Intro: Hello and welcome to the CPA Australia podcast, your weekly source of business, leadership, and public practise accounting information.

John Purcell: Hello. My name is John Purcell. I'm policy advisor ESG at CPA Australia. I'm joined here today by Kris Peach, chair of the Australian Accounting Standards Board and Roger Simnett who is chair of the Australian Audit and Assurance Standards Board. Our discussion centres on the joint boards guidance, which was issued in December last year and recently updated. Climate related and other emerging risk disclosures, assessing financial [stipend 00:00:47] materiality using AASB practise statement two. The significance of these discussions is in fact really very timely. There's growing momentum of interest in climate change, how our economy adjusts to these emerging risks, and what the role is particularly of investment behaviour, corporate behaviour, and more particularly corporate disclosure in dealing with these emerging forms of risk.

John Purcell: Firstly, to open up to discussion. I was wondering if I could get an understanding from respectively Kris and Peach as to the motivations. What drove the two boards to develop this guidance.

Kris Peach: Thanks, John. There was a couple of motivations. There were a few documents that the International Accounting Standards Board had put out, which was the practise statement on materiality, but it was also the TCFD recommendations were also out there. Plus a lot of investors were actually starting to say very concretely that they were being influenced by the climate related risks that entities were being exposed to. And so, Roger was a key driver in wanting to put out something in this space, and we felt the best thing that we could be doing was to actually highlight to people what requirements there actually were for financial statement reporting. That's very much the focus of the bulletin, and it's also ... It's not just climate related risks.

Kris Peach: We also wanted to highlight to people that in fact this type of analysis should be applied for any of the emerging risks that an entity might be facing. Things like data risk or cyber security as well.

John Purcell: Yes, which is also very prominent here and internationally at the moment.

Kris Peach: One of the important things that's become evident is that investors are concerned about credibility of information. And one of the issues is that if information is in financial statements, then obviously it's subject to quite a rigorous level of assurance. Whereas, if it's outside, then it's not. And so, that was again one of the motivators as to why we wanted to do this is to actually make clear, when does it need to go into the financial statements and have that extra degree of credibility? And then, when is it okay to leave it outside? That's a very important distinction I think that we need to focus.

John Purcell: Yeah. I think, will it focus director's attention on truth and fairness? Those overarching principles and requirements.

Kris Peach: We would hope so. And probably also worthwhile mentioning that the ISP has a management commentary project, which is looking at some of the broader disclosures. Not going quite as far as integrated reporting, but again, it's how do you make sure that all of that information that's actually being provided is in fact credible and subject to the same rigorous process that a financial statement is?

Roger Simnett: And that information is so key to a lot of investor decisions at the moment. It's again, making sure we're getting the right information in that area, and Kris is on that working group at the ISB. And as Kris said, then making sure ... There will be straight assurance implications here. Making sure we've got the right credibility enhancing techniques associated with that type of information.

John Purcell: Look, and it's a significant development and I think it's shown, dare I say it, the two Australian boards are very much on the front foot. The initiative has certainly being picked up at an international level. I note it's been remarked upon by the chair of the International Accounting Standards Boards in a number of speeches. Locally here it's been included as a key reference in one of the leading opinions, which have been pretty much acknowledged as driving change in this area. And this is an opinion from [Doll 00:05:19] [Hutley 00:05:20] SC and Sebastian [Harper-Davies 00:05:22]. Their titled opinion on climate change and directors duties.

John Purcell: One of the interesting points, and I think it's important to clarify, as to the guidance is it's limited to disclosures in financial statements. It doesn't touch upon narrative disclosures. Is that correct?

Kris Peach: It's narrative disclosures within the financial statements, but also in some cases quantitative as well. You're quite right. It's not focused at disclosures in your management commentary or your broader external reporting other than the highlight, well, in fact there might be some important disclosures. And certainly from Roger's audit perspective there's obviously some key considerations there.

