

# Financial Reporting Bulletin

## Disclosure of accounting estimates and judgements

### Background

An entity which prepares its financial statements in accordance with International Financial Reporting Standards (IFRS) is required to include disclosures which, in certain respects, are more comprehensive than those required by UK GAAP. Where companies have adopted IFRS, the quality and extent of these additional disclosures has been variable.

In particular, while both UK GAAP and IFRS require the disclosure of significant accounting policies, IAS 1 also requires the disclosure of both:

- significant judgements (IAS 1.113)
- key assumptions concerning the future (estimation uncertainty) (IAS 1.116).

In practice, the level of disclosures made has ranged from detailed, quantified discussion to cursory one line statements (and in some cases, no disclosure at all). The Financial Reporting Review Panel (FRRP), in its 'Preliminary Report on IFRS Implementation', noted that these disclosures were often 'bland and uninformative'. The FRRP report highlighted a number of recurring issues identified in its review of IFRS financial statements 'in order to draw them to the attention of companies planning the preparation of their next IFRS accounts'. It follows that the FRRP is likely to focus on disclosures made by companies in this area, and so it is important that companies reporting in accordance with IFRS ensure that these disclosures are complete, and do not contain irrelevant information.

The purpose of this FRB is to:

- provide a reminder of the requirements
- provide examples of the disclosures made by a number of companies in practice.

### Significant judgements

The disclosure requirements are set out in IAS 1.113 to 115.

These are the judgements (other than estimates) that have had the most significant effects on the amounts recognised in the financial statements. The examples given in IAS 1 include:

- classification of financial instruments as 'held to maturity'
- When 'substantially all' the risks and rewards of ownership have been transferred
- whether particular sales are financing arrangements
- whether a special purpose entity is controlled by an entity
- why an investee is not consolidated even though the investor controls the majority of the voting power (IAS 27)
- classifying property as investment property, owner-occupied property or property held-for-sale (IAS 40).



These are all judgements that are made when applying accounting policies. The purpose of the disclosures is to enable users of financial statements to understand how accounting policies are applied, and to make comparisons between entities on how these judgements are made.

It should be noted that some of these disclosures are already required by the relevant standards on certain specific transactions.

## Key sources of estimation uncertainty

The disclosure requirements are set out in IAS 1.116 to 124.

The disclosures cover key assumptions concerning the future (and other key sources of estimation uncertainty at the balance sheet date) that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of these assets and liabilities, the notes are required to include details of both:

- (a) their nature
- (b) their carrying amount as at the balance sheet date.

The standard gives the following examples of 'future-orientated estimates' that are used to measure items at the balance sheet date:

- recoverable amounts of property, plant and equipment
- the effect of technological obsolescence on inventories
- the outcome of litigation
- provisions for long term employee benefits (eg pensions).

Estimating these amounts may involve:

- estimating future cash flows
- adjusting cash flows for risk
- selecting discount rates
- estimating future salaries and price changes.

Estimation uncertainty need not be disclosed for items held at a fair value, if those fair values are based on recent market prices. This is because, although the value may change in the future, the balance sheet value is not based on estimates and assumptions about the future.

## Disclosure of significant judgements and key sources of estimation uncertainty

Disclosure of significant judgements and key sources of estimation uncertainty is limited in scope 'to items that have a significant risk of causing material adjustment to the carrying amounts of assets and liabilities within the next financial year. A period longer than the next financial year might obscure the most relevant information with other disclosures' (IAS 1: BC 37).

The standard does not prescribe the form or detail of the disclosures, but IAS 1.120 gives the following examples of disclosures:

- (a) the nature of the assumption or other estimation uncertainty
- (b) the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity
- (c) the expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected
- (d) an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.

## Disclosures in practice

As this is a new requirement for UK companies, practice in this area is likely to evolve. However, the FRRP's 'Preliminary Report' has provided some guidance for the approach that should be followed by companies reporting in the UK.

