



Where are the judgements?



In preparing financial statements, entities have to make decisions about outcomes that are subjective or uncertain.

NZ IAS 1: *Presentation of Financial Statements* requires disclosure of the critical judgements, other than those involving estimations, made by management in the process of applying the entity's accounting policies. These are described as those judgements that have the most significant effect on the amounts recognised in the financial statements.

NZ IAS 1 also requires disclosure of major sources of estimation uncertainty (referred to as 'estimates') at the reporting date that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

The purpose of these disclosure requirements is to enable stakeholders to understand the areas of the financial statements that are the most subjective, and which could have a material impact on the financial statements if different judgements or assumptions were made.

The critical judgements and estimates for disclosure are unlikely to remain static when market conditions are volatile. For example, when performing sensitivity analysis on cash flow projections (such as for goodwill impairment or asset valuations) there may be a wider-than-normal range of reasonably possible outcomes. Careful consideration is needed to ensure that critical judgements are identified and estimation uncertainty described appropriately in the financial statements.

In this issue we consider what critical judgements and major sources of estimation uncertainty are being disclosed by companies, where they are presented in the financial statements, and the extent of sensitivity disclosures provided for estimates.

The survey results suggest that this is a challenging disclosure area, and given ongoing volatility in the economic environment companies should expect continued focus on these disclosures by users. The Securities Commission has also previously commented on the tendency for these disclosures to be boilerplate or not sufficiently detailed. Some points to consider regarding these disclosures have been provided on page 7 as a prompt for Directors and management.

What we found

Highlights:

- Critical judgements and major sources of estimation uncertainty were considered separate categories by only 21% of companies
- 11 companies disclosed 19 critical judgements, and 33 companies disclosed 98 major sources of estimation uncertainty
- While disclosure was generally provided of the nature of assumptions made, sensitivity information was only provided for ten of the estimates

Deloitte analysed the published annual reports of 50 companies with June to September 2009 balance dates in order to determine the extent of reporting critical judgements and major sources of estimation uncertainty. 13 companies applying differential reporting concessions have an exemption from this disclosure, although one company chose not to take the exemption.



Where have critical judgements and major sources of estimation uncertainty been disclosed?

Five companies, which did not have a differential reporting concession, did not provide any disclosure on critical judgements and major sources of estimation uncertainty. The 33 remaining companies disclosed information on critical judgements and major sources of estimation uncertainty either with the accounting policies for the company or in a separate note.

21% of the 33 companies providing disclosures clearly presented critical judgements separate to major sources of uncertainty, as suggested by NZ IAS 1, with 76% presenting them together without differentiation. One company identified its major sources of estimation uncertainty throughout the financial statements with the relevant item.

Of the matters disclosed, there were 13 where it was not possible to deduce from the text or cross references provided whether it was intended to be a critical judgement or major source of estimation uncertainty, and one item where the matter raised did not appear to relate to amounts recognised in the primary financial statements.

Distinction between judgements and estimates

These results suggest that there is confusion between judgements and estimates. This was also noted by the Securities Commission in their Cycle 9 Financial Reporting Surveillance Programme report: *"Issuers should clearly distinguish between judgements management has made in the process of applying the entity's accounting policies and sources of estimation uncertainty. The Commission also notes that elements of some issuers' disclosures are unnecessarily dispersed throughout the financial statements. Preferably this information should be disclosed in the same section of the financial statements. When this is not practical clear cross-references to all relevant information should be disclosed."*

Judgements are those *"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"*. (NZ IAS 1.122)

Estimates are *"assumptions it 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"* (NZ IAS 1.125) focusing on those *"estimates that require management's most difficult, subjective or complex judgements"* (NZ IAS 1.127).

Some examples of estimates and judgements are provided in the table below¹. NZ IAS 1 does not require disclosure for assets or liabilities that are measured at fair value based on recently observed market prices. While their carrying amounts might change materially in the next financial year, these changes would not arise from assumptions or other sources of estimation uncertainty at the end of the reporting period.

Disclosure is also limited to those items that have a significant risk of causing material adjustment to carrying amounts “within the next financial year”. The purpose behind limiting the disclosure of items is to ensure that the most relevant information is not obscured by information that relates to a longer period and is therefore less specific.

Entities that take advantage of differential reporting concessions are not required to

provide disclosure of critical judgements and major sources of estimation uncertainty.

What are the critical judgements?

We were able to identify 19 critical judgements, with seven from one company. The types of judgements disclosed were around:

- classification of assets (whether a non-financial asset held for sale, or class of financial asset),
- management intentions for use or sale of assets affecting deferred tax calculations,
- whether an investment is a subsidiary, associate or joint venture,
- classification of leases as operating or finance leases, and
- going concern.

¹Further examples are provided in the Deloitte Model Annual Report 2009 on page C53.

