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Spotlight on key judgements and estimates

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Audit & Assurance

Why these disclosures matter

Management makes many judgements and estimates in preparing financial statements, some of which will have a significant effect on the reported results and financial position. Information about the key judgements and estimates made is of value to investors as it helps them to assess an entity's financial position and performance and understand the sensitivities to changes in assumptions. High quality disclosure in this area, possibly including quantified information such as sensitivities or a range of possible outcomes, on how changes to estimates could affect the following year's results enables users to assess the quality of management's accounting policy decisions and the likelihood of future changes in a way that generic disclosures do not.

Two key IAS 1 requirements

There are two distinct requirements in IAS 1 relating to disclosure of the judgements and estimates made by management that have the most significant effect on the amounts recognised in the financial statements:

Judgements in applying accounting policies	Assumptions and sources of estimation uncertainty
IAS 1.122 requires disclosure of the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognized in the financial statements.	IAS 1.125 requires disclosure of information about the assumptions the entity makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes to the financial statements include details of their: nature; and carrying amount at the end of the reporting period

The difference between these two requirements is not that one involves the exercise of judgement and the other does not. Rather, it is that the judgements disclosed under IAS 1.122 explicitly exclude those that involve estimations, which are addressed by the requirements of IAS 1.125.

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Matters do not fall within the scope of these IAS 1 disclosure requirements merely because they require the exercise of judgement or involve significant assumptions or estimates. It is important to keep in mind that these requirements are concerned only with:

- the most complex or subjective judgements that have the most significant effect on amounts recognised; and
- the assumptions and other sources of estimation uncertainty where there is a significant risk of material adjustment to the carrying amounts of assets or liabilities within the next year.

If a matter does not meet these criteria, it should not be included in the disclosure of key judgements or sources of estimation uncertainty. In straightforward cases, it is possible that an entity will not have any issues falling within the scope of these disclosures.

Prominence given to disclosures

Once an issue has been identified as being in scope of either IAS 1.122 or IAS 1.125, disclosures will need to be provided in the accounting policies or other notes to the financial statements. The prominence given to the disclosures merits consideration. They are often best provided as a separate note or separate section of the accounting policies note with cross references, where appropriate, to other notes where further details may be found. Clear headings should be used.

Judgements made in applying accounting policies other than those involving estimations

To be a key judgement disclosed under IAS 1.122, the subject matter must relate to something other than assumptions about the future or making estimates. Therefore, disclosures of key judgements do not usually address measurement although they may do when the issue relates to determining the appropriate measurement basis (e.g. fair value, amortised cost etc.) rather than what goes into arriving at the amounts recognised. Typically, these disclosures cover significant issues in applying accounting standards where management has had to exercise judgement in situations where a different judgement might have led to a materially different accounting treatment.

Examples of potential areas where judgements may arise that require disclosure under IAS 1.122 include:

- revenue recognition, e.g. in complex cases involving multiple element arrangements;
- lease classification;
- derecognition (or not) of an asset or liability;
- whether an investee is a subsidiary;
- whether an acquisition is of a business or group of assets;
- whether a joint arrangement structured through a separate entity is a joint operation or a joint venture under IFRS 11 *Joint Arrangements*;
- which entity is the acquirer in a business combination under IFRS 3 *Business Combinations* (i.e. whether the combination is an acquisition or reverse acquisition); and

- determining an appropriate discount rate for pension obligations where there is a range of rates on high-quality corporate bonds or where such rates are not available in the relevant market.

However, these areas will not necessarily involve the application of judgement significant enough to warrant disclosure under IAS 1. For example, revenue recognition may be straightforward or it may be clear without detailed consideration whether a business combination is an acquisition or a reverse acquisition.

There are many other potential situations where management may need to think about how to apply a standard, or how to deal with a situation not directly addressed by a standard, where there are several potential approaches. If the judgements management makes have a significant impact on the financial statements, they would need to be disclosed under IAS 1. In some cases, the issue in question will not be addressed directly by IFRS and management will need to apply the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to develop and apply an accounting policy.

What to disclose

Disclosures need to identify the specific judgements that management has made in a manner that enables the reader to understand their impact. Generic statements that judgement has been exercised should be avoided.

Other IFRSs include specific requirements relating to disclosure of key judgements or similar matters, for example:

- IAS 40 *Investment Property* requires, when classification is difficult, disclosure of the criteria developed to distinguish investment property from owner-occupied property and property held for sale in the ordinary course of business; and
- IFRS 12 *Disclosure of Interests in Other Entities* requires disclosure of information about significant judgements and assumptions an entity has made in determining that it has control or joint control of, or significant influence over, another entity and the type of joint arrangement (i.e. joint operation or joint venture) when the arrangement has been structured through a separate vehicle.

Example disclosure

Control over B Limited

Note __ describes that B Limited is a subsidiary of the Group even though the Group has only a 45 per cent ownership interest and has only 45 per cent of the voting rights in B Limited. B Limited is listed on the stock exchange of A Land. The Group has held its 45 per cent ownership since June 2005 and the remaining 55 per cent of the ownership interests are held by thousands of shareholders that are unrelated to the Group.