The FRRP's report supported companies that 'set out' clearly the key judgements and main areas of estimation uncertainty with details relevant to their particular circumstances'. However, other companies had made no specific disclosures (except for those required by other standards) or had made 'superficial comments which were bland and uninformative with little or no information relevant to the particular circumstances'.

A review of published financial statements showed the following examples of poor practice:

- General comments about judgements and estimates such as 'The preparation of financial statements require the exercise of accounting estimates and judgements'.
- Disclosures scattered between the directors' report, the accounting policy note and the relevant accounting note. In these situations it is difficult for the reader to form a complete picture of the estimates and judgements used, and difficult for the company to ensure completeness of disclosure.
- No quantification of what the estimates are, or of how changes to them might affect the financial statements. For example, no mention of the discount rates or growth rates used when assessing impairment.

Such disclosures are not considered to meet the requirements of the standard, and might well attract the attention of the FRRP should the company's financial statements be selected, or notified to the FRRP by third parties as being appropriate, for review and comment.

## Appendix: Examples of disclosure

The disclosure of accounting estimates and judgements must be tailored to the specific circumstances of each company, therefore this FRB does not include a single 'model' to be recommended. Instead a number of examples of disclosures in practice have been included in this appendix.

There can be an overlap between the disclosure of estimates and judgements required by IAS 1 and those required by other specific standards. One way of ensuring that the reader is aware of all significant estimates and judgements without duplicating disclosures is to include a summary of all the key areas in the accounting policy note, and, where relevant, to cross reference these through to the related notes where full disclosure will be made.

This approach has been followed (to a greater or lesser extent) in most of the examples given here.

**PartyGaming plc** (Example 4) dispenses with a summary of the specific issues altogether, and just includes cross references to the related notes. If this approach is followed it is essential to ensure that the individual notes explicitly address critical estimates and judgements.

**Diageo plc** (Example 5) has followed a different approach and provides a full discussion of critical estimates and judgements as a stand alone note. This discussion includes some quantification of the effect of changes in estimates on reported profits and net assets.

This appendix includes extracts from the following published financial statements:

Company	Year-end	Activities
Scottish and Newcastle plc	December 2006	Brewing
Haynes Publishing Group plc	May 2007	Publishing
MKM Group plc	March 2007	Marketing services
PartyGaming plc	December 2006	Internet gambling
Diageo plc	June 2006	Premium drinks
Rolls Royce plc	December 2006	Engineering

It should be noted that while these illustrate how these companies have addressed the disclosure requirements, they should not necessarily be regarded as addressing all of the disclosures that might be required. In particular, as noted above, the disclosures should be specific to the entity that is reported rather than being comprised of 'boilerplate' narrative.

## Scottish and Newcastle plc

### Note 2 Critical Accounting Estimates

The group makes estimates and assumptions about the future. The resulting accounting estimates will seldom equal the related actual results. The estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are discussed below.

#### A Testing Goodwill and Intangible Assets for Impairment

The Group tests annually whether goodwill and intangible assets with an indefinite life have any impairment. Details of the tests and the carrying value of the assets are shown in note 29. The recoverable amount of cash generating units have been determined based on value in use calculations which require estimating future cash flows. If actual cash flows are lower than estimated there is a risk that future impairments would be necessary.

#### B Pension Liabilities

The present value of pension liabilities (see note 11) depend on a number of factors that are determined on an actuarial basis using a number of assumptions. Any changes in these assumptions will impact on the carrying amount of the pension liabilities.

#### C Income Tax

The group is subject to income tax in numerous jurisdictions and significant judgement is required in determining the provision for income taxes. There are many transactions for which the tax liability/asset is uncertain. The Group recognises asset/liabilities for anticipated tax issues based on estimates of the tax treatment. Where the final tax outcome is different from the amounts that were initially recorded, such differences will impact the income tax and deferred tax provisions.

