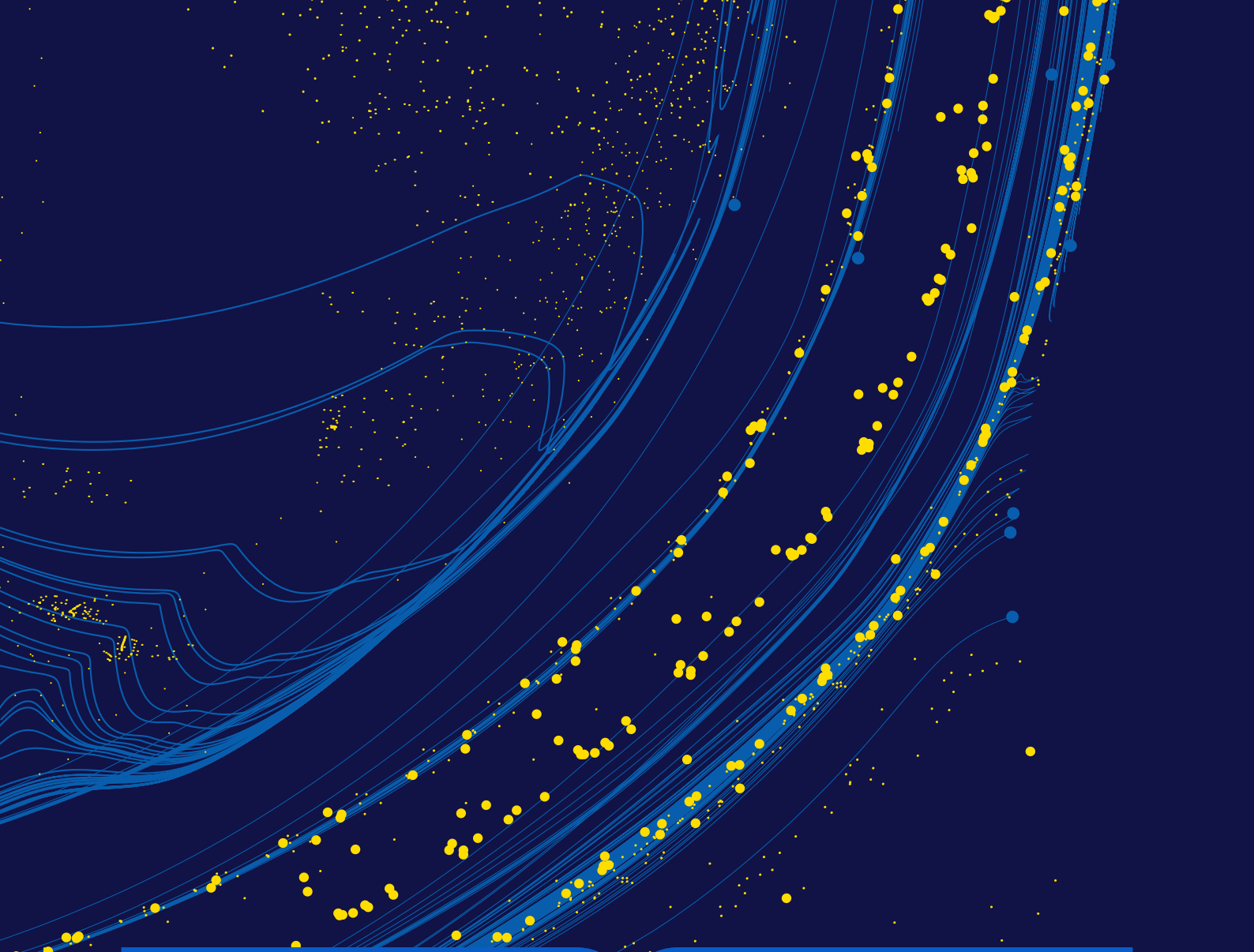

The Horizons of Financial Reporting – Part 1

Preparer Perspectives

CPA AUSTRALIA

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Executive summary

In response to an increased demand for information by capital market participants (IFAC, 2022), there is a global movement to improve the financial reporting requirements around items relevant to investors and creditors such as sustainability and intangibles.

As policymakers explore these reporting horizons, the challenge faced is to enhance relevance without sacrificing the unique competitive advantage of regulated financial reporting as the most credible information source in the marketplace (Davern et al., 2018, 2019a).

This aim of this study is to address this challenge and chart a pathway for enhanced financial reporting that can meet the evolving information needs of capital market participants, ensuring financial reporting remains relevant and credible.

Using focus groups and stakeholder interviews, we explore the "reporting pyramid" from full recognition and measurement through to mandated and voluntary disclosure. We explore financial reporting challenges in two thematic areas: sustainability and intangibles (we considered also risk/forward-looking information but subsequently view this as encapsulated in enhanced financial reporting on sustainability and intangibles).

Our findings highlight the nuances in issues of measurement uncertainty and the credibility of financial reporting. We evidence that recognition and measurement heighten scrutiny over the quality of the underlying data that is the input to financial reporting. This evidence provides a strong motivation for increased recognition and measurement requirements instead of expanding disclosure requirements.

In the case of reporting related to environmental sustainability and carbon emissions, we find that the measurement uncertainty is driven more by regulatory uncertainty. Such uncertainty makes assessing the financial impacts challenging. In contrast, the physical characteristics (e.g., of carbon sequestration or carbon emissions) can be measured with comparatively high degrees of precision.