The directors of the Company assessed whether or not the Group has control over B Limited based on whether the Group has the practical ability to direct the relevant activities of B Limited unilaterally. In making their judgement, the directors considered the Group's absolute size of holding in B Limited and the relative size of and dispersion of the shareholdings owned by the other shareholders. After assessment, the directors concluded that the Group has a sufficiently dominant voting interest to direct the relevant activities of B Limited and therefore the Group has control over B Limited. If the directors had concluded that the

45 per cent ownership interest was insufficient to give the Group control, B Limited would instead have been classified as an associate and the Group would have accounted for it using the equity method of accounting.

Assumptions about the future and other sources of estimation uncertainty

For a matter to fall within the IAS 1.125 disclosure requirement relating to assumptions about the future and other sources of estimation uncertainty, there needs to be subjectivity around assumptions and estimates. There also needs to be a significant risk that a material adjustment to the carrying amount of assets or liabilities may be required as a result of changes in those assumptions or estimates in the next period, not just in any future period whenever that might be. Such situations could arise, for example, when:

- reasonably possible different assumptions could have led to measurement at a materially different amount;
- an uncertain factor could cause the carrying amount of an asset or liability to change materially in the next year; or
- a reasonably possible change in an assumption could occur, with a consequential material impact on the amounts recognised.

Potential examples of areas where disclosure may be necessary, depending on the individual facts and circumstances of a particular case, include, amongst others:

- recognition and measurement of provisions where there are uncertainties relating to the future outcome of litigation;
- recognition and measurement of liabilities relating to uncertain tax positions;
- measurement of obligations for long-term employee benefits such as pensions;
- forecast of future profits affecting the amount recognised for a deferred tax asset;
- assumptions underlying the estimation of recoverable amounts of assets for impairment tests; and
- fair value measurements that depend on significant unobservable inputs.

However, these and other issues will fall within the IAS 1 disclosure requirement only if there is a significant risk of material adjustment to the carrying amounts of assets or liabilities in the next year. Taking impairment assessments as an example, if the tests show that there is significant headroom such that changes in assumptions that are considered reasonably possible would not lead to material impairment, this would suggest that a material adjustment to the carrying value of the assets is unlikely to arise in the next year. Hence, impairment would not then fall within the scope of this disclosure requirement.

There are many other assumptions and estimates underlying what goes into financial statements but they do not fall within the IAS 1 disclosure requirement if the risk of material adjustment in the next period due to changes in assumptions or other sources of estimation uncertainty is not significant.

The IAS 1 disclosures are not required for assets or liabilities that are measured at fair value based on a quoted price in an active market for an identical asset or liability. This is so even if there is a significant risk that their carrying amounts might change materially within the next financial year. This is because these changes would not arise from assumptions or other sources of estimation uncertainty at the end of the reporting period. Similarly, an observable market rate that is used in measuring an asset or liability is not itself a subjective or complex assumption about the future or other source of estimation uncertainty, although selection of an appropriate rate may be a key judgement in applying accounting policies.

By contrast, some estimates involve subjective assumptions, such as those relating to risk adjustments to cash flows, determining an entity's weighted average cost of capital or future increases in salaries or prices. The Basis for Conclusions to IAS 1 notes that no matter how diligently an entity estimates the carrying value of an asset or liability based on such estimates and assumptions, the amount included in the financial statements cannot itself provide information about the underlying estimation uncertainties involved in determining the amount included or the implications of those uncertainties for future results. The IAS 1 disclosures seek to address this issue.

What to disclose

When there are uncertainties that have a significant risk of causing a material adjustment to the carrying amount of assets and liabilities within the next financial year, the notes to the financial statements need to disclose:

- information about the assumptions concerning the future; and
- other major sources of estimation uncertainty at the end of the reporting period.

In respect of those assets and liabilities, the notes need to include details of:

- their nature; and
- their carrying amount at the end of the reporting period.

IAS 1 states that the disclosures should be presented in a way that helps users of the financial statements to understand the judgements management makes about the future and about other key sources of estimation uncertainty. The nature and extent of the information to be disclosed will vary according to the nature of the assumptions and the other circumstances. IAS 1.129 gives the following examples of the types of disclosures to be made:

- the nature of the assumption or other estimation uncertainty;
- the sensitivity of the carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;
- the expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected; and
- an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.

In more complex circumstances, it may be necessary to go further than simply providing these example disclosures to enable users to understand fully the estimates and judgements made in the preparation of financial statements.

Note that IAS 1 confirms that it is not necessary to disclose budget information or forecasts in making these disclosures.

Sometimes, it may be impracticable to disclose the extent of the possible effects of an assumption or another key source of estimation uncertainty at the end of the reporting period. In such cases, IAS 1 requires the entity to disclose that it is reasonably possible, based on existing knowledge, that outcomes within the next financial year that are different from assumptions could require a material adjustment to the carrying amount of the affected asset or liability. In all cases, the nature and the carrying amount of the specific asset or liability, or class of assets or liabilities, needs to be disclosed.

