What's Behind the Numbers?

Recognition Decisions

Agenda

- **Terms and concepts**
    - Recognition definition
    - Recognition criteria
- **Examples**
- **Company disclosures**
- **Take-aways**

Recognition definition

Recognition decisions

- A company has just purchased a building. Should the company recognize the building as an asset?
- A company has just completed the design for a product it plans to develop in the future. Should the company recognize the plan as an asset?
- A company has just received notification from the government that it owes taxes not previously anticipated. Should the company recognize the owed taxes as a liability?
- A company has just learned that one of its ships carrying toxic chemicals has been in an accident causing extensive environmental harm. Should the company recognize a liability for expected clean-up costs?
- A company has just entered a contract with a new chief executive officer that guarantees her a specified salary for her first three years on the job providing she meets responsibilities specified in the contract.
    - Should the company recognize a liability for the guaranteed salary upon signing the contract?
    - Should the company recognize an asset for the future benefits she is expected to bring to the company?

Recognition definition

Recognition

Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition.

IASB Framework, ¶ 82

Synonyms

- Recognized: reported, stated, carried, held or capitalized (when referring to an asset)

Recognition decision

Determines whether and when an item satisfies the definition and recognition criteria for a financial-statement element.

Recognition criteria

Desirable qualities of reported items

- Understandable
- Relevant
    - Nature
    - Materiality (size)
- Reliable
    - Faithful representation
        - Substance over form
        - Neutral
        - Complete
- Comparable
- Timely

IASB Framework, ¶ 25-43

Recognition criteria

Recognition criteria

An item that meets the definition of an element should be recognized if:

a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

b) the item has a cost or value that can be measured with reliability.

IASB Framework, ¶ 83

Materiality

Materiality should be considered when making recognition decisions.

IASB Framework, ¶ 84

Example

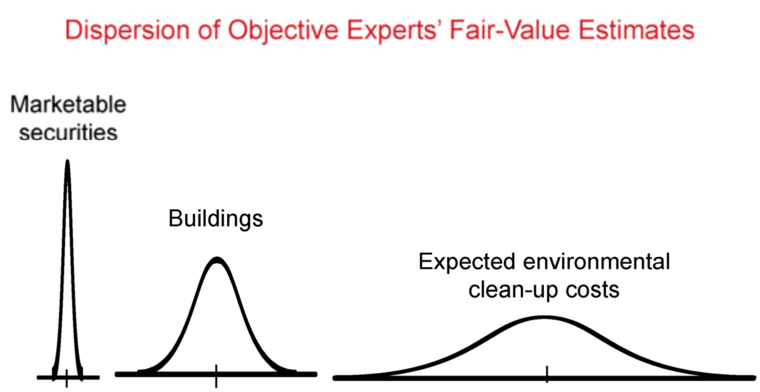
Faithful representation and uncertainty

- Assume the distributions below are objective experts' estimates of the fair values of a company's marketable securities, buildings, and expected environmental clean-up costs.

  - **Fair value** is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

    IAS 32, ¶ 11

- For which asset or liability would an objective expert's estimate be least likely to faithfully represent the value the asset would be exchanged for, or the liability settled for, in an arm's length transaction with a willing party?



Example

Faithful representation and substance over form

- **Round-trip sale**: On December 31, 2012, Nifty Gadgets sells and delivers products to a distributor, Trusty Sales. On the same day, Nifty Gadgets promises to buy the same products back from Trusty Sales the next day, January 1, 2013, for 2% more than Trusty Sales paid for them.

- Which company should recognize the products as inventory on December 31, 2012 to ensure the reported item faithfully represents probable future benefits controlled by the entity?

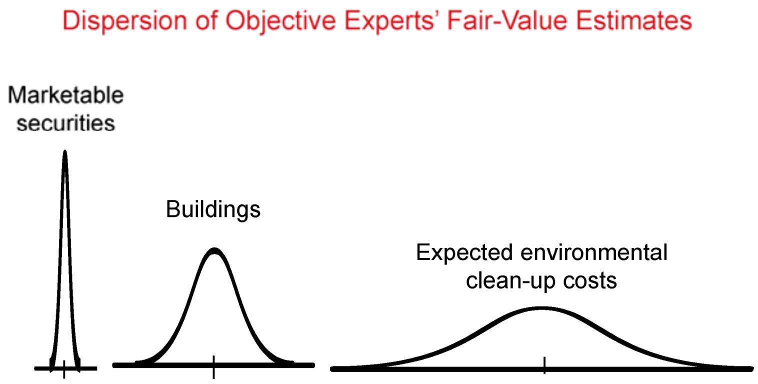
Example

Faithful representation and neutrality

- Assume the distributions below are objective experts' estimates of the fair values of a company's marketable securities, buildings, and expected environmental clean-up costs.

- Which one would you be most concerned about a non-expert making an honest error?

- Which one would you be most concerned about an opportunistic manager reporting a manipulated measure to achieve a desired outcome?



Example

Asset recognition decision

- When a company purchases a building, should the building be recognized as an asset?

