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IFRS Today

Our series on the most topical issues in IFRS® Standards and financial reporting

29 May 2020

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EPISODE TRANSCRIPT

COVID-19 – Estimating in uncertain times

Speakers

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Reinhard

Hello and welcome.

In a matter of months, COVID-19 has completely changed the macroeconomic landscape. Many countries have seen dramatic declines in economic activity and trade, with the full impacts on unemployment and government finances yet to emerge.

The level of uncertainty about the future outlook – and the related market volatility – pose significant challenges for management when making estimates.

I'm **Reinhard Dotzlaw**, a partner at KPMG in Canada and global IFRS leader at KPMG International, and I've invited **Matt Cook**, a partner in our International Standards Group, and **Michal Dusza**, a partner in the Department of Professional Practice at KPMG in the US, to join me to provide their insights on some of the key challenges around making estimates in uncertain times, including:

– getting to grips with estimation uncertainty;

– how to select the amount to recognise from a range of possible outcomes; and

– getting the disclosures right.

So, Matt, let's start with understanding estimation uncertainty. What's the crux of the issue?

As management, you need to identify the key sources of estimation uncertainty. The question to ask is: for which parts of the estimate could a variation that's reasonably possible have a material effect?

Matt

Well as you said, Reinhard, we're in unprecedented times, and there's a lot of unknowns:

– we don't know how long the social distancing and travel restrictions will last;

– we don't know how long the economy will take to recover;

– we don't know how quickly the economy will recover; and

– we don't know what the new normal is going to look like.

So the unknowns are significant because we just don't know what the longer-term impacts will be.

And the situation is complex because it's changing rapidly, with new information coming to light every day that could significantly affect management's assessment of these uncertainties.

Reinhard

So I guess for management, making estimates will require more thoughtful planning and effort given these uncertainties?

Matt

Absolutely.

As management, you need to identify the key sources of estimation uncertainty. The question to ask is: for which parts of the estimate could a variation that's reasonably possible have a material effect?

And you need to bear in mind that because these things are changing so rapidly:

– the key sources of estimation uncertainty may be different to last year and

– the degree of variability may be larger and may change as the situation develops.

If an estimate includes a number of assumptions that are highly sensitive to changes in economic conditions, then the range of the reasonably possible measurement outcomes for that estimate are likely to significantly increase from previous years.

Reinhard

Thanks Matt – so can you bring this to life for us with an example?

Matt

Certainly – so let's assume management performed an annual impairment test of goodwill last year. As part of determining the value-in-use, management estimated that the reasonably possible projected cash flows could vary between 90 to 100 million.

This year, when performing the annual impairment test, management estimates that the reasonably possible projected cash flows could vary between 60 to 80 million.

So whilst the total projected cash flows have decreased this year, the variability in the reasonably possible cash flows has increased – from 10 million to 20 million. This is a direct consequence of the impact of the unknowns on the estimation process.

Given the economic landscape has changed so dramatically in the last few months, historical financial information may be far less relevant now as a basis for predicting the future.

Reinhard

Thanks Matt – that's really helpful.

Michal – Clearly, making accounting estimates in the current environment is going to call for significantly more judgement. Are there some guiding principles that could help management in getting this right?

Michal

You're absolutely correct, Reinhard. And as much as we tend to think that the judgements simply represent our opinions in the absence of hard facts, accounting judgements must meet several criteria to be sound.

- First of all, they must be grounded in the principles of the accounting standards. For example, when making assumptions about future cash flows, accounting standards generally require that assumptions reflect conditions as of the measurement date and are free from hindsight. This may be difficult in the current environment when things are changing so fast.
- Second, judgements should be based on a thorough understanding of the company's specific facts and circumstances.
- And third, judgements must be consistent – from period to period, from one estimate to another, and across the company's financial reporting. For example, the assumptions you make about future cash flows for your impairment assessment should be consistent with the ones you are using in your going concern evaluation.
- And last but not least, judgements cannot be made just in the minds of management. They should be documented on a timely basis. Such documentation will help management to monitor the decisions made and re-evaluate them in the next reporting period.

