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## **KASB PAPER**

### ***A REVISIT TO THE DEFINITION OF ACCOUNTING ESTIMATES***

#### **Issues Paper**

#### **Objective**

- 1 The objective of this session is to discuss the KASB Paper '*A Revisit to the Definition of Accounting Estimates*' that will be presented at the October 2019 ASAF meeting.

#### **Summary of the KASB Paper**

- 2 The KASB acknowledges that the IASB has attempted to introduce a definition for 'accounting estimates' in ED/20175 *Accounting Policies and Accounting Estimates* ('the IAS 8 ED') but considers that 'estimation' is a much more fundamental concept that needs to be addressed..
- 3 The KASB notes in particular that the important concept of 'measurement uncertainty', which is discussed in the Conceptual Framework, is not reflected in any IFRS Standard.
- 4 The paper first analyses the important features of 'measurement uncertainty' and develops a typology that categorises monetary amounts that cannot be directly observed:
  - (a) **type 1**- items that cannot be directly observed due to physical or economic barriers (e.g. oil reserves...);
  - (b) **type 2** - items than cannot be directly observed ex-ante but can be directly observed ex-post (e.g. bad debt, warranty obligations, inventory obsolescence); and
  - (c) **type 3** - items than cannot be directly observed by its nature (e.g. depreciation, fair value and impairment).

#### **Proposed definitions**

- 5 The paper suggests distinguishing between 'accounting estimation' (as a process) and accounting estimates (as an output of that process) and proposes the following definitions:
  - (a) **accounting estimation** is to measure an item in financial statements using measurement techniques when, in the presence of measurement uncertainty, monetary amounts cannot be observed directly; and
  - (b) **accounting estimates** are the output of accounting estimation.

- 6 To illustrate the applications of the proposed definitions, the paper considers the selection of a cost formula for interchangeable inventories (FIFO or weighed average) and concludes that:
  - (a) both the FIFO and weighted average cost methods involve an entity making judgements and assumptions– which are the measurement by estimation; and
  - (b) the nature of selecting a cost formula constitutes selecting an accounting estimate.
- 7 Contrary to the view in the paper, the IASB has assessed in the IAS 8 ED that selecting a cost formula for ordinarily interchangeable inventories constitutes selecting an accounting policy.
- 8 In the last part of its paper, the KASB also suggests the ways in which the paper could be helpful:
  - (a) In the short term:
    - (i) to finalise the Exposure Draft on IAS 8 considering the concept of ‘measurement uncertainty’ in the conceptual framework; and
    - (ii) to discuss the circumstances in which a change in accounting estimates is permitted.
  - (b) In the longer term, to consider defining estimation, in the light of measurement uncertainties, in the Conceptual Framework.

#### The IAS 8 ED

- 9 The IAS 8 ED proposes to define accounting estimates as *‘judgements or assumptions used in applying an accounting policy when, because of estimation uncertainty, an item in financial statements cannot be measured with precision’*.
- 10 At its April 2019 meeting, the IASB considered the feedback received in response to its ED. A majority of respondents were supportive of the proposed clarifications but some suggested that accounting estimates should not be defined as judgements or assumptions themselves, but rather the output (ie a numerical or monetary amount) of a measurement technique (such as a valuation technique or an estimation technique) that requires an entity to use judgements and assumptions.
- 11 It was noted that the terms ‘estimation uncertainty’ and ‘precision’ are not defined in IFRS Standards and could be usefully replaced with ‘measurement uncertainty’.
- 12 As a consequence the IASB Staff suggested to revise the definition of accounting estimates to specify that:
  - (a) accounting estimates are **monetary amounts in the financial statements that are subject to measurement uncertainty**;
  - (b) these monetary amounts are outputs of measurement techniques used in applying accounting policies; and
  - (c) an entity uses judgements and assumptions in selecting and applying the applicable measurement techniques.
- 13 The IASB Staff also considered whether the reference to ‘monetary amounts’ in the definition of accounting estimates (also in the KASB approach) was not too restrictive and whether reference should also be made to non-monetary amounts (e.g. useful life of depreciable assets, estimate of the number of equity instruments expected to vest, timing or uncertainty of future cash flows). However, they concluded that it was not necessary to refer to non-monetary amounts because entities use non-monetary amounts as inputs to estimate monetary amounts in the financial statements: for instance an entity estimates the useful life of an asset (a

non-monetary amount) in estimating the depreciation charge for that asset (a monetary amount).

- 14 Although no formal decisions was taken by the IASB members generally expressed support for the direction of the changes and in particular the focus on measurement uncertainty. Before deciding on the next steps for the project, the IASB will reconsider the costs and benefits of the revised proposals.'

**EFRAG Secretariat preliminary views**

- 15 The EFRAG Secretariat observes that, if approved, the above changes would partly address the suggestions raised in the KASB paper (in particular regarding the concept of 'measurement uncertainty'). The main remaining difference would be:
- (a) the reference to "observed directly" (KASB), absent on the IASB definition; and
  - (b) the distinction between accounting estimations (process) and accounting estimates (output) in the KASB approach.
- 16 The EFRAG Secretariat is not persuaded that the distinction in paragraph 14 is needed. We note in particular that the terms 'directly observable', used in IFRS 13 *Fair Value Measurement* are not defined.
- 17 Lastly, we note that the KASB paper raises the question as to when change in accounting should be permitted (questions to ASAF members reproduced paragraphs 19, 20 and 21). The EFRAG Secretariat considers that this question is not directly related to the discussion on the definitions of accounting estimates and would encompass a broader set of considerations.
- 18 As noted in EFRAG's comment letter in response to the IAS 8 ED, the distinction between change in accounting estimates and correction of errors is important some of the proposed changes would remove guidance that aimed at clarifying the distinction between a change in an accounting estimate and the correction of an error. In particular that changes in accounting estimates must result from new information or new developments and, this distinguishes them from corrections of error.

**Questions for EFRAG TEG and EFRAG CFSS**

- 19 What is your view on the KASB approach to the concept of 'estimation' in accounting?
- 20 Do you agree with the proposed typology of measurement uncertainty? Do you think this can be helpful to better understand the concept of 'estimation' in accounting?
- 21 What would in your view be the circumstances when a change in accounting should be permitted? For example, should the criteria for a change in accounting policy also apply to a change in accounting estimate?

**Agenda Papers**

- 22 In addition to this cover note, agenda papers for this session are:
- (a) Agenda paper 12-02 – ASAF 06 Accounting estimation Cover note- EFRAG TEG - CFSS 19-09-25; and
  - (b) Agenda paper 12-03 – ASAF 06A Accounting estimation- EFRAG TEG - CFSS 19-09-25.