Roger Simnett: Yeah, it certainly does cover just the financial statement disclosures, which is the mainstream disclosures in this area. And we may touch on later the broader accounting and reporting measurements and assurance considerations.

Roger Simnett: Just on one of the other points of putting this thing together, as well as emphasising the subject matter, is the clear indication of the Accounting Standards Board and the Auditing Standards Board working together on these things. That's a very good indication to the market also as just to how we are combining now in these particular areas and the messages we're getting across.

John Purcell: Yeah. And I think the stakeholders who are interested in the subject matter here are most welcoming of the Initiative.

Kris Peach: And probably the other thing I would also add is I think ... The concern for me was that people were focused on disclosures outside of the financial statements and there was really very little debate about, do we need to actually put something in the financial statements? And so, from my perspective, and certainly from Roger's perspective, the important thing is making sure people are actually thinking about that and making clear decisions.

John Purcell: Yeah. I think it's important just how much of the guide for those who are either interested or necessarily engaged in the subject matter, it gives a fairly good structured approach as to how to deal with the issues. One of the parts which I found quite attractive in guidance is the introductory decision tree as to how the assessments are made from different types of perspective, and I was wondering if it would be possible to briefly step through how this might operate from a preparer's perspective.

Kris Peach: Thanks, John. Yes, it took a fair bit of effort to pull the decision tree together, but we did want something that was short and sharp and actually highlighted to people what the key outcomes of the bulletin were. What we wanted to focus on is it's investor expectations. If you think about materiality, the definition of materiality says that it's anything that would be capable of influencing an investor's or a user's decision making. And so, that really then is the key starting point is, would an investor have an expectation that if we use the climate risk example that the entity's particular industry could be or should be impacted by climate risk? And if the answer to that is, "Yes, it's reasonable to have that expectation," then that means that the company's on a heightened notice that a lot of this information is going to be material.

Kris Peach: And then there's really two streams of the decision tree. If we take the ordinary side. This is a side where the company knows what its own risks are and it's made its own assessment that, yes, in fact, climate risk is material. For example, it might be an impairment test. Yes, they know that climate risk is important to that impairment test and material. Therefore, you'll make that disclosure about the assumptions you've used in that impairment test. And that's actually had an impact in the financial statements. Everybody's comfortable with that.

Kris Peach: Now, you might also make the assessment that there's no impact whatsoever and there's no reasonable expectation that a user could actually have that expectation. And in that case, then again there's no disclosures and that's no different. What is different is where you answer that question that, actually, my investors could have that expectation of the impact. In that case, again, if they had that impact, have that expectation, and then you've actually had an impact on your financial statements, then there needs to be some disclosures. And again, that's fairly normal.

Kris Peach: What's different is where you have that investor expectation, but there's actually been no impact on the financial statements. For example, you're a mining company. You expect that your mine is going to finish up in five years time. Your expectation might be that climate risk is actually not going to have an impact on that because it's a shorter timeframe to when your life is finishing. What we're saying though, in this case, is that this is when you have to think about some extra disclosures to actually make that assumption clear, and that's the new piece that we want people to think about.

John Purcell: Interestingly, that type of thinking ... Does that make this assistant at this particular point in time, looking out at a time horizon of say 5 or 10 years, does it create an increased expectation about more frequent reassessments? How frequently are these materialities going to be applied, would you imagine, in this content?

Kris Peach: Well, you always have to come back to materiality each year, and your assessment and materiality could be quite different each year. I certainly don't think it's a set and forget. I've made that assumption this year and I can forget about it. That's definitely not the case now with financial statements.

John Purcell: Both generally and specifically in relation to these issues.

Kris Peach: Really the key message is there can well be circumstances where you have to make disclosures in financial statements now even where there's actually been no financial impact. That's quite a different way for directors and preparers to think about things, and also auditors.

