

October 2019 ASAF Meeting
Agenda paper 6A

A Revisit to the Definition of Accounting Estimates

KASB

Contents

Korea Accounting Standards Board

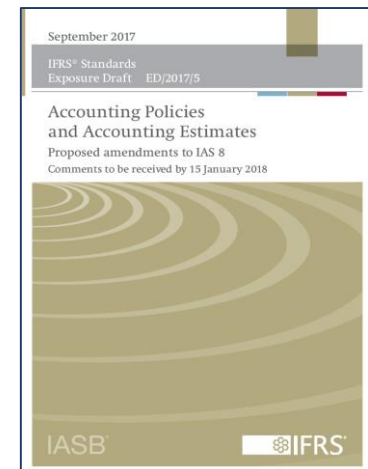
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I. Purpose and scope of ASAF discussion



Purpose

- **To shed some light on the definition of 'accounting estimates':**
 - **by proposing an alternative route to articulating it, focusing on the concept of 'accounting estimation' and 'measurement uncertainty'**



I. Purpose and scope of ASAF discussion



Scope

- **Covers:**
 - **the concept of accounting estimation;**
 - **the typology of measurement uncertainty**

- **Does not cover:**
 - **the argument about distinguishing changes in accounting policies and changes in accounting estimates;**
 - **the definition of accounting policies**

II. 'Estimation' and 'uncertainty' in accounting



Prevails in the Standards and practice

- The use of 'estimation' and 'uncertainty' in the Standards

| Term | Number of Use | |
|-------------|---------------------------------|---------|
| | Currently active IFRS Standards | IFRS 17 |
| Estimation | 511 | 109 |
| Uncertainty | 125 | 34 |

| Term | Number of Use | |
|-------------|---------------|-----------|
| | CF (2010) | CF (2018) |
| Estimation | 22 → | 60 |
| Uncertainty | 7 → | 71 |

II. 'Estimation' and 'uncertainty' in accounting



Prevails in the Standards and practice

- **Moreover, a multitude of estimates are embedded in most financial statement items**
 - **From the simplest level such as 'average' to the most complicated level such as 'manufacturing cost';**
 - **Practically, all accruals are based on estimates**

II. 'Estimation' and 'uncertainty' in accounting



No explicit definition in the Standards

- 'Estimation' in accounting is critical and prevalent in practice, yet not explicitly defined anywhere in the IFRS Standards

- The Conceptual Framework (2018)

2.19 When monetary amounts in financial reports ***cannot be observed directly*** and ***must instead be estimated, measurement uncertainty*** arises. The use of reasonable estimates is an essential part of the preparation of financial information and ...

III. Exploration into 'measurement uncertainty'

- **Basically, we focus on 'measurement uncertainty' to lay a foundation for how best 'accounting estimation' and 'accounting estimates' can be defined**

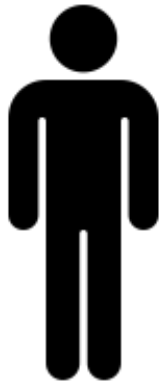
✓ **Even though ED IAS 8 attempts to define 'accounting estimates' for the distinction between 'accounting policies' and 'accounting estimates,' we believe that 'estimation' in accounting is a much more fundamental concept**

- The Exposure Draft (ED/2017/5) – IAS 8

5 Accounting estimates are judgements or assumptions *used in applying an accounting policy* when, because of *estimation uncertainty*, an item in financial statements cannot be measured with precision