Judgements	Estimates
Classification of leases as finance or operating	Effect of technical obsolescence on inventory
Classification of financial instruments as debt or equity, or as held to maturity	Whether sufficient taxable profits will arise to support the recognition of a deferred tax asset
Timing of revenue recognition	Measurement of provisions
Whether the company controls a special purpose entity	Expected future cash flows, discount rates and other assumptions when considering the possible impairment of goodwill and other assets
Classification of owner occupied property as investment property	Fair value of unlisted equities, investment property or property, plant and equipment

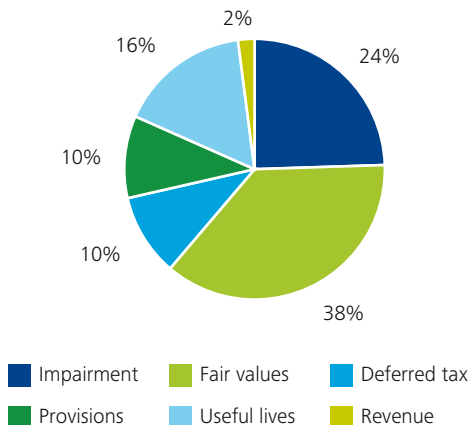
What are the major sources of estimation uncertainty?

There were 98 major sources of estimation uncertainty disclosed, with companies disclosing between one and 12 estimates. As shown in Figure 1, the most common areas discussed were around the determination of fair values (predominantly for assets) and asset impairment, reflecting the recent economic environment. Fair value estimates were mostly in relation to financial instruments as noted in Figure 2. Useful lives over which assets are depreciated or amortised was also common. The results indicate that many companies face the same issues when making decisions that affect the financial statements.

On the other hand, these results also indicate that management may not necessarily be considering the judgements that uniquely affect their company, but instead providing generic statements to satisfy another disclosure requirement. For example, we noted several companies who had included the valuation of derivatives as a major source of estimation uncertainty, yet the level of derivatives held at balance date was clearly not material and no explanation was provided as to why a valuation using observable market data might have a significant risk of causing a material adjustment to the carrying amount.

NZ IAS 1 notes that the nature and extent of information provided will vary according to the nature of the assumption and other

Figure 1: What topics do the major sources of estimation uncertainty disclosures cover?



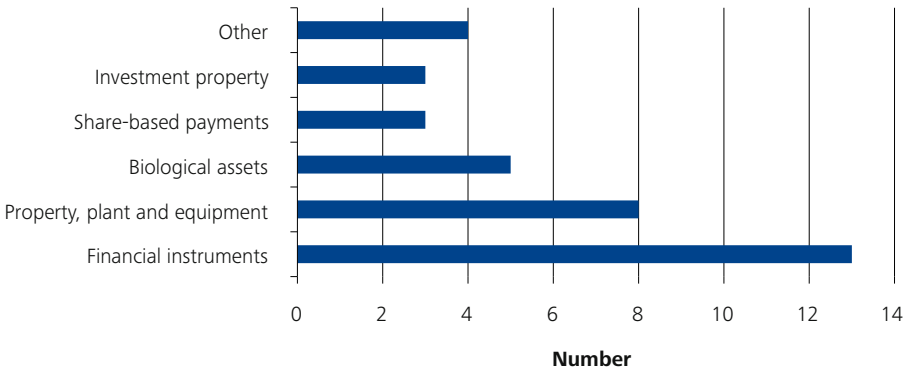
circumstances. Paragraph 129 provides the following examples of the types of disclosures an entity might make:

- the nature of the assumption or other estimation uncertainty,
- the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including reasons for sensitivity,
- the expected resolution of any uncertainty and the range of 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.

While disclosure was generally provided of the nature of assumptions made, sensitivity information was only provided for ten of the estimates and this was where another standard also required sensitivity information (such as for goodwill and financial instruments). In four instances the sensitivity of value in use calculations to changes in assumptions was along the lines of “considerable headroom” or that there was “no reasonably possible change in assumptions” that would affect the amount recorded.

Five companies provided an expected timeframe for resolution with others only providing a current/non-current classification of items in the balance sheet. No companies provided a range of possible outcomes within the next financial year in respect of the carrying amounts of affected assets and liabilities and while comparatives were often provided for assumptions when given, there was no explanation for the changes made.

Figure 2: What were the fair value estimates in relation to?





Questions Directors should ask

- Do the financial statements describe all of the critical judgements about the application of accounting policies, and major sources of estimation uncertainty inherent in assets and liabilities? Is the information appropriately tailored to the company's circumstances?
- Are disclosures only made for:
 - o those judgements that have the most significant effect on the amounts recognised in the financial statements, and
 - o those assumptions about the future and other major sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year?
- Has consideration been given to changes in judgements and estimates disclosed since last year and are those changes consistent with the circumstances of the company?
- Are the critical judgements separately identified from the estimation uncertainties?
- Are disclosures of critical judgements and estimation uncertainties provided in one place, either in their entirety or with clear cross reference to where further information is provided?
- Is the extent of disclosure appropriate? For example, have the major assumptions and the sensitivity of major sources of estimation uncertainty been provided where practical (or reason why not practical)?



The Deloitte Financial Reporting Survey Series

This publication is Issue 4 in our Financial Reporting Survey Series in which we consider a series of questions regarding the financial reports of a sample of New Zealand entities.

This issue focuses on companies in our sample with June to September 2009 balance dates. More information on the sample can be found in Issue 1.

Other issues in the series available at June 2010 include:



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