Roger Simnett: And also auditors. These considerations and these discussions are exactly what auditors should be doing as well. As well as the directors and preparers, the auditors should be challenging on these discussions. And the auditors will bring that public expectation, the investor expectation. Is there an expectation of disclosure here? And if so, then what is it? And if not, why not? And tell us why not? Because that is useful information to the market. That's really been the benefit of this. But the auditor's really ... And it's not questioning that the auditor's necessarily had undertaken in the past, but it's one that has now been pushed very hard through this type of practise statement.

Kris Peach: And I think it's also useful to point out is that, we do see climate related risk at the moment being different to some of the other risks, and the reason for that is because investors have been very public that they are looking for this information and it is actually changing your investment decisions. It's not necessarily the case with some of the other emerging risks, but also the really important point is we're not saying that every single company is going to be impacted this way. You do have to make that assessment about your particular investors, and it's also the investors themselves, which is typically creditors, typically other lenders and your shareholders. It is not the broader gamut of stakeholders that you could possibly have.

John Purcell: We're not changing the rules, the expectations as to who makes decisions in relation to financial disclosures. It's how the financial disclosures adapt to contemporary challenges.

Kris Peach: That's exactly right. It's very targeted in what we're trying to get people to think about.

Kris Peach: And the other key point I'd also make is that we are not expecting that all of your climate related risks would go into your financial statements. The point here is, disclose what are your key assumptions that have or have not had an impact in the financial statements.

John Purcell: Would expect that perhaps in parallel to this you'll get changes in relation to management commentary type disclosure stuff in the operation of financial review, and even in governance disclosures on the whole area as moving forward.

Kris Peach: Yeah. And again, when we discussed this guidance internationally, there was a lot of concern that you might end up with boiler plate disclosures. And so, my message again is, no, that is not what we're looking for. It absolutely has to be targeted disclosure to your particular circumstances.

John Purcell: If you could address for us fairly quickly which particular financial accounting standards are the ones which directors, CFO's, financial accountants, and auditors are going to have the most attention directed at, and which type of sectors do you think are going to be the areas where you'd expect to see a greater level of disclosure?

Kris Peach: Broadly, I think if you split the industries into two, there's the financial sector side and then there's a nonfinancial sector side. If we think about the nonfinancial sector side first, then clearly there's your mining type companies, your agricultural type companies. Anyone that's really got exposure to carbon in significant ways, and that's all been pretty well highlighted by the TCFD recommendations. Those are going to have an impact there.

Kris Peach: In terms of the financial sector, it's obviously pretty much all your insurers and your banks are already starting to take into account some of these risks. Now, from the financial sector side, some of the key risks are around how you value your portfolio of your loans. It's more of an indirect exposure. How do my particular clients actually have an impact from climate risk, and does that impact the ability to pay back my loan? And if that's the case, then clearly there needs to be some disclosures. And so, some of the things that we'd be expecting to see there is perhaps an analysis of your portfolio as to who you think is or isn't going to be impacted by climate risk.

Kris Peach: In terms of your non-financial sector, your key areas are around in payment testing. It's a direct impact. Do I actually have something that's a stranded asset that I'm not going to be able to use in the future because of these changes that are coming? Or, do I have a provision? Do I have a significant restoration provision or an onerous contract that now means I need to start to recognise some form of liability in the balance sheet?

John Purcell: Particularly with reference the impairment standard AASB 136, do you see in the foreseeable future any significant reexamination of that standard, either specifically in relation to how it contends with climate change risk, or more generally as to perhaps it's fitness for purpose?

Kris Peach: Well that's a very good question. The IASB at the moment is currently looking at doing some limited scope change to the impairment standard. The AASB has just done some work, and our view is that it absolutely should be completely re-opened up again. We think at the moment there's some really significant issues with the impairment standard. And if you think about audit quality issues, if you think about financial statement surveillance programmes that regulators do, one of the key areas that always comes up is the impairment testing that has been done.

