CHAPTER 1

Key accounting and financial reporting issues- judgements and estimates

This article aims to:

Highlight key areas that regulators have highlighted and have provided improvement points relating to judgements and estimates with the help of illustrative examples and case study.

Background

Development of accounting estimates involves use of judgements and/or assumptions based on the latest available, reliable information. Disclosures of such significant accounting judgements and sources of estimation uncertainty facilitates a better understanding of assumptions made and the extent to which changes to those assumptions may affect a company's future financial position.

Ind AS 1, *Presentation of Financial Statements*, prescribes requirements for disclosure of judgements[1] that management has made in the process of applying an entity's accounting policies and assumptions it makes about the future and other major sources of estimation uncertainty[2]. However, regulators observed that in certain cases, these disclosures did not contain sufficient information, or appeared inconsistent with information elsewhere in the report and accounts. Accordingly, in this issue of key accounting and financial reporting issues, we will touch upon some of the key areas that regulators have highlighted and provided improvement points in the area of **judgements and estimates**. We have also provided illustrations of disclosures from thematic reviews performed by the Financial Reporting Council (FRC).

Source

While preparing this article, we have referred to:

- The Report on Audit Quality Review issued by the Quality Review Board issued in October 2023,
- The report- Annual Review of Corporate Reporting (2022/23) issued by the Financial Reporting Council,
- Thematic review: Judgements and Estimates: Update- issued by FRC in July 2022, and
- Recent ESMA[3] enforcement directions.

1. Judgments, apart from those involving estimations, 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. This disclosure is required by paragraph 122 of Ind AS 1.
2. 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.
3. European Securities and Markets Authority. This disclosure is required by paragraph 125 of Ind AS 1.

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Example disclosure

Significant accounting estimates [1]

The preparation of the Group's consolidated financial statements includes the use of estimates and assumptions. The significant accounting estimates with a significant risk of a material change to the carrying value of assets and liabilities within the next year in terms of IAS 1, *Presentation of Financial Statements*, are:

- Fair value of forestry assets – refer to note 14
- Actuarial valuations of retirement benefit obligations – refer to note 24

Other areas of judgement and accounting estimates [2]

The consolidated financial statements include other areas of judgement and accounting estimates. While these areas do not meet the definition under IAS 1 of significant accounting estimates or critical accounting judgements, the recognition and measurement of certain material assets and liabilities are based on assumptions and/or are subject to long term uncertainties. The other areas of judgements and accounting estimates are:

- Taxation – refer to notes 7 and 33
- Residual values and useful economic lives of property, plant and equipment – refer to notes 10 and 33
- Fair value of assets acquired and liabilities assumed in business combinations – refer to note 25

[1]- Significant estimates are listed separately. There is a clear statement that these estimates have a risk of material adjustment to the carrying value of assets and liabilities within the next year.

[2]- The other areas of judgement and accounting estimates section explains that the judgements/estimates relate to material assets and liabilities that are based on assumptions and/or are subject to longer term uncertainties.

(Source: Thematic review: Judgements and Estimates: Update- issued by FRC in July 2022)

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Quantification of risks of material adjustments

The regulators stated that when disclosing significant estimates, the specific amount of the asset or liability which is at a risk of material adjustment should be prescribed. Further, there should be sufficient granularity in the descriptions of assumptions and/or uncertainties to enable users to understand management's most difficult, subjective or complex judgements.

Example disclosure

The disclosure given below provides a detailed description of the nature of the estimation uncertainty and quantifies the specific amount at risk of material adjustment (a specific inventory provision).

Inventory reserve - Raw Materials and Sub-Assemblies

Consistent with last year, the Group adopts a usage-based approach in calculating its inventory provision. COVID-19 and global commodity shortages have significantly impacted our operations, logistics and supply chains over the past year and therefore the approach to identify inventory at risk has been flexed to consider the impact from these factors. Management's focus has been on inventory that is over 365 days old.

Raw materials and sub-assemblies are reserved if the quantity on hand, that is greater than 365 days old, exceeds three year's historical usage and, following review by engineering and supply chain personnel, there is no reasonable prospect of the components being used or their shelf life not being exceeded. Three years is felt to be appropriate at this time as: recent usage has been depressed following the economic impacts from COVID-19; the majority of components have a long shelf life; product demand mix between project and MRO business has been skewed; and new products or upgrades have been delayed.