### Note 29 Impairment Testing of Brands and Goodwill

Goodwill and brand values have been allocated across cash generating units and the recoverable amounts of these units have been estimated and compared to the carrying amounts. In all cases the recoverable amounts were in excess of the carrying amounts.

The table below shows, for the units with material goodwill/brand value, the key information used in this process.

	Value of goodwill		Value of brand		Long term growth rates*		Discount rates	
	2006	2005	2006	2005	2006	2005	2006	2005
Unit	£m	£m	£m	£m	%	%	%	%
UK	270	269	314	-	4.6	5.1	9.3	9.3
France	1,315	1,333	428	435	3.5	3.5	7.9	8.0
Portugal	399	406	-	-	3.7	4.5	9.0	9.0
Finland	191	195	-	-	4.3	4.2	7.9	7.9

## Financial Reporting Bulletin Issue 17/2007

The key commercial assumptions relate to market growth, market share and net selling prices. The assumptions are based on historic trends adjusted for management estimates of future prospects. These estimates take account of inter alia economic forecasts, S&N marketing plans, political factors and estimates of competitors' strategy. In all case the recoverable amount was based on value in use. The impairment review on France produced a recoverable amount that was in excess of the carrying value by £228m. If the long term growth rate assumption was reduced from 3.5 per cent to 2.8 per cent or if the discount rate assumption was increased from 7.9 per cent to 8.4 per cent the recoverable amount would be in line with the carrying value.

\*Used to extrapolate cash flows beyond the cash flow projection period of five years.

## Haynes Publishing Group plc

### Critical Accounting estimates and judgement

The preparation of the consolidated financial statements requires the Group to make certain estimates and assumptions that have an impact on the application of the policies and the amounts reported in the consolidated financial statements. Estimates and judgements are evaluated based on historical experiences and expected outcome and are believed to be reasonable at the time such estimates and judgements are made, although actual experience may vary from these estimates.

The estimates and assumptions which have the most significant bearing on the carrying value of assets or liabilities are explained below:

#### (i) Impairment of goodwill

In line with IAS 36 the Group is required to test the carrying value of goodwill, at least annually, for impairment. As part of this review process the recoverable amount of the goodwill is determined using value in use calculations, which requires estimates of future cash flows and as such is subject to estimates and assumptions. Further details are contained in note 13 to the consolidated financial statements.

#### (ii) Depreciation of property, plant and equipment

Depreciation is provided in the consolidated financial statements so as to write-down the respective assets to their residual values over their estimated useful lives and as such the selection of the estimated useful lives and the expected residual values of the assets requires the use of estimates and judgements. Details of the estimated useful lives are as shown above in the policy note for depreciation.

#### (iii) Impairment of property, plant and equipment

Where there is an indication that the carrying value of items of property, plant and equipment may have been impaired through events or changes in circumstances a review will be undertaken of the recoverable amount of that asset based on value in use calculations which will involve estimates and assumptions to be made by management (refer to note 12 of the Consolidated Financial Statements).

#### (iv) Pension and other post retirement benefits

In determining the pension cost and the defined benefit obligation of the Group's defined benefit pension schemes a number of assumptions are used which include the discount rate, salary escalation, price inflation, the expected return on the schemes' investments and mortality rates. Further details are contained in note 20 to the consolidated financial statements.

#### (v) Inventory provisions

The Group reviews its finished goods inventory on a regular basis and, where appropriate, makes provision for slow moving and obsolete stock based on estimates of future sales activity. The estimate of the future sales activity will be based on both historical experience and expected outcomes based on knowledge of the markets in which the Group operates (refer to note 14 of the Consolidated Financial Statements).

## Financial Reporting Bulletin Issue 17/2007

### Extracts from the notes cross-referenced from the 'estimates and judgements' note

#### Extract from **Accounting Policy Note Property, plant and equipment (depreciation)**

Depreciation is provided to write off the cost of property, plant and equipment less any estimated current residual values, by equal instalments over their estimated useful lives. Residual values are based on commercial and industry experience and where appropriate using the services of professional surveyors.