Further to advocating for greater recognition and measurement, we find evidence suggesting recognition, where measurement numbers are "soft", is informative to investors. This evidence depends on the clarity of reported information – whether it is "soft" as opposed to "hard" or objective.

This has implications for the scope for preparers to exercise judgment in financial reporting and a corresponding increased need for expert assurance. It also emphasises the role of principles versus narrow rules in regulating financial reporting while ensuring comparability and consistency are not unduly compromised.

In summary, we see a bright future for financial reporting on a broader range of items than has traditionally been the case. In our pathway forward measurement uncertainty is seen not as a barrier or challenging to financial reporting, but rather an opportunity to reassert the essential role of professional judgement in all aspects of financial reporting (preparation, assurance, and use).

Introduction

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, in recent years there has been some debate about whether financial reports in their current form can continue to meet the evolving information needs of investors in an increasingly complex business environment.

For those alleging the declining relevance of statutory financial reporting (e.g., Lev & Gu 2016), a number of common themes emerge, including:

- the increased use of non-GAAP performance metrics in annual reports, such as "street earnings"
- the academic debate over the value relevance of traditional accounting numbers to investors, such as statutory profit and total equity
- the increasing divergence between book value and market capitalisation, indicating that investors are drawing on alternative information sources to value companies.

In light of these criticisms and concerns, this project seeks to explore opportunities to clarify the scope of financial reporting. Specifically, this project aims to identify how financial reporting can continue to meet the evolving information needs of investors and provide guidance to help future-proof financial reporting in an increasingly complex business and social context.

The key aim of the project is not to necessarily extend the scope of financial reporting per se, but rather to help in re-positioning the financial reporting function to ensure it remains an effective communication tool to 'tell the story' of an entity's performance. In doing so, the seeks to inform the ongoing evolution of financial reporting in light of the changing information needs of investors and the increasingly complex business environment.[1]

This entails an exploration of the issues, challenges and enablers to reporting on items that are within scope of financial reporting but, often because of concerns over measurement uncertainty, are not currently measured and disclosed in financial reports produced under international standards.

This research report builds on earlier research undertaken by Davern et al (2018, 2019a) which focused on the decision usefulness of 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.[2] In particular, it was also highlighted that to maintain the relevance of financial reporting, the underlying credibility of reported information should not be sacrificed.

[1]For example, Lev and Zarowin (1999), Lev and Gu (2016) and Lev (2018) argue there is deteriorating usefulness of financial statements due largely to backward-looking measurement and reporting approaches and call for bold new ways to measure periodic financial performance. Others such as Dechow et al. (2014), Davern et al. (2018, 2019a), and Barth et al. (2021) provide an alternative view, suggesting a more nuanced but not declining relevance of financial reports for investors and other interested parties.

[2]For example, according to Davern et al. (2018, 2019a), financial reporting has remained consistently relevant for equity investors over time. This work also indicates the relevance of contemporary non-GAAP measures such as EBITDA and EBIT, but as complements, rather than substitutes.

The primary aim of this research is to explore how to enhance the relevance of financial reporting without sacrificing the unique competitive advantage of regulated financial reporting as the most credible information source for capital markets (Davern et al 2019). To this, end we explored thematic areas that have been subject to increasing calls for more informative reporting and disclosure. Specifically, we explore two key thematic areas, which are explained briefly below:[3]

- **Sustainability-related Financial Information:** With the establishment of the International Sustainability Standards Board (ISSB), the need for sustainability reporting is not in question (IFRS 2020), rather at issue is what and how to report. We follow the ISSB's 'climate first' approach to sustainability and explore financial reporting in regard to climate risk and carbon emissions. While the ISSB's first exposure drafts (S1 and S2) (IFRS 2022a, IFRS 2022b), focus on disclosures, we focus our examination on issues of recognition and measurement. This is consistent with our premise (from prior work), that recognition and measurement results in more credible reporting.
- **Intangibles:** We explore the potential for increased recognition of internally generated intangible assets and the disclosure of additional information on intangible assets, whether internally generated or externally acquired. As a logical parallel to increased recognition of intangible assets, we consider recognition and measurement of intangible liabilities. By exploring broader recognition and measurement of intangibles (both assets and liabilities), we consider how more risks and forward-looking information can be captured in statutory financial reporting.

The objective is not to compare and contrast alternative reporting frameworks (e.g., the IASB's Conceptual Framework, and the Integrated Reporting Framework developed). Rather, we sought to examine the common challenges and issues across the thematic areas to synthesise guidance, enabling financial reporting to evolve to 'tell the story' of entity performance in an increasingly complex business environment.

Methodologically, we conducted a series of focus groups and interviews with various stakeholders, including practitioners, academics, investors, and regulators with deep experience in the specific thematic areas.