Reinhard

Thanks Michal. And of course, that documentation can only ever be as good as the information it's based on.

So I'm guessing that availability and quality of information used is another area that management really needs to be paying close attention to?

Michal

That's a great point, Reinhard.

Given the economic landscape has changed so dramatically in the last few months, historical financial information may be far less relevant now as a basis for predicting the future. And otherwise reliable sources of information, on – for example, expected future economic growth or loan default rates – may become stale fairly quickly in this rapidly changing environment.

So management need to have processes and controls in place to continuously monitor the availability and quality of the data they need.

Reinhard

And when you talk about quality, what are you looking for?

Management will likely be looking at information from a range of potential sources before selecting the final data set.

Michal

By quality we mean:

- is the data reliable – that is, does it come from authoritative sources?
- and is it relevant – that is, is it specific to the company's business and industry, and the nature of the estimate being made? And is it up-to-date with what we know about the future? Although here care needs to be taken not to reflect hindsight knowledge that may not be allowed by the accounting standards, as we discussed a moment ago.

So management will likely be looking at information from a range of potential sources before selecting the final data set.

Reinhard

Okay. That's interesting, and brings us neatly onto the challenges around selecting the amount that should be recognised in the financial statements.

Matt – how might the significant increase in estimation uncertainty affect the selection of this so-called point estimate?

Matt

Well Reinhard, the simple answer is that it will be more challenging, and management may decide to change their approach to selecting the appropriate amount to recognise in the financial statements.

To help explain why, let's pick up again on the example we discussed earlier and explore it further.

In the prior year, the economic conditions were more stable and management prepared *one* cash flow projection for impairment testing. They projected cash flows would be 95 million, and management's sensitivity analysis for key assumptions indicated that the projected cash flows could vary between 90 to 100 million.

When determining the value-in-use, management applied what is known as the traditional approach using their single cash flow projection, with all adjustments for risk reflected in the discount rate.

When assessing whether the discount rate should be adjusted for forecasting risk, management concluded that this was unnecessary as the upside and downside risks to projected cash flows were approximately equal, and there was evidence that the single cash flow projection they had prepared was consistent with the views of market participants. However, if this hadn't been the case, the discount rate would have needed to have been adjusted to reflect the forecasting risk.

Reinhard

OK – What about the current year? How is the situation different?

Certain accounting standards may have prescriptive requirements regarding how to select the amount to be recognised in the financial statements. So management will obviously need to consider those requirements when they're determining the appropriate approach.

Matt

Well, given the increased uncertainty, management has assessed that there are *three* possible scenarios and they have prepared a projected cash flow for each of them. Those projected cash flows are 60 million for a pessimistic scenario, 70 million for a base case and 80 million for an optimistic scenario. Management's assessment is that the pessimistic scenario and the base case each have a 40 percent probability, with the optimistic scenario having only a 20 percent probability.

So given that the variability in the reasonably possible projected cash flows has significantly increased this year, and the more likely cash flows are biased towards the lower end of the range, management concludes that selecting a cash flow projection for a single scenario and then adjusting for forecasting risk in the discount rate may be challenging.

So instead, management selects the cash flow projections for all three scenarios, multiplies each projection by the percentage likelihood that it will occur, and then adds the results together to arrive at a probability-weighted cash flow.

Reinhard

So, by management taking this approach, the forecasting risk has then been reflected in the expected cash flows, and an adjustment to the discount rate for this risk is not necessary, right?

Matt

Possibly. It's true that the variability of the different cash flow outcomes has now been reflected in the probability-weighted expected cash flow. Therefore, assuming that the cash flow projections used and the probability assessments made are reasonable, then an adjustment to the discount rate for forecasting risk shouldn't be necessary.

I should make one last point. Certain accounting standards may have prescriptive requirements regarding how to select the amount to be recognised in the financial statements. So management will obviously need to consider those requirements when they're determining the appropriate approach.

Reinhard

Thanks, Matt. So, we've talked quite a lot about what management should be doing, but what about those with responsibility for oversight of the financial reporting process?

Michal. What should audit committees be thinking about in this area?

