

# AGENDA PAPER

IFRS Advisory Council Meeting

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Agenda ref 3

TOPIC *Use of judgement in financial reporting*

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This paper has been prepared for discussion at a public meeting of the IFRS Advisory Council. The views expressed in this paper are those of the authors. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS.

## **Purpose of this session**

1. The attached presentation discusses use of judgement in financial reporting.
2. During the break-out session, we would like the Council members to address the following questions:
  - Q1 IFRSs are principle-based, but also include guidance on how to apply principles and some exceptions to principles. Is there the right balance between principles and detailed guidance in IFRSs?
  - Q2 What should be the IASB's role in the exercise of judgement? Should the IASB avoid "bright lines" and anti-abuse provisions in accounting standards?
  - Q3 Can principle-based standard-setting and the use of judgement in applying the standards be made compatible with the objectives of all financial reporting stakeholders?
  - Q4 Does your group have any other views on the use of judgement?

### **Additional background information**

3. Further information on the use of judgement in financial reporting is available in the report ‘Principles Not Rules: A Question of Judgement’ issued by The Institute of Chartered Accountants of Scotland (ICAS). The report is the culmination of an ICAS working group project which was established to help find a resolution to the Principles versus Rules debate within international accounting standard setting. It can be downloaded from this website: <http://icas.org.uk/principlesnotrules/>.
4. Regulators have been focussing on disclosures surrounding judgement, for example, Australian Securities and Investments Commission recently [noted](#), with respect to observance of guidelines on Operating and Financial Review:

We observed opportunities for entities to improve the quality and completeness of disclosures in relation to judgements, key assumptions, estimation uncertainties, and significant judgments in applying accounting policies.

Disclosures in this area are important to allow users of the financial report to assess the reported financial position and performance of an entity with all relevant information.

## International Financial Reporting Standards



# USE OF JUDGEMENT

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The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

# CONTENTS

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- Introductory comments
- Principles that involve judgement
- Is more guidance needed?
- Role of judgement versus consistency - what is acceptable level of diversity?
- What are the impediments to judgement?
- Questions for the break-out session

# INTRODUCTORY COMMENTS

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- Judgement: the process of reaching a decision where there are a number of possible alternatives.
- Judgement is used by:
  - standard setters when setting standards;
  - management when preparing financial statements;
  - auditors in auditing financial statements; and
  - regulators in evaluating preparer and auditor judgements.

# INTRODUCTORY COMMENTS

- From the preparer point of view, key judgments used in preparing financial statements include:
  - selection and implementation of an accounting standard;
  - determining whether and what to recognise;
  - accounting for a transaction with no specific standard;
  - determining the appropriate financial statement presentation; and
  - estimating the amount to record.

- Definition of a principle:
  - "A general statement, with widespread support, which is intended to support truth and fairness and acts as a guide to action" ICAS 2006
  - Principles cannot be replaced by mechanical rules.
  - Sometimes rules may be proposed to guide the observance of the principle.
  - Above definition emphasises importance of interpretation and judgement.

- Definition of a rule:
  - "A means of establishing an unambiguous decision-making method." ICAS 2006
  - There can be no doubt about when and how the rule is applied.
  - Rules represent specific instructions (although judgement may still be required).



- It is also worth noting the notion of “objectives-oriented” standards introduced by an SEC Staff Report in 2003:

“The optimal principles-based accounting standard involves a concise statement of substantive accounting principle where the accounting *objective* has been incorporated as an integral part of the standard and where few, if any, exceptions or internal inconsistencies are included in the standard. Further, such a standard should provide an appropriate amount of implementation guidance given the nature of the class of transactions or events and should be devoid of bright-line tests. Finally, such a standard should be consistent with, and derive from, a coherent conceptual framework of financial reporting.”

# PRINCIPLES THAT INVOLVE JUDGEMENT

- All principles require some kind of additional guidance and judgement will be needed in most cases:
- "Measure all derivatives at fair value":
  - what is a derivative?
  - what is the definition of "fair value"?
  - how should fair value be determined?

# IS MORE GUIDANCE NEEDED?

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- The notion of “principles-only” accounting cannot credibly be supported.
- It is surely always helpful to specify the accounting objective.
- There will always be a need for some additional guidance.
- The issue is a matter of degree: HOW much additional guidance is needed?

# IS MORE GUIDANCE NEEDED?

- From the standard setter's point of view, guidance should be sufficient to make principles operational.
- Insufficient guidance may lead to unacceptable diversity in practice.
- The existence of the Interpretations Committee explicitly acknowledges that more guidance will be needed from time to time where there is diversity.
- Prima facie, current IFRS already include significant guidance: the bound volumes total in excess of 3,000 pages.

# IS MORE GUIDANCE NEEDED?

- From the preparer's point of view, the answer depends on the exercise of "good" judgement, as well as appropriate documentation of that judgement.
- A "good" judgement is:
  - made in good faith and unbiased;
  - taken with due care;
  - based on sufficient evidence; and
  - reasonable given the circumstances at the time the judgement is made.

# IS MORE GUIDANCE NEEDED?

- Users, in common with regulators and preparers, have a strong desire to see financial statements which are comparable across companies within the same sector or industry.
- To this end, users prefer guidance which is:
  - sufficient to ensure preparers exercise appropriate judgement; and
  - sufficient to minimise diversity in practice.
- User preferences do, however, vary:
  - in some jurisdictions, detailed guidance preferred (eg US);
  - in others, more emphasis on judgement (eg UK and Australia).

# ROLE OF JUDGEMENT VERSUS CONSISTENCY

## WHAT IS ACCEPTABLE LEVEL OF DIVERSITY?

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13

- Some diversity should be acceptable PROVIDED key judgements are explained in financial statements where those judgements are material.
- Complete comparability will never be possible in practice: it is impossible to specify sufficient rules to ensure this is the case.
- However the economic reality of similar transactions and events should be understood in a similar way by users of financial statements.

# WHAT ARE THE IMPEDIMENTS TO JUDGEMENT?

- Willingness and ability of all parties involved in financial reporting to exercise, or permit the exercise of, judgement.
- Challenges:
  - “Bright lines” and anti-abuse provisions in accounting standards;
  - Training of accountants who do not have experience of exercising judgement;
  - The challenge of hindsight in the subsequent audit/ review/ enforcement of judgements made.
  - Should regulators and other stakeholders be encouraged or discouraged from requesting additional guidance from standard setters?



# QUESTIONS FOR THE BREAK-OUT SESSION

15

- IFRSs are principle-based, but also include guidance on how to apply principles and some exceptions to principles. Is there the right balance between principles and detailed guidance in IFRSs?
- What should be the IASB's role in the exercise of judgement? Should the IASB avoid "bright lines" and anti-abuse provisions in accounting standards?
- Can principle-based standard-setting and the use of judgement in applying the standards be made compatible with the objectives of all financial reporting stakeholders?
- Does your group have any other views on the use of judgement?

# Thank you

