Significant judgements and estimates in practice

Presenters

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Why are we discussing this?

The guidance in IAS 1 *Presentation of Financial Statements* on disclosures of judgements made when applying material accounting policies and sources of estimation uncertainty is not new.

However:

- there are considerable variations in practice regarding how these disclosure requirements are met by reporting entities,
- sometimes the disclosures provided are even inconsistent with disclosures provided in other sections of the financial statements,
- increased focus on these disclosures from regulators (but not always consistent views), and
- in the UK, the *Financial Reporting Council* (FRC) has spent significant efforts on this area over several years.

Agenda

- What are the requirements in IFRS?
- Results of study of disclosures made by large companies listed on NASDAQ Stockholm
- Lessons from the UK – approach taken by the *Financial Reporting Council (FRC)*
- Summing up

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What are the requirements in IFRS?

Judgements when applying accounting policies

- In **applying an entity's accounting policies,** management makes a number of ***judgements*** that can **significantly affect** the amounts recognised in the financial statements
- An entity should according to IAS 1.122 disclose the judgements (other than estimates) that have the ***most significant*** effect on the amounts that it recognises in its financial statements.

IAS 1.122:

An entity shall disclose, along with its significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 125), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

IAS 1.BC77:

[…] The Board decided that disclosure of the most important of these judgements would enable users of financial statements to understand better how the accounting policies are applied and to make comparisons between entities regarding the basis on which managements make these judgements.

Judgements when applying accounting policies (cont.)

Examples of *judgements* (IAS 1.123)

- Determining when **substantially all the significant risks and rewards** of ownership of financial assets and, for lessors, assets subject to leases are transferred to other entities.
- Determining whether, in substance, particular sales of goods are **financing arrangements** and therefore do not give rise to revenue.
- Determining whether the contractual terms of a financial asset give rise on specified dates to cash flows that are **solely payments of principal and interest** on the principal amount outstanding ("SPPI")

Judgements when applying accounting policies (cont.)

Example (Eastnine, annual report 2022)

Important considerations in the application of the Group's accounting policies

The holdings in MFG, one of the holdings in which Eastnine invested during its period as an investment entity, constitutes an associated company as Eastnine owns a substantial portion of the company and holds a seat on the board of MFG, conferring some influence over the company. This holding is recognised at fair value through profit/loss, using an exemption from the equity method in IAS 28. The exemption is applicable to activities that constitute a venture capital organisation or a securities fund, share fund or similar company including investment-linked insurance funds.

The assessment is that this exemption is applicable to Eastnine. This is the same assessment as was made during the time Eastnine was an investment entity. The purpose of the holdings in Eastnine's remaining activities from the time as an investment entity is exclusively to generate returns from dividends and/or value growth, and on the condition that the holdings are retained for a limited time. Moreover, the business as an "investment entity" is clearly and objectively separable from the business as a real estate company, and there are no points of contact between the holdings related to each of the concerns.

Sources of estimation uncertainty

- In **determining the carrying amounts of** some **assets and liabilities**, management ***estimates*** the effects of uncertain future events on those assets and liabilities at the reporting date.
- According to IAS 1.125, an entity shall disclose the key assumptions it makes about the future, and other major sources of estimation uncertainty at the reporting date that have:
  - a **significant risk** of resulting in,
  - a **material adjustment** to the carrying amounts of assets and liabilities,
  - in the **next financial year**.

Sources of estimation uncertainty (cont.)

Example (BHG Group, annual report 2022)

3.1 Significant sources of estimation uncertainty
The sources of estimation uncertainty presented below pertain to those that entail a significant risk of the value of the asset or liability requiring major adjustments during the coming financial year.

3.1.1 Measurement of earn-outs and liabilities to non-controlling interests
In many of the Group's business combinations, contingent considerations to the seller arise or, in the event that the Group has issued a put option to a non-controlling interest, a liability to the non-controlling interest arises. Both contingent considerations and liabilities to non-controlling interests are largely dependent on the acquired company's earnings trend. Accordingly, an important estimate in determining the fair value of these items is the Group's assessment of the acquired company's future earnings trend. Changes in the value of contingent considerations are recognised through profit or loss, while changes in the value of liabilities to non-controlling interests are recognised directly in equity.