Kris Peach: When you've reached a stage where investors are telling us they don't understand outcomes, when preparers are struggling with applying it, and when auditors are struggling with auditing it, and you've got regulators saying it's difficult to enforce, then you start to go, "This standard actually needs to have some significant work done to it." I do think a lot of the climate related risks will put more and more pressure on the impairment test because it's going to weave its way through in a number of different ways. Value is already starting to include some assumptions about climate related risk, and so it is going to I think be more and more difficult for entities to ... And for directors and preparers to actually avoid having some form of assumptions about climate related risk.

John Purcell: Roger. Your thoughts on the significance of any root and branch review of the impairment standard from an auditor's perspective?

Roger Simnett: Again, as Kris mentioned, we're finding there is a lot of confusion in the market from the auditor's perspective on the requirements of that standard, and it's giving rise to a number of findings through the inspection process. We would be very supportive of that standard having been reviewed. We have done a review of the equivalent auditing standard to try and deal with matters of additional complexity, and we are framework neutral in that particular regard. We think we're in a good position, but again, we've got to get the subject matter right in that particular area to make sure we get the right outcome from a society perspective.

John Purcell: It's certainly a development which we'll monitor closely indeed. Thank you.

John Purcell: One of the interesting areas that I picked up on in the guidance was the following statement. It's about materiality judgments, and it's a reference. It says, "Materially judgments may also lead to the disclosure of information in addition to the specific disclosure requirements in Australian accounting standards." Now, we've touched upon briefly one of the driving forces ... Well, not one one of the key driving forces. One of the major drivers of development in this area, and this is the TCFD. The Financial Stability Board's Taskforce on Climate Related Financial Disclosures.

John Purcell: Now, one of the more interesting recommendations in the TCFD under the heading of strategy is around scenario analysis, and briefly their description of scenario analysis is as follows. "A description of the resilience of the organization's strategy taking into account climate related disclosures including a two degrees Celsius or lower scenario." If I could get your thoughts on how this rather complicated area of scenario analysis might feed into some of the financial statement disclosures.

Kris Peach: Again, I think what you have to come back to is to focus on what goes into the financial statements and what goes outside. In terms of in the financial statements, what you might need to disclose is what your key assumptions about the warming pattern might be, because that might impact your impairment assessment or your fair value assessment. Would you specifically have to put in your scenario assessment of 2%? No. There is no automatic driver of that. But if, again, you were a mining company, what you might put in is your assumption that you actually don't think it's 2%. That it's more likely it's whatever it might be. It's 1%. And therefore, if you work off that, here's the outcomes of that that have impacted on your impairment test, because it might be that your market for your product just isn't there because you happen to be one of the entities that gets caught and has some stranded assets. But would I expect to see the whole scenario planning in your financial statements? No, I think that's unlikely.

John Purcell: Okay. And I think that's an important point to tease out, given the fact that the TCFD recommendations are voluntary in nature and principle based. And I think what you're talking about is how they interact with well understood statutory requirements in relation to financial disclosures.

Kris Peach: You might also find that you do have to disclose a range in which you've assessed things. But again, it's the impact on your impairment test that you'd be focusing on rather than the broader-

Roger Simnett: It's all going to be through the assumptions on your impairment testing. As long as you outline your assumptions on the impairment testing, scenario analysis might be one way of actually outlining what your assumptions are. But it's only one way. There might be other ways to get to future cash flow considerations which may impact upon impairment testing. But really, for the standard, it really is outline the assumptions. And the auditor, for example, will be looking at those assumptions to make sure that they are reasonable. That's the auditor's test. To make sure those assumptions are reasonable.

Roger Simnett: We need to understand, what are the assumptions? Not necessarily take people down the scenario. And then to make sure those assumptions are well understood and are reasonable. Or if people are not making those disclosures with an expectation of it, why they have determined ... What are the assumptions even as to why they have determined that there is not a necessity for their particular organisation to make the assumptions, or to make those particular assessments?