While the estimated useful life of an asset is determined on acquisition, using best estimates, both residual values and estimated useful lives are monitored on an annual basis. Where the estimated current residual value is in excess of the net book value of the asset concerned, no depreciation is charged during the period.

The estimated useful lives of assets are as follows:

<b>Freehold land</b>	<b>Nil</b>
<b>Freehold buildings</b>	40 years
<b>Leasehold property</b>	The period of the lease
<b>Plant and equipment</b>	Three years to 20 years

#### Extract from **Note 12 Property, plant and equipment**

The directors are not aware of any events or changes in circumstances during the year which would have a significant impact on the carrying value of the Group's property, plant and equipment at the balance sheet date.

#### Extract from **Note 13 Goodwill**

Impairment tests for cash-generating assets containing goodwill

<b>Goodwill is analysed as follows</b>	<b>2007</b>	<b>2006</b>
<b>Unit</b>	<b>£000</b>	<b>£000</b>
<b>H North America Inc</b>	4,359	4,608
<b>S Publishing Ltd</b>	-	1,447
	4,359	6,055

The Group tests for goodwill impairment annually, or more frequently if there are indications that goodwill might be impaired. As at the balance sheet date an impairment test has been carried out on the above cash generating unit, based on value in use calculations, using the latest available financial information. The goodwill arises on the acquisition by Haynes North America Inc of certain trade and assets of Chilton Manuals in the US and Gregory's in Australia, with the business operation of Haynes North America Inc. identified as the appropriate cash generating unit.

The impairment review has been based on financial budgets which have been prepared by management and approved by the Board. The key assumptions used in the budgets relate to sales volume, sales pricing and changes in direct costs which have been based on historical performance and predicted future outcomes. Based on the impairment review undertaken, the cash flows of the cash generating unit over the next twelve month period are expected to exceed the carrying value of the goodwill asset and as such the Directors are satisfied that there is no indication of impairment at the balance sheet date (2006: £Nil).

Financial Reporting Bulletin  
Issue 17/2007

**Extract from Note 14 Inventories**

The carrying value of inventory represents cost less appropriate provisions. During the year there was a net credit of £219,000 (2006: £525,000) to the Consolidated Income Statement in relation to the inventory provisions, this included a write-back of excess provisions in the UK's general publishing division of £224,000 (2006: £173,000) which were no longer deemed necessary at 31 May 2007. The movements in the inventory provisions are included within cost of sales in the income statement.

Included within finished goods stock is £4.2m (2006: £4.6m) of editorial origination costs in relation to the production of the core automotive and motorcycle repair manuals which is amortised to the Consolidated Income Statement over a period not exceeding five years. Editorial origination costs in relation to the general interest titles are amalgamated with the cost of printing the title and are therefore not separately identifiable but are expensed to the Consolidated Income Statement over the first print run of a new title.

**Note 20 Pensions**

This contains the required IAS 19 disclosures.

## **MKM Group plc**

### **Critical Accounting Estimates**

The preparation of financial statements under IFRS requires the management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses. The estimates are based upon historical performance and are reviewed on an ongoing basis.

#### **Revenue**

The Group recognises income from setting up and handling promotions contracts to the extent that the Group has fulfilled its obligations under each contract in accordance with IAS 18.

Sales of vouchers redeemable against holidays and flights sourced by the Group are treated as deferred income in the balance sheet and released to turnover to the extent that the Group has fulfilled its redemption obligations under each contract.

The Group exercises its judgement in quantifying the initial revenue recognised and the subsequent recognition of the remaining revenue. Currently the Group recognise 50 per cent initially for setting up and handling elements of campaigns and recognises the remaining 50 per cent relating to the satisfaction of future obligations on a linear basis over the life of each campaign.