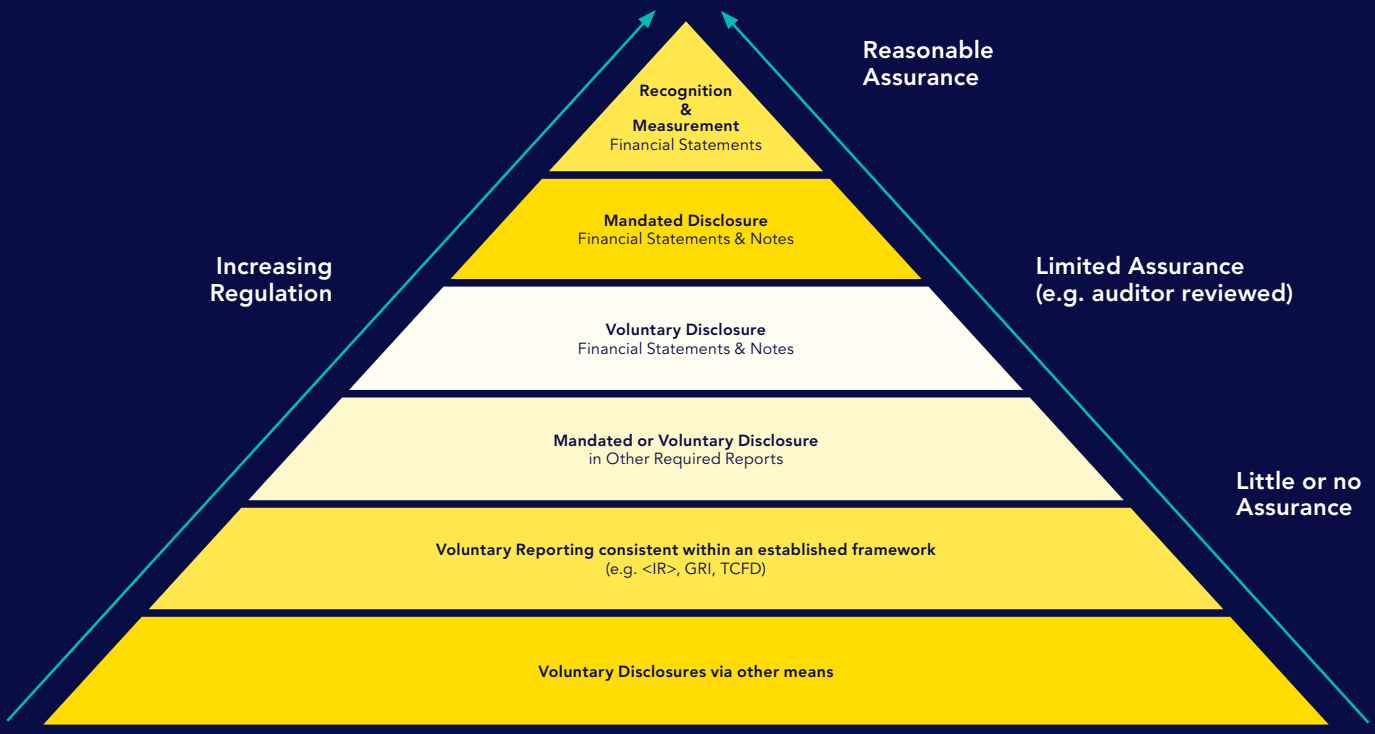
[3]We initially set out to explore a third thematic area: Risk and forward-looking information, but in the course of our investigation we found this to be more concretely captured within the other two thematic areas. For example, risk information could include climate risk exposures which are also part of sustainability.

Research approach: The financial reporting pyramid

To frame the investigation, we developed the financial reporting pyramid (Figure 1), as a starting point for analysis and discussion. The gold standard identified in the reporting pyramid is full recognition and measurement in accordance with IFRS Accounting Standards.

Prior work has highlighted that full recognition and measurement appears to drive higher quality in the underlying data (Davern et al 2019b). This is arguably due to increased management and auditor attention to items subject to full recognition and measurement. Of course, higher quality data does not necessarily translate into better quality reporting given the challenges in valuation (e.g., measurement uncertainty).

Figure 1. The Financial Reporting Pyramid



Moving further down the pyramid, voluntary disclosures are, by nature, subject to selective disclosure, potentially inducing bias. In this way, the pyramid highlights the key role of regulation and assurance in ensuring high-quality financial reporting. Consistent with prior research (Davern 2019a) the pyramid places audited statutory financial reporting as the most trusted information source for capital market participants.

We frame our research around the reporting pyramid. We explore the enablers and impediments to shifting reporting of items higher in the pyramid. By moving reporting higher in the pyramid, credibility and, therefore, informativeness[4] are both enhanced. The goal is to provide a pathway forward for policymakers and practitioners as they wrestle with the thorny challenges of enhancing the relevance of financial reporting while maintaining the credibility of what is reported.

Methodologically, our research entailed focus groups and interviews with experts in reporting in our thematic areas. All focus groups and interviews were conducted over Zoom, recorded, and professionally transcribed, generating over 28,000 words of transcript for analysis.

In the following sections, we discuss the specific analyses in the two key thematic areas of Sustainability Reporting (and in particular climate risk) and Intangibles. We then synthesise our findings into insights and policy guidance to enable reporting that incorporates these thematic areas and shifts focus to the top of the pyramid.

[4] Ceteris Paribus, more credible reporting of an individual item results in a more informative reporting of that item. However, as reporting moves up the pyramid it becomes more constrained in scope and thus reporting as a whole at the level in the pyramid is not necessarily more informative.

Sustainability-related financial reporting

With the ISSB's recent consolidation of the Sustainability Accounting Standards Board (SASB), the Climate Disclosure Standards Board (CDSB) and the Value Reporting Foundation (previously home to the SASB Standards, the CDSB framework and the Integrated Reporting Framework, respectively), sustainability reporting has come of age.