Other IFRSs include specific requirements for disclosures that would otherwise be required by IAS 1, for example:

- IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires disclosures, in specified circumstances, of major assumptions concerning future events affecting classes of provisions;
- IFRS 13 *Fair Value Measurement* requires the disclosure of significant assumptions, including the valuation techniques and inputs, the entity uses when measuring the fair values of assets and liabilities that are carried at fair value.

Compliance with specific disclosure requirements of other standards may not be sufficient to meet IAS 1's requirements. For example, it is possible that impairment testing of property, plant and equipment could involve assumptions that fall within the scope of IAS 1.125. In such cases, sensitivity disclosures may need to be provided to meet IAS 1's requirements even though they are not explicitly required for impairment tests of such assets by IAS 36 *Impairment of Assets*.

Example disclosure

<u>Uncertain tax positions</u>

The Group's current tax provision of CU__ relates to management's assessment of the amount of tax payable on open tax positions where the liabilities remain to be agreed with relevant tax authorities. Uncertain tax items for which a provision of CU__ is made relate principally to the interpretation of tax legislation applicable to arrangements entered into by the Group. Due to the uncertainty associated with such tax items, it is possible that, on conclusion of open tax matters at a future date, the final outcome may differ significantly.

Whilst a range of outcomes is reasonably possible, the extent of the maximum reasonably possible range is from additional liabilities of up to CU__ to a reduction in liabilities of up to CU__.

<u>Impairment testing</u>

The Group's cash generating units (CGUs) all have significant headroom with the exception of Division B, to which goodwill of CU__ is allocated. The assessment of the recoverable amount of goodwill allocated to

Division B is most sensitive to the achievement of the 2017 budget. Budgets comprise forecasts of revenue, staff costs and overheads based on current and anticipated market conditions that have been considered and approved by the Board. Whilst the group is able to manage most of Division B's costs, the revenue projections are inherently uncertain due to the short term nature of Division B's business and unstable market conditions. Revenue of Division B is most sensitive to changes in the market price of Commodity X as the Division's products are used by companies operating in that marketplace.

The market for Division B's products has seen a significant slowdown over the past 18 months due to

a decline in the market price of Commodity X which has only recently begun to stabilise. It is possible that further underperformance may occur in 2017 if prevailing market prices drop further or our customers reduce their capital expenditure.

A __% underperformance against budgeted sales for Division B is considered reasonably possible based on recent experience and would lead to an impairment charge of CU__.

A __% underperformance against budgeted sales would reduce the headroom in Division B to nil but would not result in an impairment charge.

Cutting out the clutter

It is also important to identify what is within the scope of either the IAS 1.122 or IAS 1.125 disclosure requirements and what is not, so that the disclosures provided are not obscured by irrelevant material that detracts from the key messages. The measurement of a particular asset or liability should not be described as a key source of estimation uncertainty merely because the associated calculations are complex. What matters is whether there is a significant risk of a material adjustment to the measurement of assets or liabilities as a result of changes in assumptions or estimates in the next period. In addition, the disclosure of key judgements and sources of estimation uncertainty under IAS 1 should not be in substitution for, or a repeat of, information that belongs in the accounting policies for the areas discussed.

The IASB noted in the Basis for Conclusions to IAS 1 that it expected that the disclosures required by IAS 1.125 would be made in respect of relatively few assets and liabilities, or classes of them, because they relate only to the most difficult, subjective or complex judgements. Similarly, only the judgements in applying accounting policies that have the most significant effect on amounts recognised are included in the IAS 1 disclosure of key judgements.

Interaction with other disclosures in the annual report

In many jurisdictions, other elements of an annual report (such as a Management Discussion and Analysis or report of those charged with governance) will also include information relating to judgement, risk and uncertainty. The interrelationship between such other components of the annual report and the financial statements is an important consideration in assessing whether the annual report, taken as a whole, tells a single, cohesive story.It should, however, be noted that the fact that an area is identified or noted as significant in other reporting does not in itself mean it is within the scope of the IAS 1 disclosure requirements relating to key judgements and sources of estimation uncertainty.

Key questions for preparers of financial statements

- Do the disclosures in the financial statements distinguish clearly between:
  - key judgements in applying accounting policies, other than those involving estimations; and
  - assumptions and other sources of estimation uncertainty affecting the future?
- Do disclosures explain clearly the specific judgements made and their effect on the financial statements?
- Are the areas of estimation uncertainty identified those where a significant risk of material adjustment to the carrying amounts of assets or liabilities in the next year, arising from changes to assumptions or other sources of estimation uncertainty has been identified?
- Has the carrying amounts of assets or liabilities identified as being subject to key sources of estimation uncertainty been stated?
- Do the disclosures explain the key sources of estimation uncertainty for each area identified?
- Do the disclosures include sensitivities or ranges of outcomes, so that users of the financial statements can fully understand the potential effect of estimates made?
- Do the disclosures avoid mere repetition of accounting policies and generic statements without quantification and focus on how particular decisions or assumptions might affect the entity's results and financial position?

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