Estimates and judgements of revenue recognition are on the basis of the fair value of the allocated revenue of each of the two elements, setting up and handling and sales of vouchers for holidays and flights.

Turnover from the Group's activities as a tour operator and travel agent is recognised when the Group has fulfilled its contractual obligations connected with the sale.

#### **Deferred Tax recognition**

The Group has estimated that future profitability will be sufficient to utilise the carried forward losses and have recognised the full deferred tax asset accordingly.

## PartyGaming

### Critical accounting policies, estimates and judgements

The preparation of consolidated financial statements under IFRS requires the Group to make estimates and judgements that affect the application of policies and reported amounts. Estimates and judgements are continually evaluated and are based on historical experience and other factors including expectations of future events that are believed to be reasonable under the circumstances. Actual results may differ from these estimates.

Included in the note are accounting policies which cover areas that the Directors consider require estimates and assumptions which have a significant risk of causing a material adjustment to the carrying amount of assets and liabilities within the next financial year. These policies together with references to the related notes to the financial information can be found below:

<b>Taxation</b>	<b>Note 6</b>
<b>Intangible assets and impairment of goodwill</b>	<b>Note 10</b>
<b>Payment processor receivables</b>	<b>Note 14</b>
<b>Provisions</b>	<b>Note 14 and 20</b>
<b>Regulatory compliance and contingent liabilities</b>	<b>Note 22</b>
<b>Share-based payments</b>	<b>Note 27</b>

### Selected extracts from the notes referred to above

#### Note 6 Tax (Extracts)

##### (b) Factors affecting the tax charge

The Group's policy is to manage, control and operate Group companies only in the countries in which they are registered. At the year end there were Group companies registered in Gibraltar, India, the UK, Alderney, Bulgaria, Bermuda and Antigua. However, the rules and practice governing the taxation of e-commerce activity are evolving in many countries. It is possible that the amount of tax that will eventually become payable may differ from the amount provided in these financial statements. In calculating the tax provision, in addition to any amounts due in respect of jurisdictions in which Group companies are currently incorporated or domiciled, a provision has been made to cover the Directors' best estimate of additional taxation exposures which may arise. Where the actual outcome differs from the amounts originally recorded, the tax and deferred tax provisions will be affected in the period(s) in which the determination is made.

The Group has received indemnities from the Principal Shareholders in connection with certain potential historic corporate taxation liabilities. The Directors consider the likelihood of any such liability arising to be remote. Accordingly, neither has a provision for any such potential taxation been made, nor has as an asset been recognised in respect of the indemnity.

##### (c) Factors that may affect future tax charges

In Gibraltar, the Group benefits from the exempt company regime. The Gibraltar exempt company regime will be phased out between 1 July 2006 and December 2010; under current rules, assessable income is taxed in Gibraltar at 35.0 per cent.

In India, the Group benefits from a tax holiday on income from qualifying activities until March 2009; under current rules assessable income is taxed in India at approximately 36.7per cent.

**10. Intangible assets (extracts)**

The other intangible assets primarily include the customer database and relationships acquired in respect of Empire Poker, Gamebookers, MultiPoker, PokerNOW and IntertopsPoker. The values are based on cashflow projections from existing customers taking into account the expected impact of attrition.

In accordance with IFRS 3, the Group regularly monitors the carrying value of its intangible assets. A review was undertaken at 31 December 2006 to assess whether the carrying value of assets was supported by the net present value of future cashflows derived from those assets using cashflow projections for a five year period.

The discount rates for the review were based on company specific pre-tax weighted average cost of capital percentages and ranged from 9 per cent to 12per cent. The future cashflows have been modelled to decline in line with historic player attrition patterns which are consistent with those experienced by the Group as a whole in recent years.

The results of the review undertaken at 31 December 2006 indicated that impairment totalling \$115.5m, predominantly in respect of Empire Poker, was necessary in respect of the intangible assets, arising due to the enactment of The Unlawful Internet Gaming Enforcement Act (UIGEA).