John Purcell: Okay. I'd like to pursue, if I could a little bit further, some of the auditing and the audit standard issues. I was wondering Roger if you could give us a quick outline of which of the audit standards you see as being critical to the guidance and to emerging practise in this particular area.

Roger Simnett: A couple of what I would say as our key auditing standards are the standard on identifying and assessing risk of material misstatement, ASA 315, and then responding to those risks. Because it was really this what we're talking about. The risk of material misstatement. We're now highlighting this as an issue that we would expect to be included within the reporting, and so there was a risk of material misstatement. The auditor's got to broaden their expectation here as to the types of risks of material misstatement that there may be in these particular areas. We are going through an update at the moment of 315 on identifying the risks of material misstatements.

Roger Simnett: The other one is 540, which is the auditing of estimates, which has just been updated and released. And a lot of the impairments will fall under the auditing of estimates. And so, that's been an area where the auditor will look at these areas and test the assumptions under these areas, make sure they're properly disclosed, make sure they're reasonable assumptions, and then look at the disclosures related to that to make sure it's in accordance with the reporting framework. They'd be the three key auditing standards that I would see.

John Purcell: And you see the development shaping the way in which auditor's conduct it going forward?

Roger Simnett: Look, I think those standards are written to be framework neutral. I think what's happened is that there is now a greater consideration within the reporting framework of these types of issues, and so, the auditor has to pick that up. The auditor has to adjust not to just the changes in the auditing standards, but to the expectations of the investors in this particular area to make sure that's in their consideration of the risks and their responses to the assessments.

John Purcell: And the guidance will help focus attention on that.

Roger Simnett: Well, the guidance really does. That's been certainly the major benefit of saying, "Yes." I think that it does focus us on this particular subject matter, and again, this is an example ... As Kris has said, this is an example of the subject matters we expect, but also just the fact that it's again the expectations of the investors. And so, even if there's an expectation of a disclosure and you have determined that there is a good reason, why not? Let the public know why you have not made that disclosure, because that is material information to their decision making.

Kris Peach: And to be honest, it's common sense because if you ... You need to be on the front foot to make sure your investors are actually understanding your key assumptions. This is really just encouraging people to focus in on what's important.

Kris Peach: But I think a couple of other key points is it's ... This guidance does not say, "You must make climate related assumptions." It's not pushing anyone down to say, "There's an expectation that everyone's going to have an impairment." What it is saying is, "Make your disclosures. Be on the front foot. Make it absolutely clear what your assumption is," and that means that you are going to be then able to sell your story appropriately. You're not going to be just casting to the whole of the industry and what an investor thinks about that industry.

Roger Simnett: And I think this ties in quite neatly with what I think was one of the other motivations for the development of the guidance which you discuss, and that's about the understanding of the requirements of directors themselves. Their duty of care and diligence requires directors to be aware of these issues impacting their companies and to ask the right types of questions, to be actively engaged in the subject matter.

Kris Peach: Yeah. And I think one of the other points that's become very evident is that this document is helping different parts of the organisation actually talk to each other. People who've been dealing with sustainability reporting or ESG reporting are now actually talking to the financial reporting people, because there is actually that linkage now to say, "Well, some of this actually does belong or should belong in the financial statements." And so, I think that's going to have a good outcome because there's plenty of other examples where we've seen accounting standards actually help with that.

Kris Peach: Impairment provisioning, for example, in banks. It's much more evident now that the credit area is actually talking to the financial reporting area, and that actually has benefits for the whole organisation. Hopefully this is also going to have the same impact, is that it just brings everyone together who actually has relevant information to make sure it's all being considered in the right way.

John Purcell: And I think the observations are that the initiative has had quite a significant impact and uptake in interest indeed. I just want to further question you Roger if I could. Do you have any thoughts you'd like to share with us more generally about what is happening in relation to the assurance of, not necessarily strict financial information, say, in relation to assurance of integrated reports and other forms of disclosures?