Raw material and sub-assembly inventory consists of a large number of Stock Keeping Units (SKUs) of varying value. Assessment of every at-risk SKU would be impractical, and the reserve has, therefore, been determined by assessing the nature, usability and condition for a range of at-risk SKUs that represent a significant population of the inventory at risk. The result from this assessment was then used to determine a reserve percentage that was applied to the remaining population, with the combination of these calculations determining the total reserve required.

The provision element that relates to raw material and sub-assembly items greater than 365 days old is GBP2.2m and represents 43 per cent of that specific aged category of inventory.

(Source: Thematic review: Judgements and Estimates: Update- issued by FRC in July 2022)

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Sensitivity of significant estimates

As per paragraph 129 of Ind AS 1, the disclosure that an entity makes regarding significant estimates *inter alia* includes the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity. Also, the range of reasonably possible outcomes within the next financial year in respect of carrying amounts of assets and liabilities affected should be disclosed.

The FRC has reiterated that sensitivity disclosures should be consistent with disclosures elsewhere in the annual report. Also, sensitivity disclosures should not be limited to those required by any other Ind AS[6].

With regard to the disclosure on ranges of outcomes, the regulators noted that ranges of outcomes may be more relevant where an estimate is not sensitive in a linear manner to changes in input assumptions. Instead, there may be several different possible outcomes depending on future circumstances, such as when estimating a provision for litigation.

Example disclosure of sensitivity analysis

Note: In this example, sensitivity is provided for forestry assets, which are disclosed as a significant estimate. It is to be noted that quantitative sensitivity analysis is not required by any other Ind AS.

Forestry assets

The Group has performed sensitivity analysis of reasonably possible changes in the significant assumptions… taking into account historical experience. The sensitivity table is based on an illustrative percentage change, however the estimates may vary by greater amounts. Therefore, the Group considers the forestry assets valuation to be a key estimate. The reported value of owned forestry assets would change as follows should there be a change in these underlying assumptions on the basis that all other factors remain unchanged:

Euro (in million)	2021	2020
Effect of EUR5/tonne increase in net selling price	71	68
Effect of 1% increase in conversion factor (hectares to tonnes)	3	4
Effect of 1% increase in risk premium	(5)	(6)

(Source: Thematic review: Judgements and Estimates: Update- issued by FRC in July 2022)

6. It is to be noted that disclosure requirements under paragraphs 125 and 129 are not required for assets and liabilities measured at fair value if this is based on quoted prices in an active market for an identical asset or liability.

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The impact of climate change on significant estimates[7]

Estimation uncertainty may be impacted by climate change and any climate targets or commitments made by a company. During their review, the regulators observed that a few companies made little or no mention of climate change in the financial statements or climate change was not adequately identified as a significant estimate.

In this regard, regulators recommended the following with regard to climate related disclosures:

- Consideration of the connectivity between climate-related narrative reporting, especially any disclosure of significant climate risks or net-zero commitments, and the financial statements
- Clarification of the timing of any impact relating to climate change assumptions and/or uncertainties
- Quantification of the specific amount at risk of material adjustment
- Sufficient granularity in the descriptions of assumptions and/or uncertainties and
- Sensitivities and/or ranges of reasonably possible outcomes.

Where climate related sources of estimation uncertainty are expected to have a material impact over a longer timeframe, for example where government regulation is **expected to be introduced** in the future, regulators expect companies to consider whether disclosure of this information may be required by paragraph 112(c) of Ind AS 1.

Where climate has a more significant impact on estimates, careful placement of climate disclosures and the use of effective cross-referencing clearly highlights these issues to users.

Example disclosure

Note: The disclosure clearly articulates that the impact of climate change can have short and longer-term effects. The disclosure is clearly separated from Ind AS 1.125 estimates.

Climate change and energy transition

In March 2021, Company X announced its commitment to being Net Zero on 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 degrees Celsius as per Article 2 of the Paris Agreement.

This note describes how Company X 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 Company X makes 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[8].

This note describes the key areas of climate impacts that potentially have short and long-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.

(Source: Thematic review: Judgements and Estimates: Update- issued by FRC in July 2022)

7. Source: Thematic review: Judgements and Estimates: Update- issued by FRC in July 2022
8. Clear disclosure that estimates with a risk of material adjustment in the next year are disclosed elsewhere. A helpful cross-reference is provided.

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