Sources of estimation uncertainty (cont.)

Required disclosures (IAS 1.129):

An entity presents the disclosures in paragraph 125 in a manner that helps users of financial statements to understand the judgements that management makes about the future and about other sources of estimation uncertainty. The nature and extent of the information provided vary according to the nature of the assumption and other circumstances. Examples of the types of disclosures an entity makes are:

a) the **nature of the assumption** or other estimation uncertainty;
b) the **sensitivity of carrying amounts** to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;
c) 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
d) an **explanation of changes made to past assumptions** concerning those assets and liabilities, if the uncertainty **remains unresolved**.

Sources of estimation uncertainty (cont.)

- Deciding the **level of detail** to be given in the financial statements requires **extensive judgement**, resulting in a wide **variety of disclosures in practice**.
- The more estimates that are disclosed, the **less specific** the disclosures typically become. This would run the risk of **obscuring** the most relevant information with other disclosures.
- The *Basis for Conclusions* to IAS 1 shows that the IASB was aware that the requirement could potentially require quite extensive disclosures and explains its attempt to limit this as follows:

IAS 1.BC84:
IAS 1 does not prescribe the particular form or detail of the disclosures. Circumstances differ from entity to entity, and the nature of estimation uncertainty at the end of the reporting period has many facets. IAS 1 limits the scope of the disclosures to items that have a significant risk of causing a ***material adjustment*** *to the* ***carrying amounts of assets and liabilities within the next financial year****. The longer the future period to which the disclosures relate, the greater the range of items that would qualify for disclosure, and the less specific are the disclosures that could be made about particular assets or liabilities.* ***A period longer than the next financial year might obscure the most relevant information with other disclosures.***

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Significant estimates under IAS 1 vs. Key Audit Matters

- Key audit matters (KAM) share characteristics with significant estimates (IAS 1.125) but are not the same – KAMs include a broader area of matters:

Those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. This includes matters of the below kind that were of most significance in the audit:

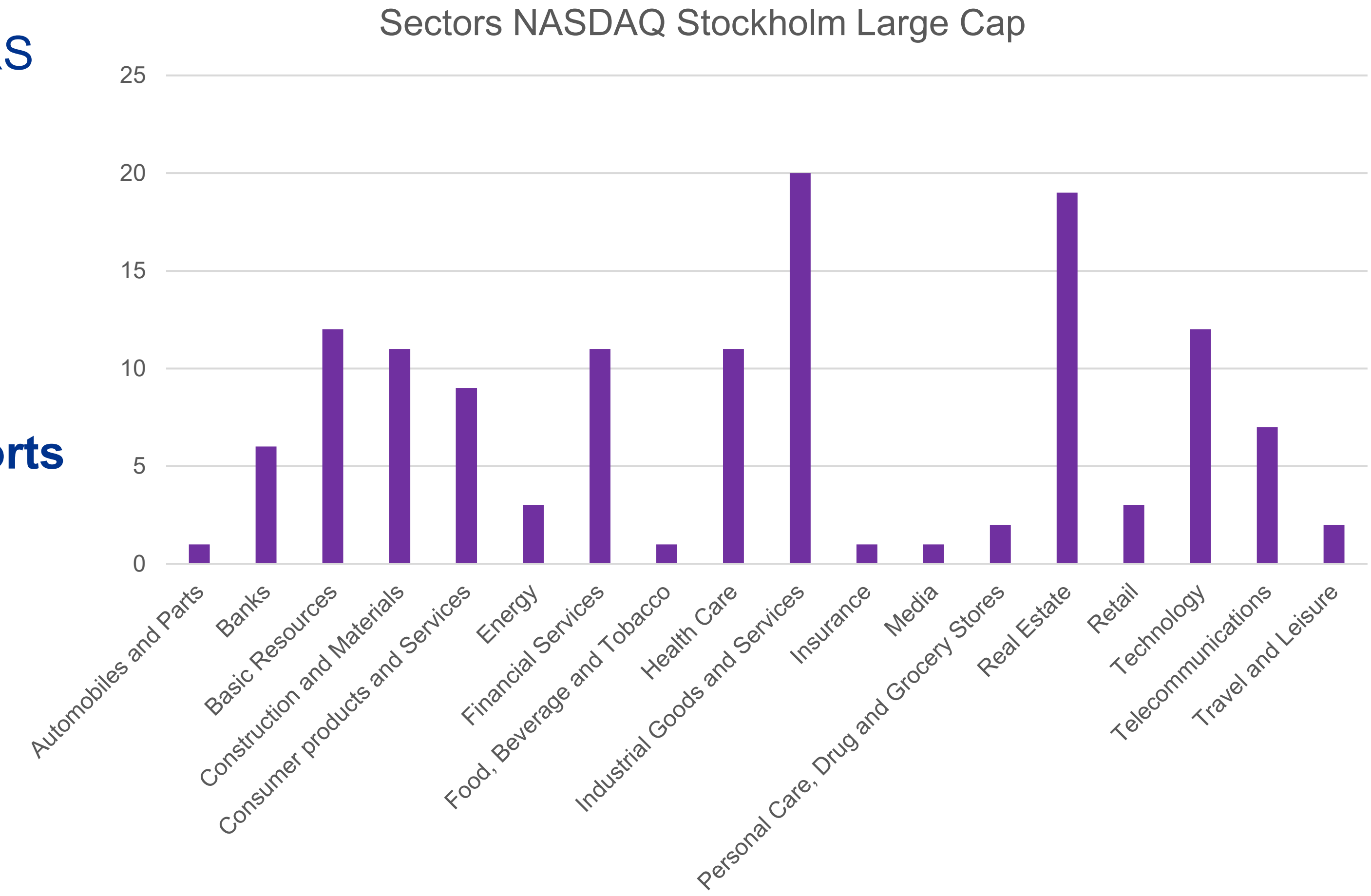
- areas of higher assessed risk of **material misstatement,** or **significant risks** identified in accordance with *ISA 315 (Revised),*
- **significant auditor judgements relating** to areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty,
- the effect on the audit **of significant events or transactions** that occurred during the period.

- Hence, the disclosures provided under IAS 1 on significant estimates would seldom be identical to what the auditor presents as key audit matters in the auditor's report.

Practice study

Study overview

- Study of companies with **shares listed** on **NASDAQ Stockholm Main Market, Large Cap**
- Companies not reporting under IFRS were excluded from the study.
- **132 companies** from 18 different sectors.
- The study is based on **annual reports** for the year **2022.**