Other intangible assets represent customer lists, brands and other intangibles which are being amortised over their estimated useful economic lives of between 18 months and five years.

**Note 14 Trade and other receivables (extracts)**

In aggregate, \$69.9m is considered to be at risk in respect of amounts due from payment processors of which \$ 63.9m arose following the enactment of the UIGEA. Due to issues around current regulatory matters (see note 22) there is a degree of uncertainty as to actions the Group is able to undertake to enforce collection of these debts which may impact the eventual recoverable amounts. Accordingly, the Directors have assessed their best estimate of the recoverability of these debts as nil.

**Note 20 Provisions (extracts)**

Provisions are expected to be settled within the next year and relate to chargebacks which are recognised at the Directors' best estimate of the provision based on past experience of such expenses applied to the level of activity.

**Note 22 Contingent liabilities (extracts)**

From time to time the Group is subject to legal claims and actions against it. The Group takes legal advice as to the likelihood of success of such claims and actions.

**(a) Regulatory issues**

As part of the Board's ongoing regulatory compliance and operational risk assessment process, the board continues to monitor legal and regulatory developments, and their potential impact on the business, and continues to take appropriate advice in respect of these developments.

Following the enactment of the UIGEA on 13 October 2006, the Group stopped taking any deposits from customers in the US and barred such customers from wagering real money on all of the Group's sites. Notwithstanding this, the aggressive public statements made by certain US regulatory authorities suggest that there remains a residual risk of an adverse impact arising from the Group having had customers in the US prior to the enactment of the UIGEA.

Financial Reporting Bulletin  
Issue 17/2007

Furthermore, the Group is aware of press speculation that certain US regulatory authorities have made enquiries of banks and other financial advisers that have had involvement with the internet gaming industry. Certain customary indemnities have been given by the Company to its advisers in connection with the Company's initial public offering in June 2005 and other assignments, and claims under such indemnities cannot be ruled out. The Group has not, however, received notice of any such claim to date.

**(Note 27 Share based payments**

This contains the disclosures required by IFRS 2.)

## **Diageo plc**      **Critical accounting policies**

The consolidated financial statements are prepared in accordance with IFRS. Diageo's accounting policies are set out in the notes to the consolidated financial statements in this annual report. In applying these policies the directors are required to make estimates and subjective judgements that may affect the reported amounts of assets and liabilities at the balance sheet date and reported profit for the year. The directors base these on combination of past experience and any other evidence that is relevant to the particular circumstance. The actual outcome could differ from those estimates. Of Diageo's accounting policies, the directors consider that policies in relation to the following areas are of greater complexity and /or particularly subject to the exercise of judgement.

### **Brands, goodwill and other intangibles**

Acquired brands are held on the consolidated balance sheet at cost. Where brands are regarded as having indefinite useful economic lives, they are not amortised. Assessment of the useful economic life of an asset, or that an asset has an indefinite life, requires considerable management judgement.

Impairment review are carried out to ensure that intangible assets, including brands, are not carried at above their recoverable amounts. In particular, the group performs a discounted cash flow analysis annually to compare discounted estimated future operating cash flows to the net carrying value of each acquired brand. The analysis is based on forecast cash flows with terminal values being calculated using the long term growth rate (the real GDP growth rate of the country plus its inflation rate) of the principal countries in which the majority of the profits of each brand are generated. The estimated cash flow are discounted at the group's weighted average cost of capital in the relevant country. Any impairment write downs identified are charged to the income statement.

In assessing whether goodwill is carried at above its recoverable amount, a discounted cash flow analysis is performed annually to compare the discounted estimated future operating cash flows of cash generating units of the group to the net assets attributable to the cash generating units including goodwill. The discounted cash flow review is consistent with the brand review in its use of estimated future operating cash flows, weighted average cost of capital for the cash generating unit concerned and long term growth rates. The tests are dependent on management estimates and judgements, in particular in relation to the forecasting of future cash flows, long term growth rates and the discount rate applied to these cash flows.