The now strengthened ISSB has been tasked with the challenge to "fulfill the growing and urgent demand for streamlining and formalising corporate sustainability disclosures" (IFRS 2021). From the perspective of the reporting pyramid, we explore this challenge to advance recognition and measurement in sustainability-related financial reporting.

We focus on climate risk, following the ISSB's climate first approach, considering first ex post reporting of climate-related impacts, and secondly a forward-looking perspective on climate risk reporting.

Climate risk reporting: Looking back

From an ex-post perspective, climate risk reporting has, to date, focused on tracking of emissions as the primary approach. There has been increasing sophistication in the tracking of emissions, as reporting has moved from "Scope 1" (direct emissions) to "Scope 2" (indirect emission through energy consumption) and ultimately "Scope 3" (any other indirect emissions). Despite progress in reporting emissions, the question remains "if climate disclosures are improving, why isn't decarbonisation accelerating?" (EY, 2021).

Clearly, climate change can impact asset values, associated liabilities, an entity's supply chains, and customer markets. Indeed, such risks have been identified as "material and warrant disclosures when preparing financial statements, regardless of their numerical impact" (AASB/AAUSB 2019, p.3).

However, we are currently far from recognition and measurement within financial statements in this regard, as one participant noted:

… 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. 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.

Consistent with the desire to elevate reporting on aspects of climate risk higher in the reporting pyramid, we see the need for assurance. Enhancements in the assurance of the underlying carbon data is the starting point before we get to assurance of judgments relating to recognition and measurement. Nonetheless assurance of the underlying data is complex and requires input from specialists beyond just the accounting and audit domain, as a one participant remarked:

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

Nonetheless, the need to move higher in the pyramid is evident. Voluntary disclosures are not meeting expectations, with the quality of reporting lagging significantly behind the coverage of climate risks in reporting (EY 2021), as explained by one participant:

… I would not be as confident that when they're disclosing carbon or other climate-related or other things they're getting something from the auditor, I'm not sure that level of assurance is uniform across the market because they're doing it voluntarily, they're doing it in an uncharted territory at the moment and I can't give them any black and white advice now as to how to do it but I would worry about what reasonable assurance over carbon disclosures actually means.

Moving beyond voluntary disclosure, is essential if we achieve requisite consistency and comparability, as one participant observed:

… we've got those robust reporting systems and processes in the financial space and therefore robust audit and assurance processes and it's consistent and it can be relied upon. But in this space [carbon accounting/climate risk], we've not got consistency and I think that needs to be mandated to achieve it.

In pushing to move reporting to the point of recognition and measurement (the top of the pyramid), our participants made several telling observations. Fundamentally participants viewed the distinction between financial and non-financial reporting as somewhat of a false dichotomy in regards to sustainability reporting from the investor and creditor perspective:

… the whole of your nonfinancial sphere, which of course is all financial, but we call it nonfinancial for want of a better term.

Investors and creditors are demanding reporting on climate risk precisely because it is expected to ultimately manifest as a financial impact. The potential financial impacts of climate risk are subject to measurement uncertainty, but are otherwise not contingent -- the existence of climate change is established. This measurement uncertainty creates challenges for preparers and assurance, but it is not an impenetrable barrier, as one participant suggested:

[there is] an element of risk appetite [for] accounting firms, … they're already doing [climate risk disclosure] but it's a new area, absolutely, and mistakes will be made.

As we seek to support the mandatory recognition and measurement of climate risk, we need to do so in a principled way. Bright line regulation is not the solution. The objective of providing useful information to the users of financial reports is, it seems, best served by allowing scope for judgment and interpretation:

… I think when we're talking about consistency and data around carbon reporting and perhaps what's reported, … that broader picture around corporate reporting and the needs of users, there is that room for interpretation of principles of reporting …to tell the story.

This focus on structured storytelling, judgment and interpretation is a key theme that emerges in our data. This does not necessarily imply more reporting but better reporting about what matters "to tell the story". As neatly expressed by one of our participants, it entails:

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

Operationalising materiality in carbon reporting and setting appropriate levels of transparency represent significant challenges. Materiality as often practised in financial reporting, can be formulaic, based on the relative size of specific line items compared to baseline figures such as assets and revenue. Materiality is a judgement of the significance of a reported item, sometimes regardless of its size.

Transparency is challenged by the legitimate need to protect proprietary information. While continuous raw data feeds from entities is becoming increasingly viable technologically, potential proprietary costs associated with disclosure mean we are unlikely to ever see a reporting regime where investors can access those feeds in real time to directly inform their own valuation models and subsequent decisions.

Fundamentally, this tension between materiality, transparency and proprietary costs is currently balanced by entities managing the volume and type of information reported, with potentially challenging the usefulness of the information for equity investors.

Climate risk reporting: Looking forward

How then should firms be suitably transparent about the material impact on firm value of climate risks? For example, is it sufficient to recognise this through appropriate asset impairments? What about broader issues in supply chains and customer markets? Are the disclosures under the ISSB's S1 and S2 exposure drafts adequate (IFRS 2022a,b), not just in breadth but perhaps more importantly in credibility?

The metrics and targets of the exposure draft are arguably not the same in credibility as recognition and measurement in the financial statements, where reporting systems and assurance are robust. Fundamentally, this is about reporting on current expectations of how future climate change impacts will affect firm value. This "looking forward" approach is a source of some trepidation, as noted by one participant:

Some of this seems to be moving very much from if you look at traditional accounting being very historically driven to now being much more forward-looking information that we're trying to disclose and report on.