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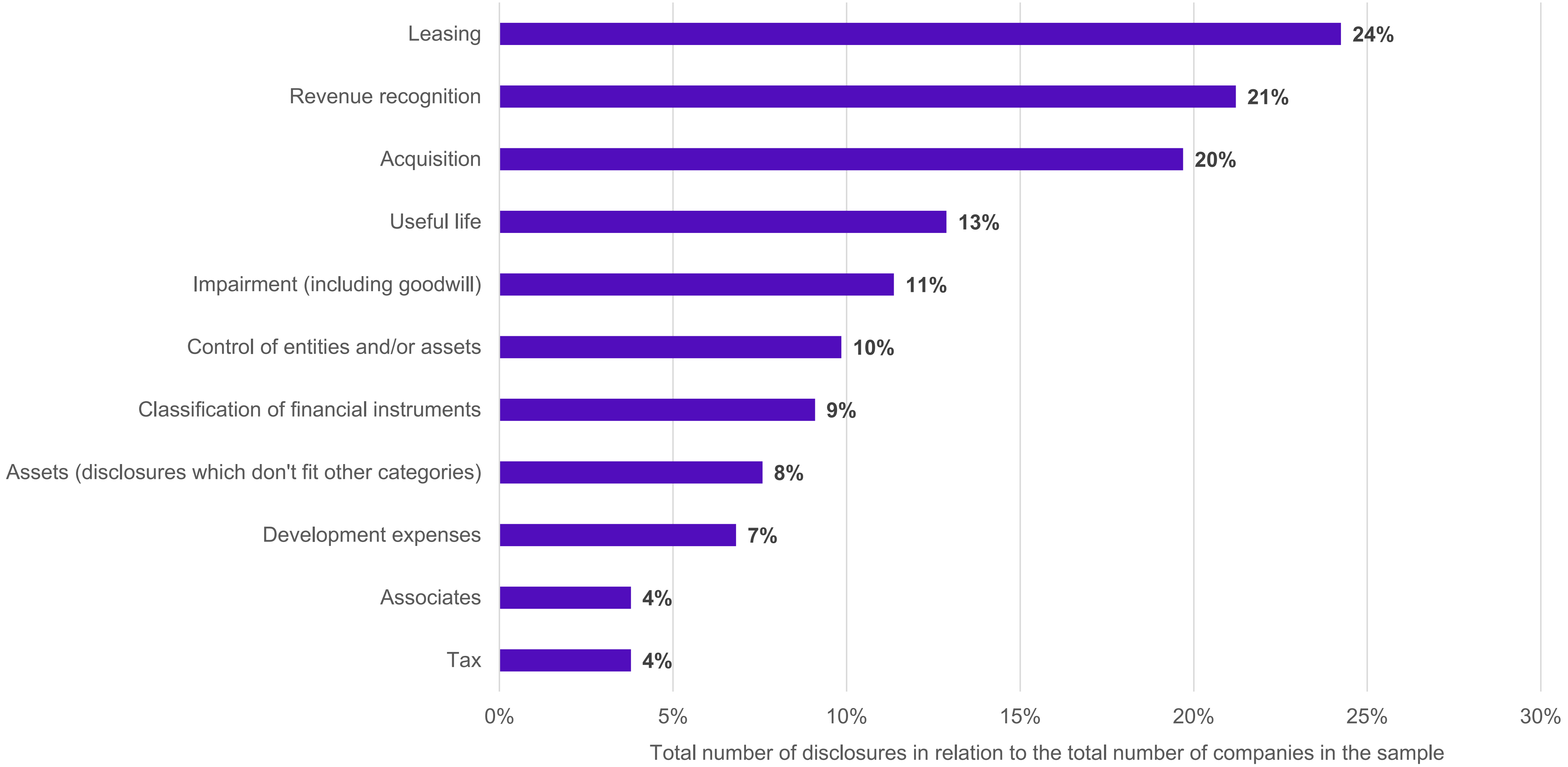
Differentiation between judgements and estimates

- All but one of the companies in the study have disclosures about judgements (IAS 1.122) and/or estimates (IAS 1.125).

- However, only **32 out of 132 companies (24%)** clearly separate disclosures on judgements from disclosures on estimates, in particular:
  - companies that do **not separate disclosures** often write about judgements and estimates in a manner which makes it **unclear** whether the disclosures refer to IAS 1.122 or IAS 1.125, and
  - according to our high-level assessment, only **16 out of these 32 companies** appear to categorise all items in a way that is consistent with the use in IAS 1 of judgements and estimates, respectively.

