really different interpretations and really different consequences as an investor. And so would I want to see it? Yes. If it was in a regime where the costs were actually going to be borne by the companies? Then I think I definitely would want to see it. If not, then what I want to see that on the face of the financials, possibly not, is it something that should be heavily disclosed elsewhere? Quite possibly. (Investor 3)

INSIGHT

Scenario analysis clearly has a key role to play in informing investors of an entity's climate risk exposure, but clear reporting standards, part of which may include requiring transparent articulation of the underlying assumptions used, are required to help mitigate the risk of greenwashing and window-dressing.

Policy implications and issues

The clear consensus among investors is that climate risks are not yet ready to reach the pinnacle of the financial reporting pyramid – recognition and measurement. This finding supports the establishment of separate standards for sustainability reporting, but also highlights the need for careful consideration of the connectivity between sustainability reporting and financial reporting. Climate scenario analysis plays a key role, but much remains to be explored regarding how best to communicate these scenarios without misleading investors or distracting them from underlying financial performance. For example, what are the thresholds at which a climate scenario should lead to asset impairment in the balance sheet? Materiality, a crucial but often poorly understood concept (e.g. Frick, et al. 2023), is particularly relevant here. Materiality assessment involves integrating both quantitative (e.g. financial consequences, and the likelihood of climate risk events) and qualitative information.

Other insights about investors and measurement uncertainty

As noted previously, we specifically sought to interview investors that represented a broad cross-section of the investor marketplace. This breadth enables us to draw additional, broader insights about financial reporting through comparing and contrasting the perspectives of different investors.

For example, it was very apparent in the interviews that not all investors are alike. Investors differ widely in their views on whether expanding recognition of items in general-purpose financial statements is more useful for decision-making. Investors also have vastly varying degrees of comfort with measurement uncertainty and subjectivity in general-purpose financial reporting. Their approaches to interpreting financial information also differ, from relatively unsophisticated retail investors to investors relying exclusively on quantitative analytics.

Further, the approach of one investor for dealing with measurement uncertainty was particularly interesting. This investor was a long-time horizon investor, intending to hold stocks for 10–15 years. To handle measurement uncertainty concerns, this investor timed their investments, such that they ensured measurement uncertainty for target investments was low, or the potential variability was primarily on the upside for the investor. In essence, their investment strategy took measurement uncertainty into consideration in the timing of the buy decision.

The value of financial reporting to investors was evident even for investors relying exclusively on market analytics and who did not use the financial statements of an entity at all in making an investment decision. For example, one investor described their approach as chasing short-term volatility and mispricing in the market using quantitative analytics (i.e., it appears to be a sophisticated form of technical analysis). This investor, while not using the financial reports themselves, wanted to see improved financial reporting. Their rationale was that while better reporting may reduce volatility, it grows the pool of investors and so creates more opportunities for trades following their algorithmic approach.

Conclusion: The future of financial reporting

We reaffirm our position that voluntary disclosures are insufficient, and advocate for either move to expanded recognition and measurement (e.g. for intangibles) or better articulation of the linkages between mandated disclosures (e.g. climate scenario analysis in a sustainability report) and recognised items on the face of general-purpose financial statements. Notably, the IASB's intangibles project and the move to mandated climate reporting by policymakers indicates that we are heading in the right direction. Overall, the move towards mandated reporting of climate scenario analysis for certain entities in Australia, and the development and implementation of sustainability reporting standards internationally, are to be applauded, but challenges remain.

Uncertainty in measurement may be pervasive, however, the presence of uncertainty should not be a barrier to reporting. Greater tolerance for subjectivity in measurement would seem warranted – provided it is accompanied by transparency of underlying assumptions, and reasonable assurance. Still in debate is when such uncertain measures of accounting items are to be pushed higher up the pyramid to warrant recognition in general-purpose financial statements, or if mandated note disclosure is sufficient. Investor (and indeed preparer) sophistication in handling measurement uncertainty needs to be considered – recognising that not all investors are alike. A "one-size-fits-all" approach is unlikely to succeed.

When considering how measurement uncertainty challenges the expansion of recognition, several themes emerge. The future is always uncertain, and while measurement techniques are evolving but may not be well understood by investors – leading to a lack of trust. Inadequate transparency of underlying measurement assumptions and unclear explanations of measurement techniques inhibit comparability and usefulness. Further research is needed to understand how investors interpret disclosures of uncertainty and subjectivity to inform careful policymaking. Issues already arise in the reporting of ranges of fair value level 3 inputs, with some entities presenting such broad ranges that they lack meaningful interpretation.

How should policymakers proceed? While policymakers are moving in the right direction, several issues require deeper consideration. For intangibles, policymakers could consider further disentangling recognition and measurement. Materiality, of course, is also a key consideration and itself is not well understood or applied in practice, despite its long history. This becomes particularly evident as we move to sustainability reporting, where new aspects of materiality have been under debate. Connectivity is clearly an area where further policy is needed to give enhance the meaning and value of both financial reporting and sustainability reporting.

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