However, to claim traditional accounting is only historical is clearly a misperception. Expectations of the future have already a long precedent in financial reporting, as countered in the following remarks from a participant:

…we've always looked at future information when we've been calculating the valuation of assets and obviously also trying to determine future cashflows. It's not easy, … and 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"

Turning to the Conceptual Framework, we clearly see that assets and liabilities are future oriented. The framework defines assets and liabilities in terms of economic resources. In turn, economic resources are defined as "a right that has the potential to produce economic benefits." The term "potential" is, by definition, an expectation of the future.

Pragmatically, the challenge is again that recognition and measurement of climate change-related financial impacts requires specific domain knowledge and an awareness and understanding of the risks posed by climate change. This was noted by one interviewee:

… this is an area of different expertise, quite an area of different expertise and that's where we are going to employ and need to involve others with knowledge of that.

The challenges pertaining to recognition and measurement also extend to measurement uncertainty being heavily impacted by the uncertainty related to the future policy settings of governments and regulators and the likely impact on businesses, populations and consumption patterns of individuals:

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

For example, the prospect of future regulations restricting carbon emissions may lead to the need to impair the value of productive assets that generate carbon emissions. The uncertainty that arises is when the restrictions might be imposed, and how tight those restrictions might be. This is not simply uncertainty on the downside, but measurement uncertainty on the upside.

The value of investments in carbon-reducing technologies that reduce, offset or eliminate carbon emissions in the supply chain is also contingent on the nature and timing of regulatory activity. Australia has been an exemplary case study in this issue over the last 10-15 years, with quite dramatic shifts in policy related to climate change between different governments.

Climate risk scenario modelling

The Task Force promotes scenario modelling on Climate-related Disclosures (TCFD) as a useful tool for reporting on the potential future impacts of climate change. Given the possible scenarios identified, it enables forward-looking information to be communicated to investors about how a company is positioned.

However, practice here is quite nascent, underdeveloped and lacking the regulation and assurance to provide the credibility to use scenario-based estimates in full recognition and measurement of climate risk financial impacts, as noted by one participant:

… I often find myself in boardrooms explaining … the impact of climate change on them where depending where their assets are, what they are, especially for coastal operations like ports and so on which I do a bit of work with. 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.

It is clear we are at a turning point, as entities are beginning to consider how to use scenarios to inform measurement, as observed in the following comment from a participant:

… So, 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?

Moving forward using scenario analysis to inform recognition and measurement of the financial impacts of climate risk, is a non-trivial change. Two key interrelated issues need to be understood here: (a) modelling challenges and (b) the shift from measuring cost to measuring value.

Modelling challenges

In terms of modelling scenarios, to inform measurement, it is often not adequately recognised that there are three different groups of models involved:

1. The model of climate change.
2. The model of the financial impact of climate change estimated in (1).
3. The model of the financial effectiveness of the response to the expected impacts.

Breaking down the models we can see that first-stage models (1) are largely a matter of science not accounting, the second-stage models (2) are similar to impairment models, and the third-stage models (3) rely heavily on assumptions about future actions by management. This has significant impacts on measurement uncertainty, with decreasing reliability of the models; from reliable scientific models at stage 1 down to stage 3, which reflect managerial intent as much as they do future expectations.

Credible recognition and measurement that relies on stage 1 and 2 models seems quite feasible, as a participant active in climate modelling commented:

… it's interesting 'cause 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…

Indeed, there are concrete examples of well-established science already providing information about biophysical aspects of the environment, as one participant observed:

… there are satellite companies now that can tell you how well your canola is growing and what day and time you should be harvesting it so you don't have that in financial accounting…

From a modelling perspective, we might expect that recognition and measurement based on stage 1 and 2 models is where financial reporting should be moving. Stage 3 models, as statements of management intent, however, are perhaps best left to some form of voluntary disclosure, despite the lower credibility of such reporting.

It is notable that the ISSB's exposure draft suggested reporting relating to "strategy" does not include reporting on the expected impacts of an entity's climate risk strategy, only disclosures of the impact of climate risk (i.e., consistent with stage 1 and 2 models) and the strategy itself.

Assurance is quite different under these alternatives: the assurance over "data" that can be used as inputs to valuation judgments by investors or assurance over an expected impact financial impact is arguably less contentious than assurance over a modelled impact of a managerial intent in respect to climate risk.

From measuring cost to measuring value

As reporting evolves in this space, the scenario modelling discussed above suggests a move from measuring the cost of historical carbon emissions to measuring the value of the assets and liabilities impacted by climate change (i.e., stage 2 models above). As described by one participant, the analysis for assets would proceed as follows:

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.

Of course, this shift from a cost basis (with impairment) to value introduces greater measurement uncertainty. Measurement uncertainty is always present to some extent; the question is whether the measurement uncertainty is sufficiently contained so that credible and informative recognition and measurement can occur. As one participant aptly described the situation:

… 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.

Exactly how we report measurement uncertainty is a key question. In part, this parallels discussions about reporting climate risk scenarios under guidance like the TCFD regarding how many different scenarios should be presented. For example, should a single "best estimate" scenario and valuation be presented (as is the case now?), or should we be presenting multiple valuations, such as 'best', 'worst' and 'most likely' scenarios.