Most common areas of judgements

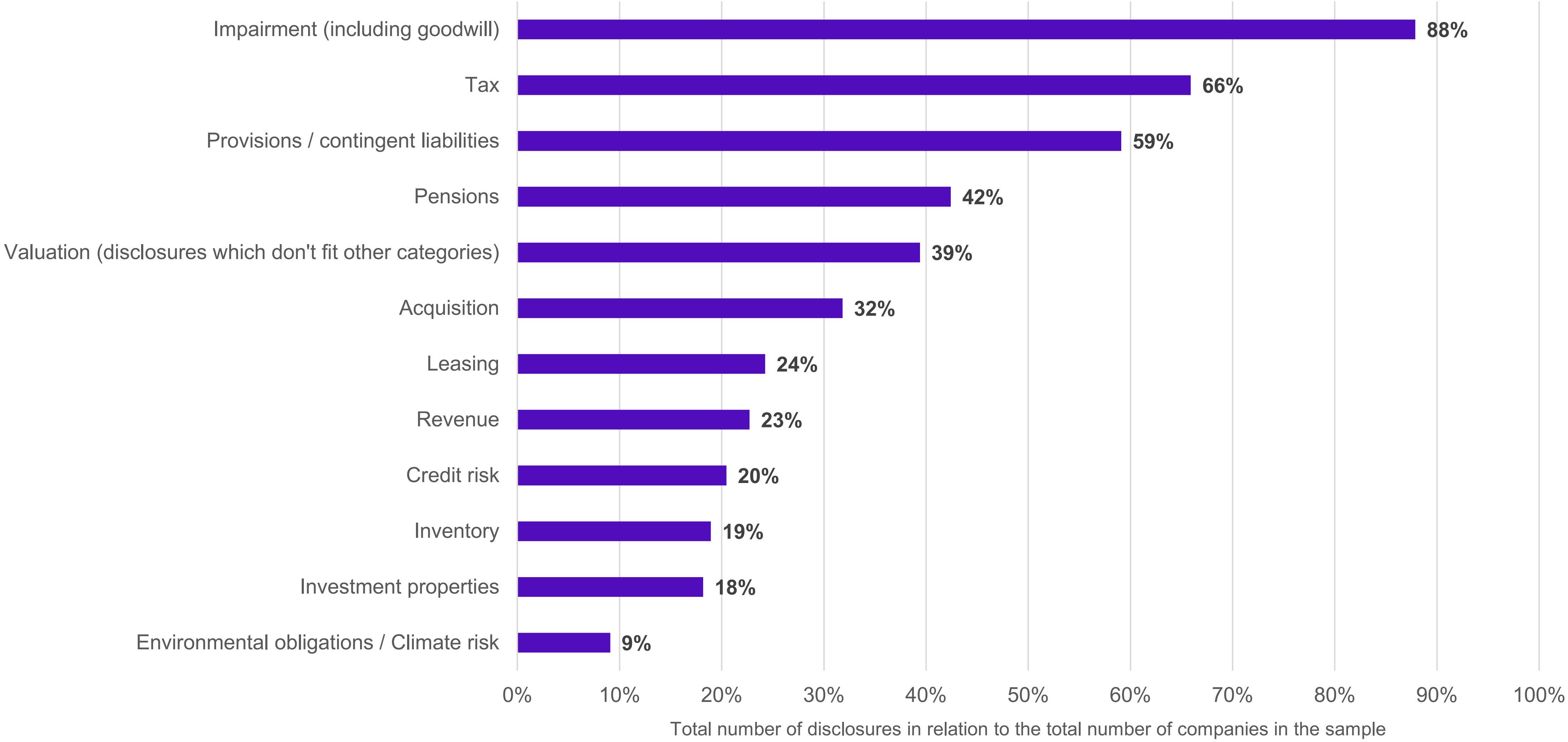


Disclosures on estimates

- **All but two** of the companies included **disclosures about estimates** in their annual financial reports.
- However, **only 21 out of 132 (16%)** stated that **all three factors** in IAS 1.125 applied to the disclosed estimates, i.e:
  - a **significant risk** of resulting in
  - a **material adjustment** to the carrying amounts of assets and liabilities
  - in the **next financial year**.

- According to our high-level assessment, **only 2 out of 132 (2%)** of companies only disclose estimates where **all three factors in IAS 1.125 apply**.

Most common areas of estimates



Inconsistent disclosures on goodwill?

- **50 out of 97 companies (52%)** which mention goodwill in the estimates and judgements section appeared to be **inconsistent** with the disclosures on impairment of goodwill.

- For these 50 companies, sensitivity analyses for goodwill impairment **showed no scenarios** where impairment would be needed.