Audit committees should be asking probing questions about key assumptions made by management, using their understanding of the company's business and environment.

Michal

The current environment has created a number of new challenges and risks within the estimation process – from the availability and quality of information used to develop underlying assumptions through to selecting a point estimate.

There may even be estimates that are new to management altogether. For example, some companies may not have performed impairment assessments for many years due to their historically strong financial performance.

As part of their oversight responsibilities, audit committees have an important role to play in monitoring management's response to this changing risk landscape. For example, they should consider whether the company has sufficient qualified resources in-house to prepare certain more complex estimates. They should inquire about the internal controls that address the new areas of risk that we have been discussing.

And audit committees should be asking probing questions about key assumptions made by management, using their understanding of the company's business and environment. They should be particularly alert to situations where the methods, assumptions or data sources that management are using should have changed from the prior year – but they have not.

Matt

I agree, Michal, and I would add that management can expect to have similar conversations with their auditors this year.

Significant estimates are obviously going to be a key area of focus for the audit – particularly now – and regular and robust communications with the auditors will make it more likely that the potential issues are picked up and resolved quickly.

Reinhard

Thanks both. A follow up question for you, Matt. With the increased uncertainty, how are financial statement disclosures expected to change?

Matt

Well, we all know how important disclosures are to users of the financial statements. They need to understand the judgements management made in arriving at the amount that's been recognised in the financial statements.

So, management need to ask themselves whether the notes will help the user understand three things:

- the nature of key assumptions, and the sources of estimation uncertainty;
- the sensitivity of the carrying amount to changes in those assumptions; and
- the range of reasonably possible measurement outcomes, as well as the key assumptions used to determine that range.

So, pulling it back to our example, management might consider the importance to users of disclosing the range of cash flows for the impairment testing – being 60 to 80 million – and how they determined the estimate within that range to use.

Obviously, management will need to consider the disclosures required by the relevant accounting standards. But they also need to consider whether additional disclosures might be necessary, beyond those specifically required, to achieve fair presentation of the financial statements as a whole.

This year is going to call for significantly more judgement and effort as you deal with the increased estimation uncertainty this crisis has caused. So make sure you start early and allow enough time.

Reinhard

Great points. And presumably something else worth thinking about is reviewing disclosures prepared by industry peers who have already issued their financial statements.

Matt

Absolutely. A lot of companies are in the same boat on this. If the information is publicly available, reviewing a peer's disclosures can be a very useful way to benchmark assumptions and key judgements, and to get some ideas about how to effectively structure the notes to ensure you get your points across.

And it's more important than ever for management to share the draft notes with their auditors and audit committees in good time so that, if there are any suggestions or concerns, there's sufficient time to discuss and resolve these.

Reinhard

Michal – Any final thoughts on disclosure?

Michal

Yes. One additional point Reinhard. Many companies also include other information about their performance in their annual or interim reports, such as management's discussion and analysis (MD&A). In the current environment, this other information will often have a significant focus on the current and future impacts of COVID-19 on the company's business – and on its strategy to respond – which should provide further context for the estimates made by management.

It's important that management has controls in place to make sure that the information in the MD&A is both complete and consistent with the information in the financial statements.

Reinhard

Thanks Michal and thanks Matt. Some really helpful points there.

So as we move to wrap up this discussion, can I ask each of you to briefly sum up your key takeaways for our listeners?

Matt

Sure. My key takeaway is that this year is going to call for significantly more judgement and effort as you deal with the increased estimation uncertainty this crisis has caused. So make sure you start early and allow enough time.

Michal

I agree – and that means that more than ever you should be proactive in planning and making necessary adjustments to your processes and controls, and engaging with your audit committee and auditors early and often.

Reinhard

Thank you both for your insights.

To find out more and to keep up to date on our latest thinking and guidance just type 'KPMG IFRS' into your browser. You'll find our COVID-19 financial reporting resource centre featured on that web page.

Thank you very much for joining us. Please take care and stay safe!

Publication name: *IFRS Today: COVID-19 – Estimating in uncertain times*

Publication date: June 2020

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