However, we argue that we should be using stage 1 and stage 2 models to push climate risk related financial reporting up the pyramid to recognition and measurement.

Measurement uncertainty should not be a barrier, and the disclosure approach of the ISSB's exposure draft is likely to lead to less credibility and a plethora of metrics with unclear links to financial impacts. The question that remains is how we report measurement uncertainty.

This question is not unique to sustainability reporting, so we now turn to intangibles to see how measurement uncertainty manifests in that context.

Intangibles

With a larger number of companies' operations centred around providing customer services and knowledge, firm value is becoming increasingly intangibles driven. A challenge facing financial reporting is communicating information to investors about intangible assets, particularly internally generated intangible assets which, according to IFRS Accounting Standards, currently cannot be recognised in a company's statement of financial position.

An often-noted argument for enhanced recognition and measurement of intangibles is the perception of a growing disparity between book value and market capitalisation, with one participant commenting:

… the problems I have seen over time is that the market value's running more and more away from book value. The book value used to provide a lot more useful information.

While this view was widely held amongst participants, there was acknowledgement that book value and market capitalisation need not be the same ("we're not about putting a value on the firm, we're about informing investors so that they can put a value on the firm"; and "you're not trying to map the market, you're trying to inform the market"). Consistent with the reporting pyramid, our participants gave primacy to recognition and measurement with comments such as:

… in the absence of proper recognition, disclosure is a poor second cousin so the primary focus is to get the recognition and the measurement right as best as you can and use disclosure to provide additional clarity and insight… So when recognition and disclosure's used together, that's when it's most powerful.

Recognition and measurement: The current situation

Currently, the treatment of intangible assets differs depending on whether the intangibles are internally generated or externally acquired or part of a business combination. The claimed reasoning is that externally acquired intangibles are more readily measurable as they result from an arms-length exchange transaction. However, our participants called into question the validity of this distinction with comments such as the following:

… the basic idea is when you acquire something externally everything, patents, brand name, customer list, it's based on arm's length transaction, the willing price negotiated by the buyer and seller. So, does this really apply to the internally generated intangible assets?

I think so because if you think about the process of internally developed intangibles most firms would have to use economic resources that they have already acquired either previously or concurrently with the process like the lab equipment they use, the salaries they have to pay to their research scientists, the contractor, the consultants they have to here and the marketing they have to pay for advertising firm to do. So there is really no difference in this regard from my perspective.

The consensus view of our participants was that internally generated versus externally acquired was not a useful distinction in terms of recognition, with one participant noting they:

agree they are the same or they can be viewed the same whether they're internally generated or acquired but I think they're equally difficult to measure and recognise in either case.

Delving deeper into discussions with our participants reveals that the problem is not really recognition but measurement, as the following comments from two different participants suggests:

… currently the boundary is between identifiability versus unidentifiable … Although conceptually I really … can't see why internally generated goodwill, it is an asset so why can't it be recognised.

As another participant remarked:

… you would run into problems like … it's so difficult to value internally generated intangibles, how do you recognise it?

If recognition concerns are without standing, then the challenge must fundamentally be in measurement, particularly measurement uncertainty, given the requirement for reliable measurement in AASB 138.21b. Notable in the participant's remark is a subtlety in language: the participant above refers to "value" as opposed to cost. For internally generated intangibles, costs are arguably measurable (since as noted above they draw on economic resources that have been externally acquired through arm's length transactions).

However, it may not be possible to separate out the costs from the running of day-to-day operations (per AASB 138.51), preventing recognition of the intangible asset. Whether due to lack of reliable measurement, or an inability to separate out costs, the result is that the relevant costs are then expensed in the period, the consequences of which one participant aptly described as:

the current approach of no recognition is basically destroying the income statement as well as the balance sheet.

Recognition and measurement: Towards the future

With the seemingly clear desire to see enhanced reporting of internally generated intangibles, it begs the question why reporting has not already moved in that direction? As one of our interviewees expressed it succinctly:

There's only one reason … The world's not ready for it.

Encouraging voluntary disclosure may seem like a useful strategy to progress reporting and get 'the world ready.' AASB 138.128(b) does provide such encouragement, but recent evidence shows that there have been no substantive voluntary disclosures in response to this encouragement (Davern et al 2021). Indeed, as one participant noted, meaningful disclosures will only happen if there is recognition and measurement:

because they're [intangible assets] not there on the balance sheet, people think there's nothing for me to disclose because there's nothing there to break back down, so you need that recognition first to prompt the disclosure.

Moving towards recognition and measurement of intangibles – moving up the reporting pyramid – requires us again, as with sustainability reporting, to think about measurement uncertainty, and how we can appropriately report measures of so called "soft" numbers – measures that have a high degree of measurement uncertainty.

Synthesis: Towards policy guidance

Our explorations of the horizons of financial reporting for both sustainability/climate risk and intangibles identified measurement uncertainty as the primary challenge. While standard setters have long recognised the issue of measurement uncertainty, the question is about how to actually report in the context of measurement uncertainty. In this regard, one interviewee had a quite novel suggestion:

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.

While the intent here is admirable, it introduces a further reporting complexity as it seeks to now define explicitly distinctions between "hard numbers," "soft numbers" and even "softer numbers". It also clouds the issue of data versus information. An alternative approach sometimes suggested is to move from disclosing point estimates of value to disclosing a confidence interval. Again, the intent is admirable, but the implementation is problematic.