Roger Simnett: Let me give an indication. I'll relate it back to the climate change disclosures. I think the trend we were tending to see in Australia was that a lot of these disclosures were going back into the other types of ... It was either in the annual report in the narratives types of information where you were getting some of these disclosures, or it was in your sustainability stroke integrated report where you're getting some of these disclosures. And a lot of the times, that was raising in investors' minds or other people's minds, well, does that have a financial impact? And so that's been a consideration.

Roger Simnett: There was disclosures and there's obviously been a consideration by the directors or the people putting out this additional information of this going forward, but we needed the extra leg. Does this have an impact on your financial report and your considerations? And just tell us as to how you've worked through that consideration. Give us your key assumptions as to why you've decided why or why not ... And in many cases I think it's focused people's attention to they should be looking at this. And another, it is making the disclosure.

Roger Simnett: As far as assurance, we're actually seeing ... Of this broader type of information, we are seeing trends in this type of information, and part of it is a loose use of the term assurance and it's around the terms of combined assurance. And what I would call combined assurance is basically a report by directors or those people who are signing off onto the accounts, why they believe the information is credible. And that can be a discussion of assurance services they have produced, as well as other types of systems of investing in internal controls, other governance processes they've gone through. Why we should believe this type of other information. And it's been asked for in the corporate governance. I think that's a very beneficial ... But it's a loose form of assurance. It's credibility enhancing techniques.

Roger Simnett: The mainstream assurance, we are pushing forward with that. We've got the IDAASB has a project on extended external assurance and the considerations of that and the challenges associated with that. And we are seeing in practise quite a range of new assurance reports including integrated reporting and including companies deciding that integrated reporting is a suitable reporting framework in different parts of the world, not in Australia, and auditing firms assuring against that format. Recognising it has to lend itself on other measurement frameworks in order to be able to give that, the bones in order to assure. There is a a real trend in these types of areas and so it's a little bit of a watch this space, but certainly it's a growing area and obviously an area of great interest to myself and to the AUASB.

John Purcell: Just as some concluding comments. I was wondering where you see Australia standing at the moment, as how well placed we are from a regulatory perspective in being able to adjust to these increasing demands and expectations about financial disclosure and the auditing of them.

Kris Peach: Well, I think we're very well placed in Australia. I think we have a very well educated professional body that are promoting these things. It's been quite fascinating actually, this bulletin, because the people that have picked up on it first have been the sustainability people. They're actually driving it, and it's the investors. The investors were on this within 24 hours. It was absolutely amazing. It's very rare that as an accounting standard setter that I've ever put out anything that's actually had that much take up that quickly by the user groups.

Kris Peach: And I think it's just come at the right time because there's a whole lot of information coming out from APRA and ASIC also focusing in on this area, and we actually talked to them as well. Before we issued this guidance, as well as the ASX, to make sure that we were actually seen as working constructively in this space. And I think that's really important as regulators that we're actually seen to be doing that and we're all not just doing our own individual little pieces. I think we're really well placed to actually get these disclosures into more mainstream disclosures.

Roger Simnett: I would agree with that. I mean, I think we're under an approach or undertaking an approach of continuous improvement in these areas of both accounting and financial reporting quality and audit quality. That requires many parties to be participating, and so it's again ... You've talked about the director's responsibility. It's the investors too making sure that we hear from them as to the information they want as a collective. And so, again, I think we're very well placed in going forward as long as we keep on doing it and bringing all the parties along for a part of this process.

John Purcell: Yeah. Just reflecting upon what you've described, it is very much a case of both responding to and being on the front foot in relation to shifting expectations. Kris and Roger, I'd like to thank you both very much for sharing this time with us. Thank you.

Roger Simnett: Thank you, John.

Kris Peach: Thank you.

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