III. Exploration into 'measurement uncertainty'

- **Measurement in a certain world**
→ **Direct observation**

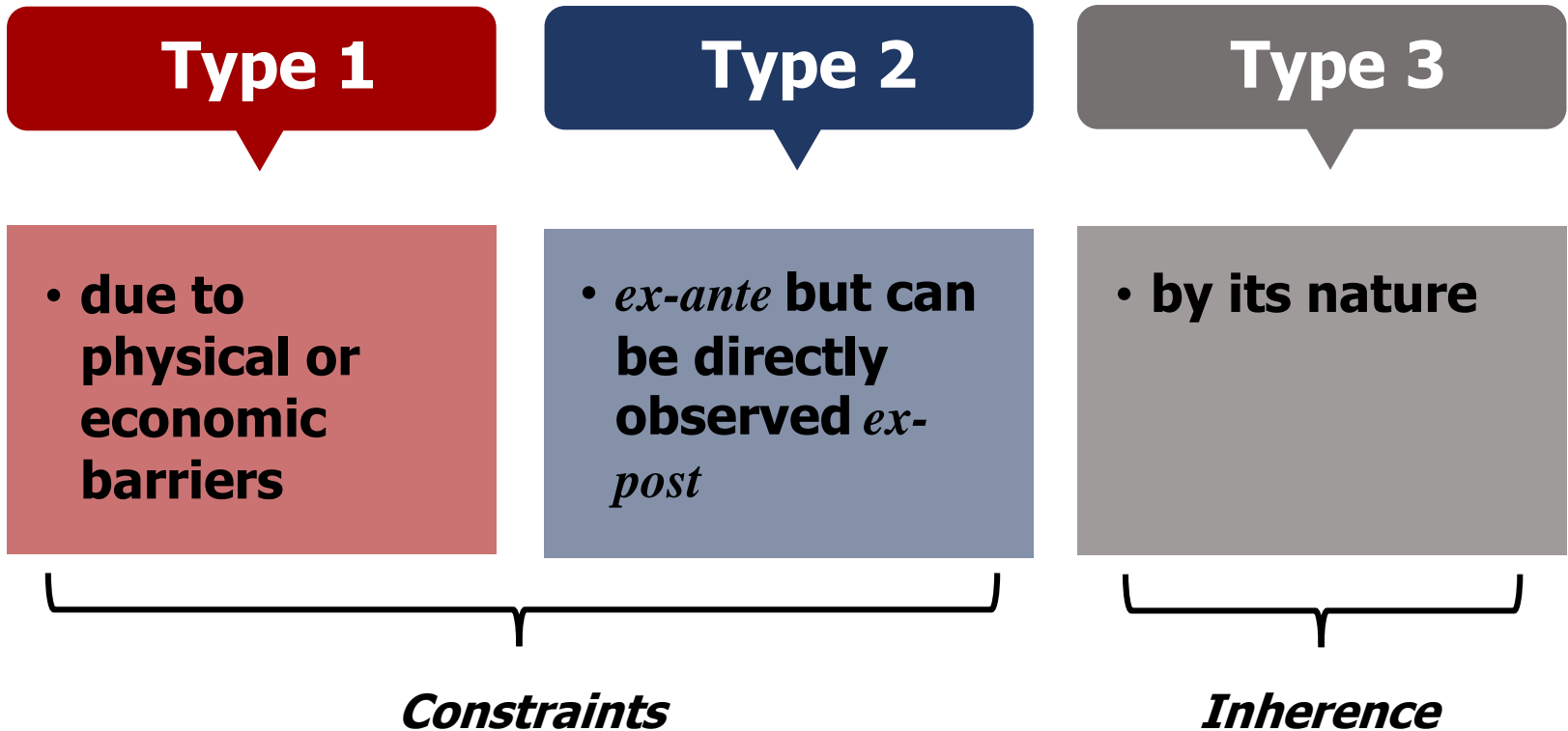


- **Measurement in an uncertain world**
→ **Estimation**



III. Exploration into 'measurement uncertainty'

- **Why measurement uncertainty exists?**
 - ✓ **Monetary amounts cannot be directly observed:**



III. Exploration into 'measurement uncertainty'

- **Why measurement uncertainty exists? – Type 1**
 - ✓ **Monetary amounts cannot be directly observed:**

Type 1

- **due to physical or economic barriers**

- **Oil reserve**
- **Fire damage**
- **Inventories in a disputed area**
- **Inventories with incomplete or missing documents**

III. Exploration into 'measurement uncertainty'

- **Why measurement uncertainty exists? – Type 2**
 - ✓ **Monetary amounts cannot be directly observed:**

Type 2

- *ex-ante* but can be directly observed *ex-post*

- **Warranty obligations**
- **Bad debts**
- **Law suits**
- **Inventory obsolescence**

