Putting emphasis on disclosures: Accounting estimates and judgments

- Opinion

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The key risk in the accounting profession is the misuse of accounting judgments and estimates, which are either too conservative or too aggressive. Currently, accounting judgments and estimates are not clearly defined, apart from the requirement of Paragraph 122 of the International Accounting

Standards (IAS) 1, which requires entities to disclose accounting judgments distinct from accounting estimates applied. While it is a controversial issue, it is clear that judgments and estimates are intertwined, such that both are subjective and have significant financial effect.

In my other article regarding the accounting scandal currently faced by Toshiba in Japan, it is clear that accounting judgments and estimates have been exercised too aggressively, resulting to significant misstatement in its financial statements. As of this writing, Toshiba still estimates a downward adjustment of $1.22 billion (accumulated misstatement from 2008 to present) as a result of its previously aggressive accounting stance.

Current accounting standards do not have explicit prohibition against management's application of judgments and estimates. Rather, the application of the current principles-based accounting standards provides a freer exercise of judgment and estimates, considering that financial statements should reflect not just the past transaction but the present status of the company. We have to agree that, without accounting judgments and estimates, financial statements would hardly be relevant to users. For the information of those not in the accounting profession, the purpose of the financial statement is to present a company's financial position (as of the reporting date); financial performance (for the reporting period); and cash flows (for the reporting period). Therefore, the exercise of judgments and estimates in accounting is to provide a better picture of the financial position and performance of a company at a given point in time.

Accounting judgments and estimates are usually exercised to determine fair valuation, and to determine percentage of completion or work done. In essence, accounting judgments and estimates, when applied within the context of responsible accounting, would help in producing more relevant financial information and more accurate reporting of the company's financial position and performance. As the adage explains, with great power comes great responsibility.

Management is in a unique position to put these judgments and estimates into play, and within the context and parameters allowed by the current accounting standards. As in the case of most accounting scandals, the fault lies not in falsified journal entries, but, rather, in extreme exercise of aggressive accounting stance.

A big question is now asked about the role of the auditor in these circumstances. Frequently, when these accounting scandals erupt, the first point of blame will be on the auditors who are expected to provide the users of the financial statements assurance that the financial statements are free from errors. As most readers of my blog are in the accounting profession, it is notable that the above notion is wrong for two reasons:

1. Assurance provided by an audit is only *reasonable* assurance; and
2. An audit does not provide assurance that the financial statements are free from error, rather, simply *free from material error or misstatement*.

These two points are accepted in the profession, as far as the legality of the issue is concerned, but the users of the financial statements clearly believe that auditors should have spotted these errors before branding the financial statements as audited. This is clearly an issue that needs to be addressed in the long run, but is not expected to fully reduce the blame on the auditors once an accounting scandal erupts. Auditors cannot be excused from blame in accounting scandals, as most of these resulted from significant aggressive accounting estimates and judgments, which should have been clearly disclosed in the financial statements. Indeed, this constitutes mayhem in the accounting profession.

Accounting standards currently require disclosure of accounting estimates and judgments applied in coming up with the financial statements, but provide only limited instances wherein these are required. Currently, International Financial Reporting Standards (IFRS) require detailed disclosures on the following accounting judgments and estimates:

1. Those involving financial instruments (IFRS 7).
2. Those involving share-based payments, wherein a valuation model is used (IFRS 2).
3. Those involving defined benefit plans (IAS 19).
4. Those involving fair-value measurements (IFRS 13).

The above items are those involving more complex accounting that requires detailed disclosures on the accounting estimates and judgments applied. These disclosures provide sensitivity analysis for users of the financial statements and insights as to the implication of a certain percentage movement in the underlying estimate or data. While the above disclosure requirements provide a tremendous insight to the users of the financial statements, they are very limited in contrast to the number of items that require judgments or estimates to be applied.

The following are examples where accounting judgement or estimate is applied:

- Classification of a financial instrument as either trading security or available-for-sale;
- Estimating percentage of completion for long-term revenue contracts;
- Estimating impairment losses for financial and nonfinancial assets; and

- Estimating useful lives of finite life assets; and
- Estimating value-in-use.

Those are just some of the examples where accounting estimates and judgments are applied, which could have potentially large impact on profit or loss. Current practice in the accounting profession for these items is just to insert a generic (boilerplate) narrative disclosure, either in the accounting-policy section or in the accounting judgment, and estimates section of the financial statements without any reference to potential fluctuations resulting from varying levels of estimates.

International Standards on Auditing (ISA) 540—*Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures*—currently provide a catch-all requirement for the audit of accounting estimates and the related disclosures. After considering the current auditing standards, it all refers back to the requirement for auditors to ensure compliance with the disclosure requirements of the accounting standards.

While auditors may disagree with management on the lack of disclosures as to the accounting judgments and estimates, which the auditors assessed to be significant, management is still in a unique position to determine which accounting judgments and estimates are material enough to warrant a disclosure in the financial statements.

In these situations, auditors are not in a position to further push a disclosure to be placed in the financial statements, as these disclosures are covered by management's judgment, as well. The dilemma is a circular risk, which ends up with the disclosures

being within the control
of management.

So, do I mean that auditors can't do anything and just have to deal with it? Not necessarily. The International Auditing and Assurance Standards Board is issuing an amendment to ISA 700 (among others) to update the previous simple auditor's report, which does not provide any additional information as to the audit issues encountered and key accounting disclosures that auditors would like to highlight to the users of the financial statements.

Effective 2016, auditors are required to provide users of the financial statements, a commentary of the Key Audit Matters, aside from the standard audit opinion issued.

Is the game changing? Well, at least some balls are rolling in the right direction now.

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