### **Post employment benefits**

Diageo accounts for post employment benefits in accordance with *IAS19 – Employee benefits*. Application of IAS 19 requires the exercise of judgement in relation to various assumptions including future pay rises in excess of inflation, employee and pensioner demographics and the future expected returns on assets.

Diageo determines the assumptions to be adopted in discussion with its actuaries, and believes these assumptions to be in line with UK practice generally, but the application of different assumptions could have a significant effect on the amounts reflected in the income statement, statement of recognised income and expense and balance sheet in respect of post employment benefits. The assumptions vary among the countries in which the group operates, and there may be an interdependency between some of the assumptions. The major assumptions used by the group for the two years ended 30 June 2006 are set out in note 4 to the consolidated financial statements.

## Financial Reporting Bulletin Issue 17/2007

It would be impracticable to give the impact of the effect of changes in all of the assumptions used to calculate the post employment changes in the income statement, statement of recognised income and expense and balance sheet, but the following disclosures are provided to assist the reader in assessing the impact of the changes in the more critical assumptions.

The finance income and charges included in the income statement for post employment benefits are partly calculated by assuming an estimated rate of return on the assets held by the post employment plans. For the year ended 30 June 2006, this was based on the assumption that equities would outperform fixed interest government bonds by three and a quarter percentage points. A one percentage point decrease in this assumption would have reduced profit before taxation by approximately £40 m.

The rates used to discount the liabilities of the post employment plans are determined by using rates of return on high quality corporate bonds of appropriate currency and term. A half a percentage point decrease in the discount rate assumption used to determine the income statement charge in the year ended 30 June 2006 would have reduced profit before taxation by approximately £8 million. A half a percentage point decrease in the discount rate assumption used to determine the post employment liability at 30 June 2006 would have increased the liabilities before tax by approximately £400m.

The net liability for post employment benefits is partly determined by the fair value at the end of the year of the assets owned by the post employment plans. A 10% movement in worldwide equity values would increase /decrease the net post employment liability before tax at 30 June 2006 by approximately £350 million.

The mortality assumptions used in the UK plan were reassessed in 2006 and are based on the recent mortality experience of the plan and allow for future improvements in life expectancy. For example, it is assumed that members who retire in 2026 at age 65 will live on average for a further 22 years if they are male and for a further 24 years if they are female. If assumed life expectancies had been one year greater, the charge to profit before taxation would have increased by approximately £14m and the net post employment liability before tax would have increased by approximately £180m.

### **Exceptional items**

The Group presents certain items separately as 'exceptional'. These are items which, in management's judgement, need to be disclosed by virtue of their size or incidence in order for the user to obtain a proper understanding of the financial information. The determination of which items are separately disclosed as exceptional items requires a significant degree of judgement. Exceptional items, as reported, do not represent extraordinary items under US GAAP.

### **Taxation**

The group is required to estimate the income tax in each of the jurisdictions in which it operates. This requires an estimation of the current tax liability together with an assessment of the temporary differences which arise as a consequence of different accounting and tax treatments. These temporary differences result in deferred tax assets or liabilities which are included within the balance sheet. Deferred tax assets and liabilities are measured using substantially enacted tax rates expected to apply when the temporary differences reverse.

## Financial Reporting Bulletin Issue 17/2007

The group operates in many countries in the world and is subject to many tax jurisdictions and rules. As a consequence the group is subject to tax audits, which by their nature are often complex and can require several years to conclude. Management judgement is required to determine the total provision for income tax. Amounts accrued are based on management's interpretation of country specific tax law and the likelihood of settlement. However the actual tax liabilities could differ from the provision and in such event the group would be required to make an adjustment in a subsequent period which could have a material impact on the group's profit and loss and/or cash position.