Even if defining a confidence interval is easier and less contentious than a point estimate (which is arguably unlikely), it makes the interpretation of reported information more challenging for users. Further to this point, the decision to quantify complex phenomena in financial terms has a range of consequences for organisations, individuals and societies. As such, assigning multiple values for a given line item is a decision not to be taken lightly.[5]

Reflecting more holistically on the data gathered in the study, it becomes clear that 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. With measurement uncertainty not a roadblock to recognition and measurement, financial reporting relating to sustainability and intangibles can move towards the top of the reporting pyramid.

Two caveats remain. First, in any disclosure made by an entity (including full recognition and measurement), consideration may be given to avoiding perceived proprietary costs associated with the disclosure of competitively sensitive information.

Reporting aggregated information is a potential solution here, but the decision about what level of aggregation enables reporting of meaningful information while still avoiding undue proprietary costs is a question beyond the scope of the current project.

Associated with this is the need to think more carefully about the nature, extent and drivers of real proprietary costs associated with disclosure. Empirical research demonstrating the drivers and consequences of such costs is relatively sparse.

[5]This literature, often referred to as the focusing on the Sociology of Quantification, typically explores the diverse ways in which such quantifications can impact how we understand ourselves and how we attend to and organise our lives. For a useful discussion of this literature refer to Mennicken and Espeland (2019).

This suggests two things. First, more work is needed to think differently about the nature and extent of such costs associated with disclosure. Second and related, it also suggests that perceptions of proprietary costs should not, on their own, justify lower levels of disclosure.

A second caveat relates to summary measures such as earnings and total assets. It is a long-standing criticism of the historical cost tradition in accounting that it leads to the adding of 'apples and oranges' (e.g., because of inflationary effects).

However, this is not the sort of aggregation that is suggested here as a way of balancing between enhanced reporting and perceived proprietary costs. Rather, we turn to the fundamentals of the Conceptual Framework, and that the role of financial reporting is to provide useful information to users to inform their resource allocation decisions not to provide a summary valuation of the firm as a whole.

There are some non-trivial implications to reporting if we adopt an approach that becomes more tolerant to measurement uncertainty. For example, our themes of sustainability and intangibles. With an approach that enables reporting of "softer" measures, a logical conclusion could be to recognise an intangible liability for climate risk. Since we have already established that we should be considering internally generated intangible assets, surely the possibility of intangible liabilities arises now that we are less concerned with measurement uncertainty.

Since the science has established climate change, classification as contingent liability could only be because of measurement uncertainty, rather than a question of existence. From a preparer perspective the issue is what number to report for the liability, and how to report the associated measurement uncertainty. From an auditor perspective there is a question of what reasonable assurance amounts to in regards to reporting such a "soft" number.

From an investor perspective, there is the question of how long it takes for investors to get comfortable with this higher degree of measurement uncertainty, which depends on how preparers report and investors interpret disclosures related to measurement uncertainty.

In conclusion, the choice between the top two echelons of the reporting pyramid is about who (the entity versus the user) is best positioned to put a value on the reported item. Measurement uncertainty should not be a barrier to recognition and measurement, provided entities can effectively communicate the degree and major sources of that uncertainty.

The role of assurance here is, of course, critical. More broadly, the potential path forward requires understanding of how we use aggregation to convey necessary information irrespective of any perceived proprietary costs. Of course, this also reinforces the pre-eminence of assurance lest the aggregated measures used become meaningless.

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Research team

Professor Michael Davern

Professor Michael Davern, BCom (Hons.), PhD, FCPA, holds the Chair of Accounting and Business Information Systems in the Faculty of Business and Economics at the University of Melbourne, where he currently leads a major teaching initiative in Sustainable Commerce. For over 30 years, both in Australia and internationally (New York, Minneapolis), he has led industry engaged research projects focusing on decision making by external and internal stakeholders, and the impacts of reporting, and business data analytics.

He is actively publishing and supervising PhD students across diverse areas including analytics, ethics, financial reporting, governance, risk and controls. He has extensive board level experience with for-purpose and privately held companies. Michael's industry collaborations have included work with the AASB, EY, Microsoft, Telstra, NAB, and PETRONAS, among others, on topics ranging from intangibles and IFRS 15 to data analytics and enterprise risk management. He is currently a member of CPA Australia's Centre of Excellence for Digital Transformation.

Nikole Gyles

Nikole Gyles B.Com (Hons.), FCPA, CA, MAICD is the AASB Technical Director. Nikole currently leads the AASB staff in developing and delivering the AASB work program, including sustainability reporting.

Nikole has over 20 years of experience in policy development and industry focused research roles. Her roles include extensive standard-setting expertise, technical accounting, and advisory at Big 4 accounting firms in Australia and London. Nikole was also previously appointed as an Enterprise Fellow at the University of Melbourne, leading University-Industry linkages and partnerships, including developing the Hong Kong Institute of Certified Public Accountants professional program.

Nikole is a member of CPA Australia's External Reporting Centre of Excellence and has acted as a subject matter expert for the professional program for CPA Australia since 2004.

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Dean Hanlon BEc, MCom (Hons.), PhD, CA, FCPA is a Professor in Accounting at RMIT University. Dean's current research interests are in financial reporting, taxation and corporate governance. He has been the recipient of several competitive industry-based research grants and has published extensively in both international and domestic peer-reviewed journals.