III. Exploration into 'measurement uncertainty'

- **Why measurement uncertainty exists? – Type 3**
 - ✓ **Monetary amounts cannot be directly observed:**

Type 3

- **by its nature**

- **Fair value**
- **Impairments**
- **Depreciation**

IV. An alternative approach to the definition of 'accounting estimates'

- **Hence, we consider that:**

- ✓ **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 ”

*** Judgments and assumptions are used in selecting and applying measurement techniques**

- ✓ **accounting estimate is:**

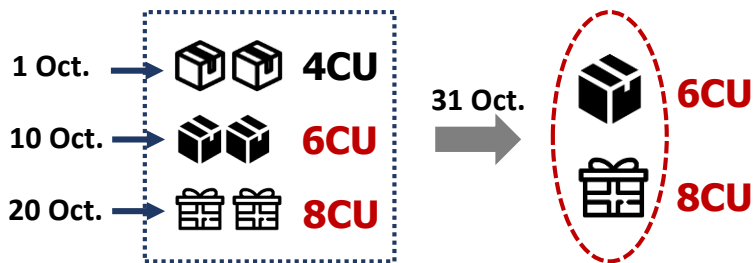
“ an output of accounting estimation ”

IV. An alternative approach to the definition of 'accounting estimates'

• (Case) Measurement of per-unit inventory cost:

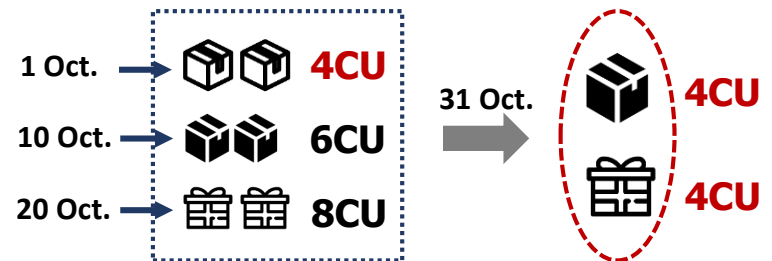
 in a certain world
→ Direct observation

✓ Specific identification

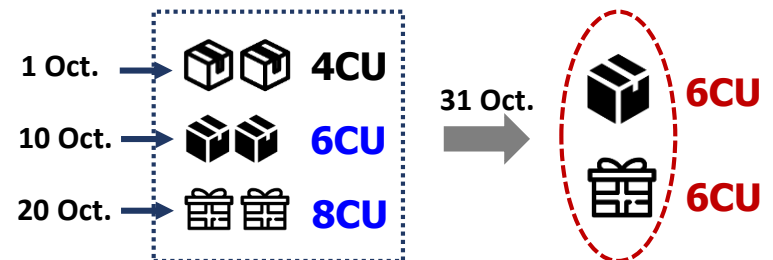


???
 in an uncertain world
→ **Estimation**

✓ FIFO



✓ Weighted average method



V. Suggestions

● Short-term

- **The use of terms in finalizing the ED IAS 8 should be in line with the revised Conceptual Framework (2018) – i.e., measurement uncertainty, etc.**
- **The circumstances when a change in accounting estimate can be permitted should be thoroughly discussed**

V. Suggestions

● Long-term

- **Accounting estimation in light of measurement uncertainty should be explicitly defined in the Conceptual Framework**

Questions for the ASAF members

- 1. What is your thought on our approach to the concept of 'estimation' in accounting?**
- 2. 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?**
- 3. Which do you think would be the circumstances when a change in accounting estimate can be permitted?**

Appendix A. Estimation and measurement bases

| Measurement bases | Types of measurement |
|--|--|
| Historical cost | Direct observation Estimation |
| Current value <ul style="list-style-type: none">• Fair value• Value in use and fulfilment value• Current cost | Estimation |

Appendix B. Summary of feedback from Big 4 in Korea

Q. The typology of measurement uncertainty

- **Most respondents agreed with the proposed typology of measurement uncertainty**

Q. The definition of accounting estimates

- **Some respondents said that the proposed definition of accounting estimates is helpful and clear to understand**
- **Some respondents said that defining accounting estimates does not seem to be fully sufficient to distinguish a change in accounting policy and a change in accounting estimate in practice**