Tax benefits are not recognised unless it is probable that the tax positions are sustainable. Once considered to be probable, management reviews each material tax benefit to assess whether a provision should be taken against full recognition of the benefit on the basis of potential settlement through negotiation and/or litigation. Any interest on tax liabilities is provided for in the tax charge. Deferred tax assets are not recognised where it is more likely than not that the asset will not be realised in the future. This evaluation requires judgements to be made including the forecast of future taxable income.

## Rolls Royce plc

### Key sources of estimation uncertainty

In applying the above accounting policies, management has made appropriate estimates in many areas, and the actual outcome may differ from those calculated. The key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing material adjustment to the carrying amounts of assets and liabilities within the next financial year are:

### Forecasts and discount rates

The carrying values of a number of items on the balance sheet are dependent on the estimates of future cash flows arising from the Group's operations:

- the impairment tests for goodwill are dependent on forecasts of the cash flows of the cash generation units that give rise to the goodwill and the discount rate applied. No impairment resulted from the annual impairment test in 2006 (carrying value at December 31, 2006 £735m, December 31, 2005 £751m).
- if the assessment of development, participation, certification and recoverable engine costs recognised as intangible assets indicates the possibility of impairment, a detailed impairment test is undertaken. No impairment resulted from the assessment in 2006 (carrying value at December 31, 2006 £674m, December 31, 2005 £530).
- The financial liabilities arising from financial risk and revenue sharing partnership are valued at each reporting date using the amortised cost method ( carrying value at December 31, 2006 £324m, December 31, 2005 £423m). This involves calculating the present value of the forecast cash flows of the arrangement using the internal rate of return at the inception of the arrangement as the discount rate.
- The realisation of the deferred tax assets (carrying value at December 31, 2006 £ 141m, December 31, 2005 £439m) recognised is dependent on the generation of sufficient future taxable profits. The Group recognises deferred tax assets where it is more likely than not that the benefit will be realised.

### Assessment of long-term contractual arrangements

The Group has long-term contracts that fall into different accounting periods. In assessing the allocation of revenues and costs to individual accounting periods, and the consequential assets and liabilities, the Group estimates the total revenues and costs forecast to arise in respect of the contract and the stage of completion based on appropriate measure of performance as described under revenue recognition above.

### Post-retirement benefits

The Group's defined benefit pension schemes and similar arrangements are assessed annually in accordance with IAS 19. The accounting valuation, which was based on assumptions determined with independent actuarial advice, resulted in a deficit of £995m before deferred taxation being recognised on the balance sheet at December 31, 2006 (December 31, 2005, £1659m). The size of the deficit is sensitive to the market value of the assets held by the schemes and to actuarial assumptions, which include price inflation, pension and salary increases, the discount rate used in assessing actuarial liabilities, mortality and other demographic assumptions and the levels of contributions. Further details are included in note 23.

## Financial Reporting Bulletin Issue 17/2007

### Provisions

As described in the accounting policy above, the Group measures provisions (carrying value at December 31, 2006 £335m, December 31, 2005 £361m) at the directors' best estimate of the expenditure required to settle the obligation at the balance sheet date. These estimates are made taking account of information available and different possible outcomes.

### Taxation

The tax payable on profits is determined based on tax laws and regulations that apply in each of the numerous jurisdictions in which the Group operates. Where the precise impact of these laws and regulations is unclear then reasonable estimates may be used to determine the tax charge included in the financial statements. If the tax eventually payable or reclaimable differs from the amounts originally estimated then the difference will be charged or credited in the financial statement for the year in which it is determined.

### Contingent liabilities

As described in note 30 the Group has significant long-term contingent obligations. The directors consider that the possibility that there will be any significant loss arising from these contingencies as remote. In reaching this opinion, the directors have considered the likelihood of the contingency crystallising and have taken account of forecast aircraft values that generally provided security against the contingent liability.

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