Questions to address

- Does the building meet the asset definition?
    - Is it a resource controlled by the entity as a result of past events from which future economic benefits are expected to flow to the entity?
- Is it probable the future economic benefits will flow to the entity?
- Does the building have a cost or value that can be measured with reliability?
    - Faithful representation?
        - Reasonable uncertainty?
        - Substance over form?
        - Neutral?

Example

Asset recognition decision

- A company has just completed the design for a product it plans to develop in the future. Should the company recognize the plan as an asset?

Questions to address

- Does the plan meet the asset definition?
    - Is it a resource controlled by the entity as a result of past events from which future economic benefits are expected to flow to the entity?
- Is it probable the future economic benefits will flow to the entity?
- Does the plan have a cost or value that can be measured with reliability?
    - Faithful representation?
        - Reasonable uncertainty?
        - Substance over form?
        - Neutral?

Example

Liability recognition decision

- A company has just received notification from the government that it owes taxes not previously anticipated. Should the company recognize the owed taxes as a liability?

Questions to address

- Do the taxes owed meet the liability definition?
    - Does the entity have a present obligation arising from past events the settlement of which is expected to result in the outflow of resources embodying economic benefits?
- Is it probable there will be a settlement that results in the outflow of resources embodying economic benefits?
- Do the taxes owed have a cost or value that can be measured with reliability?
    - Faithful representation?
        - Reasonable uncertainty?
        - Substance over form?
        - Neutral?

Example

Liability recognition decision

- A company has just learned that one of its ships carrying toxic chemicals has been in an accident causing extensive environmental harm. Should the company recognize a liability for expected clean-up costs?

Questions to address

- Do the expected clean-up costs meet the liability definition?
  - Does the entity have a present obligation arising from past events the settlement of which is expected to result in the outflow of resources embodying economic benefits?
- Is it probable there will be a settlement that results in the outflow of resources embodying economic benefits?
- Do the expected clean-up costs have a cost or value that can be measured with reliability?
  - Faithful representation?
    - Reasonable uncertainty?
    - Substance over form?
    - Neutral?

Example

Liability recognition decisions

- A company has entered a contract with a new chief executive officer that guarantees her a specified salary for her first three years on the job providing she meets responsibilities specified in the contract.
  - Should the company recognize a liability for the guaranteed salary upon signing the contract?
- This is an example of an **executory contract**: a stage in the life of a contract when both parties still have significant obligations to perform.

Questions to address

- Does the guaranteed salary meet the liability definition?
  - Does the entity have a present obligation arising from past events the settlement of which is expected to result in the outflow of resources embodying economic benefits?
- No:
  - In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognized as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.

IAS Framework, ¶ 91

Company disclosures

British Airways, 2008/2009 Annual Report and Accounts, page 82, www.bashares.com

Notes to the accounts

1 Authorisation of financial statements and compliance with IFRSs

The Group's and Company's financial statements for the year ended March 31, 2009, were authorised for issue by the Board of Directors on May 21, 2009, and the balance sheets were signed on the Board's behalf by Willie Walsh and Keith Williams. British Airways Plc is a public limited company incorporated and domiciled in England and Wales. The Company's ordinary shares are traded on the London Stock Exchange.

The Group has prepared its consolidated financial statements in accordance with International Financial Reporting Standards (IFRSs)* as adopted by the EU. IFRSs as adopted by the EU differ in certain respects from IFRSs as issued by the International Accounting Standards Board (IASB). However, the consolidated financial statements for the periods presented would be no different had the Group applied IFRSs as issued by the IASB. References to 'IFRS' hereafter should be construed as references to IFRSs as adopted by the EU. The principal accounting policies adopted by the Group and by the Company are set out in note 2.

The Company has taken advantage of the exemption provided under Section 230 of the Companies Act 1985 not to publish its individual income statement and related notes.

* For the purposes of these statements, IFRS also includes International Accounting Standards (IASs).

2 Summary of significant accounting policies

Basis of preparation

The basis of preparation and accounting policies set out in this Report and Accounts have been prepared in accordance with the recognition and measurement criteria of IFRS as issued by the IASB and with those of the Standing Interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) of the IASB.

The financial statements for the prior period include

"The basis of preparation and accounting policies set out in this Report and Accounts have been prepared in accordance with the recognition and measurement criteria of the IFRS..."

pounds sterling and all values are rounded to the nearest million pounds (£ million), except where indicated otherwise.

Basis of consolidation

The Group accounts include the accounts of the Company and its subsidiaries, each made up to March 31, together with the attributable share of results and reserves of associates, adjusted where appropriate to conform with the Group's accounting policies.

Subsidiaries are entities controlled by the Group. Control exists when the Group has the power either directly or indirectly to govern the financial and operating policies of the entity so as to obtain benefit from its activities. Subsidiaries are consolidated from the date of their acquisition, which is the date on which the Group obtains control, and continue to be consolidated until the date that such control ceases.

All intra-group account balances, including intra-group profits, have been eliminated in preparing the consolidated financial statements. Minority interests represent the portion of profit or loss and net assets in subsidiaries that are not held by the Group and are presented separately within equity in the consolidated balance sheet.