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He has previously served on the Technical Committee of AFAANZ and on CPA Australia's External Reporting Centre of Excellence. Dean has also acted as a subject matter expert for the professional programs of the Chartered Accountants Australia and New Zealand, CPA Australia and the Hong Kong Institute of Certified Public Accountants.

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Brad Potter BCom (Hons.), PhD, FCA, FCPA is an Associate Professor in Accounting at the University of Melbourne and head, of the Department of Accounting. Brad's research primarily focuses on the measurement and reporting approaches used by entities to communicate diverse information relating to performance, position and social and environmental impact and the relevance of that information for stakeholders.

He is passionate high quality accounting standards that are underpinned by sound concepts and a rigorous evidence base, and which enable a robust financial reporting environment. His work relating to sustainability seeks to enable a sound evidence base for more informed decisions relating to the management and reporting of the broader environmental and social implications of company activities.

Much of his research involves collaboration with key organisations and individuals in accounting and business, including the two major professional accounting bodies CPA Australia, CA ANZ, key NGOs, accounting standard setters and government regulators. This work is disseminated widely through presentations and publications to academic and practitioner audiences.

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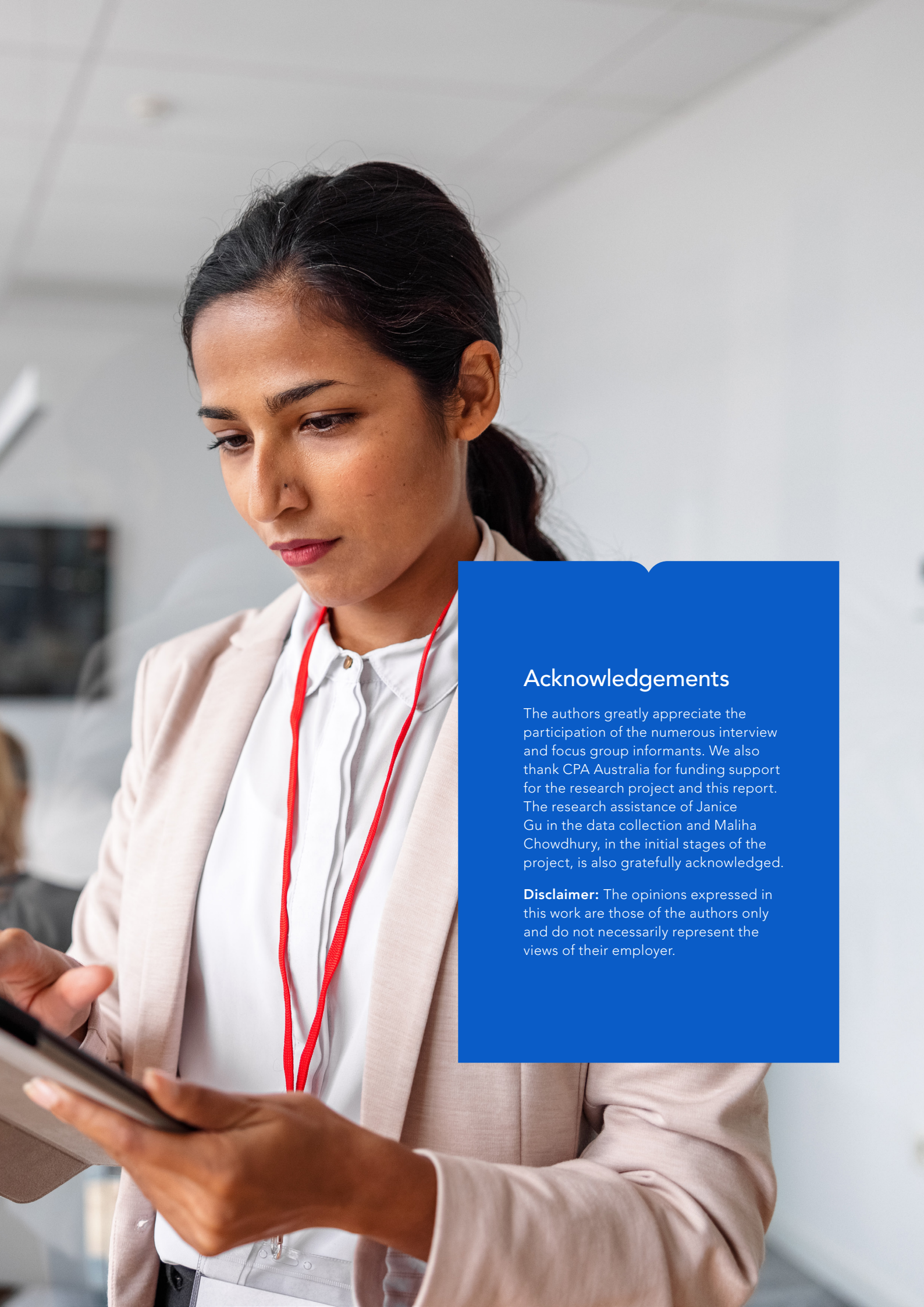
He is actively involved in formulating policy positions and commenting on reporting developments, including input to developments in the not-for-profit sector. Previously, he worked in senior roles within the public practice sector in the United Kingdom for a number of years, including managing the technical advisory services of the Institute of Chartered Accountants in England and Wales.



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