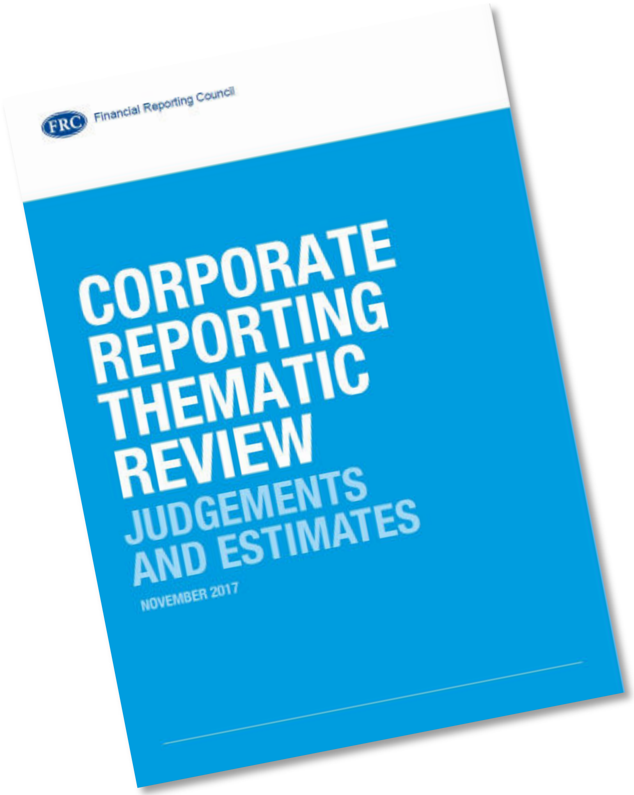
- Common with a statement in the notes that **no reasonably possible change in a key assumption** could cause the carrying amount of goodwill to exceed the recoverable amount.

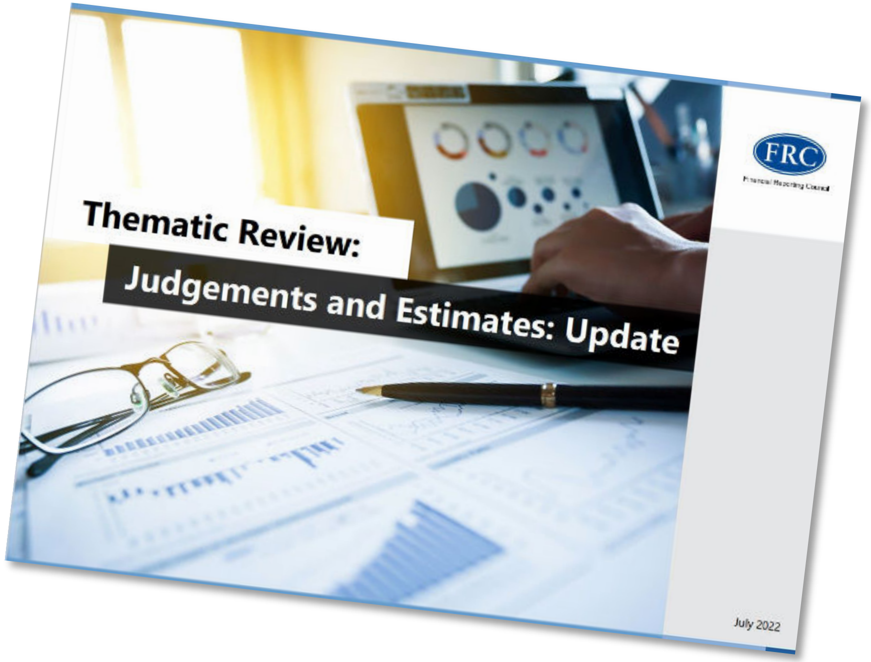
  - Appears inconsistent to include such goodwill as significant estimate under IAS 1.125, which requires disclosures of estimates that have a **significant risk** of resulting in a **material adjustment** to the carrying amounts of assets and liabilities in the **next financial year.**

Lessons from the UK - approach taken by the FRC

Long standing focus on judgements and estimates by the FRC

- The Financial Reporting Council (FRC) in the UK has performed two ”thematic reviews” focusing on disclosures on judgements and estimates made by UK listed entities.
- Two published reports: November 2017, follow up in July 2022.





