How to disclose judgements made in application of accounting policies

It is said that the length of financial statements has grown extensively in recent times and, in the process, financial statements have become cumbersome. This is often blamed on the increased complexity of financial reporting standards, as well as an increase in regulations. However, this may indicate that there has been a shift in focus during the preparation of financial statements. The focus may have shifted from meeting the needs of the primary users onto ensuring compliance with various reporting requirements, whether contained in IFRS or imposed by local regulators. Through this, management and preparers may have inadvertently lost sight of the objective of financial statements which is to provide financial information about a reporting entity that is useful to a wide range of users in making The objective of *IAS 1 Presentation of Financial Statements* is to prescribe the basis for presentation of general-purpose financial statements including understandability of the decisions management has made in preparation of the financial statements.

IAS 1 has two requirements regarding judgements and estimates:

- **IAS1.122** require disclosure of key judgements management has made in the process of applying accounting policies and
- **IAS 1.125** requires disclosure of assumptions and other sources of estimation uncertainty underlying amounts included in the financial statements.

This article discusses disclosure of key judgements under IAS 1.122.

When faced with two options as to how to account a particular item in the financial statements, management inevitably has to make a decision as to which option to take. Such decisions are referred to as judgements.

The most common error made by preparers of financial statements is lack of specificity in making disclosures. This is a frequent complaint from regulators including the Johannesburg Stock Exchange (JSE). In a bid to encourage more detailed and transparent reporting, the JSE has cited a number of examples of inappropriate generic disclosures in their recent

Proactive Monitoring Financial Statements reports.

Generic disclosures result from use of boilerplate templates to prepare financial statements. Many preparers take the lazy route of using the example disclosures provided in illustrative financial statements or programmed wording appearing on preparation software . Preparers also fall into the trap of simply regurgitating the requirements of the accounting standards in disclosing their judgements. Wording from illustrative financial statements and template information from software programmes should be viewed and as nothing more than useful examples or guides. Preparers should go a step further and draft entity and industry specific disclosures.

An example of generic disclosure is given below:

The Group determines the lease term as the non-cancellable term of the lease, together with any periods covered by an option to extend the lease if it is reasonably certain to be exercised, or any periods covered by an option to terminate the lease, if it is reasonably certain not to be exercised. The Group has several lease contracts that include extension and termination options. The Group applies judgement in evaluating whether it is reasonably certain whether or not to exercise the option to renew or terminate the lease. That is, it considers all relevant factors that create an economic incentive for it to exercise either the renewal or termination. After the commencement date, the Group reassesses the lease term if there is a significant event or change in circumstances that is within its control and affects its ability to exercise or not to exercise the option to renew or to terminate.

The above disclosure gives an overview of the requirements of *IFRS 16 Leases* and could apply to virtually all companies given that very little is disclosed that is company specific. SAICA Educational Material on the Disclosure of Judgements (available on the SAICA website) recommends preparers follow these three steps in disclosing entity-specific disclosures:

1. Identify the alternatives that management considered.
2. Explain why the choice was difficult.
3. Provide an entity specific explanation as to why one alternative was chosen over the other.

In following the steps above, the leases disclosure above could be improved as follows.

Identification of the alternatives that management considered:

In determining the lease term for purposes of accounting for leases under IFRS 16, management needs to consider extension and termination clauses in lease contracts. The Group has one material lease which relates to the rental of the Group's office park located at 5 Memory Lane, Sandton. The lease is for a five-year period commencing 1 January 2020 with a three-year extension available at the option of the holding company which is the entity contracted to the lease. Consequently, the lease term of the contract for accounting purposes is either five years if the extension option is not expected to be exercised or eight years if the company expects to extend the rental period.

Explain why the choice was difficult:

The property at 5 Memory Lane in Sandton is a highly sort after office park with ample parking and excellent facilities. Furthermore, the Group has

spent a significant amount of money customising the office space to meet the Group’s needs. The fittings installed on the premises would not be easily transferable to a new location.

The factors described above give management reason to consider extending the lease of the office park. However, the onset of COVID-19 has resulted in a transition to a work-from-home policy that impacts all the Group’s employees. There is uncertainty as to whether the Group will require expansive office space in future.

Provide an entity-specific explanation as to why one alternative was chosen over the other:

The work-from-home policy has had a marginal impact on all divisions of the company except for the products segment. Management has set up a taskforce to consider ways of improving product segment revenues under the new working arrangement. Interim reports are encouraging in this regard and management therefore believes that the transition to a work-from-home policy will continue for all segments for a long period of time. It is on this basis that management has determined the lease term to be five years given the likelihood that the lease extension option will not be exercised.

Conclusion

As illustrated above, following the steps outlined by SAICA in disclosing judgements will undoubtedly result in more useful disclosures that enable users to understand the decisions taken by management in applying its accounting policies.

Raymond Chamboko CA(Z) CA(SA) JSE-IFRS Advisor

raymond.chamboko@wconsulting.co.za