Areas of improvement identified in the 2017 report

- Clear differentiation of estimates from judgements
- Several companies disclosed judgements that did not appear to have a material effect on the financial statements
- Boilerplate text and unnecessary clutter should be avoided
- Estimates which, although they may be related to material amounts, did not appear to have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities at all (common example: goodwill impairment)
- Distinction should be made between estimates that have a significant risk of resulting in a material adjustment to the carrying amounts within the next year, and other estimates such as those that may affect carrying amounts in the longer-term
- Expect companies to reassess whether disclosures made in a previous year remain relevant
- Often lack of quantification of amounts and sensitivity analysis

(d) Tax losses
The Group's deferred tax assets at 31 December 2021 are recognised to the extent that taxable profits are expected to arise in the future against which tax losses and allowances in the UK can be utilised. A $127.6 million tax credit has been recognised as an exceptional item, reflecting the reversal of the previous deferred tax asset derecognition. In accordance with IAS 12 Income Taxes, the Group assesses the recoverability of its deferred tax assets at each period end. Sensitivities have been run on the oil price assumption, with a 10% change being considered a reasonable possible change for the purposes of sensitivity analysis (see note 2). A 10% reduction in oil price would result in a deferred tax asset derecognition of $318.6 million and a 10% increase in oil price would result in an increase in deferred tax asset recognition of $107.9 million.

EnQuest PLC
Annual Report and Accounts, p137

Sensitivity provided for the effect of oil price assumptions on deferred tax asset recognition.

From FRC's 2022 report

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Some observations in the 2022 report

Improvements made

- Did not find much in the way of irrelevant or boilerplate narrative; companies had generally **made an effort to tailor the disclosures**.
- Significant estimates were supported by quantification, such as information about **assumptions made and the specific amount at risk** of material adjustment.
- Observed many instances of **effective linkage** and the **use of cross-referencing** to achieve well-integrated estimate disclosures.

Room for furhter improvement

- Should **explicitly state** whether estimates have a **significant risk** of a **material adjustment** to the carrying amounts of assets and liabilities **within the next financial year**.
- **Sensitivity disclosures** should be provided more frequently and in the way that is most meaningful to readers.
- Should **reassess** whether **disclosures** made in a previous year need to be revised.
- Where additional estimate disclosures are provided, such as those carrying lower risk, having smaller impact or crystallising over a longer timeframe, they should be **clearly distinguish**ed from those with a significant short-term effect.

26. Climate change and energy transition
In March 2021, Tullow announced its commitment to being Net Zero on our Scope 1 and Scope 2 emissions on a net equity basis by 2030 supporting the goal of limiting global temperature rise to well below 2° C as per Article 2 of the Paris Agreement.

This note describes how Tullow has considered climate related impacts in some key areas of the financial statements and how this translates into the valuation of assets and measurement of liabilities as Tullow make progress in the energy transition.

Note (ag) key sources of estimation uncertainties describes those uncertainties that have the potential to have a material effect on the Group Balance Sheet in the next 12 months.

This note describes the key areas of climate impacts that potentially have short and longer-term effects on amounts recognised in the Group Balance Sheet as at 31 December 2021. Where relevant this note contains references to other notes to the Group Financial Statements and aims to provide an overarching summary.

Tullow Oil plc
2021 Annual Report and Accounts, p146

Clear disclosure that estimates with a risk of material adjustment in the next year are disclosed elsewhere. A helpful cross-reference is provided.

Articulation that the impact of climate change can have short and longer-term effects. The disclosure is clearly separated from IAS 1.125 estimates.

From FRC's 2022 report

Summing up

Summing up

- **Findings from the practice study**
  - The **distinction** between estimates and judgements is in many cases unclear.
  - Estimates often include items which **do not** represent a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities in the next year.
  - Fairly common that **impairment of goodwill** is included as a significant estimate, even though other disclosures indicate that there is no significant risk of impairment the next financial year.

- **Our recommendations**
  - Ensure that a **distinction** is made between judgements and estimates in the disclosures to help the reader.
  - Consider **separating** the disclosures of **more long-term / lower risk estimations** from those of an IAS 1.125 nature.
  - **Reconsider** the **disclosures made last year** – which are no longer relevant and should something be added?
  - Don’t forget the **analysis of sensitivities** for those estimates that really meet the criteria in IAS 1.125.
  - **Be specific** in the disclosures and **avoid boiler plate** language.
  - **If** there are **no significant judgements or estimates** in a particular year – just state that fact!

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Thank you!