Revenue

Passenger and cargo revenue is recognised when the transportation service is provided. Passenger tickets net of discounts are recorded as current liabilities in the 'sales in advance of carriage' account until recognised as revenue. Unused tickets are recognised as revenue using estimates regarding the timing of recognition based on the terms and conditions of the ticket and historical trends.

Other revenue is recognised at the time the service is provided. Commission costs are recognised at the same time as the revenue to which they relate and are charged to operating expenditure.

Revenue recognition – mileage programmes

The Group operates two principal loyalty programmes. The airline's frequent flyer programme operates through the airline's 'Executive Club' and allows frequent travellers to accumulate 'BA Miles' mileage credits that entitle them to a choice of various awards, primarily free travel. The fair value attributed to the awarded mileage credits is deferred as a liability and recognised as revenue on redemption of the miles by the participants to whom the miles are issued. The accounting policy for mileage revenue recognition was amended during the year in line with the adoption of IFRIC 13. Refer to 'Impact of new International Financial Reporting Standards' note in this section for impact of the change in policy.

In addition, 'BA Miles' are sold to commercial partners to use in promotional activity. The fair value of the miles sold is deferred and recognised as revenue on redemption of the miles by the participants to whom the miles are issued. The cost of the redemption of the miles is recognised when the miles are redeemed.

The Group also operates the AIRMILES scheme, operated by the Company's wholly-owned subsidiary Air Miles Travel Promotions Limited. The scheme allows companies to purchase miles for use in their own promotional activities. Miles can be redeemed for a range of benefits, including flights on British Airways and other carriers. The fair value of the miles sold is deferred and recognised as revenue on redemption of the miles by the participants to whom the miles are issued. The cost of providing redemption services is recognised when the miles are redeemed.

Segmental reporting

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker. The chief operating decision-maker, who is responsible for resource allocation and assessing performance of the operating segments, has been identified as the Management Board as detailed on page 35. The nature of the operating segments is set out in note 3.

British Airways, 2008/2009 Annual Report and Accounts, page 83, www.bashares.com

Intangible assets
Intangible assets are held at cost and are either amortised on a straight-line basis over their economic life, or they are deemed to have an indefinite economic life and are not amortised, but tested annually for impairment.

a Goodwill
Where the cost of a business combination exceeds the fair value attributable to the net assets acquired, the resulting goodwill is capitalised and tested for impairment annually and whenever indicators exist that the carrying value may not be recoverable. Any goodwill arising on the acquisition of equity accounted entities is included within the cost of those entities.

Goodwill is allocated to cash-generating units for the purpose of impairment testing.

b Landing rights
Landing rights acquired from other airlines are capitalised at cost or at fair value, less any accumulated impairment losses. Capitalised landing rights based outside the EU are amortised on a straight-line basis over a period not exceeding 20 years. In October 2008 the Group revised the economic life for landing rights acquired within the EU to that of an indefinite economic life, due to regulation changes in the EU regarding the ability to trade landing rights. Landing rights with indefinite economic lives are reviewed annually for impairment. Had the Group not revised the economic life for landing rights, the amortisation charge for the year would have been £5 million greater than is currently reported.

c Software
The cost of purchase or development of computer software that is separable from an item of related hardware is capitalised separately and amortised over a period not exceeding four years on a straight-line basis.

The carrying value of intangibles is reviewed for impairment if events or changes in circumstances indicate the carrying value may not be recoverable.

Property, plant and equipment
Property, plant and equipment is held at cost. The Group has a policy of not revaluing property, plant and equipment. Depreciation is calculated to write off the cost less estimated residual value on a straight-line basis, over the useful life of the asset. Residual values, where applicable, are reviewed annually against prevailing market values for equivalently aged assets and depreciation rates adjusted accordingly on a prospective basis.

The carrying value is reviewed for impairment when events or changes in circumstances indicate the carrying value may not be recoverable and the cumulative impairment losses are shown as a reduction in the carrying value of property, plant and equipment.

a Capitalisation of interest on progress payments
Interest attributed to progress payments, and related exchange movements on foreign currency amounts, made on account of aircraft and other significant assets under construction is capitalised and added to the cost of the asset concerned.

b Fleet
All aircraft are stated at the fair value of the consideration given after taking account of manufacturers' credits. Fleet assets owned, or held o[...]
deprecia[...]
estimate[...]
lives on [...]

Cabin int[...]
changes [...]
years an[...]

Aircraft [...]
expansio[...]
separatel[...] are carried as property, plant and equipment and generally depreciated in line with the fleet to which they relate.

"Where the cost of a business combination exceeds the fair value attributable to the net assets acquired, the resulting goodwill is **capitalized** ..."

Major ov[...]
labour co[...]
expected[...]
spares ar[...]
(including[...]
are charg[...]
incurred respectively.

"Landing rights acquired from other airlines are **capitalized** ..."

c Property and equipment
Provision is made for the depreciation of all property and equipment, apart from freehold land, based upon expected useful lives, or i[...]
the lease[...]

d Lease[...]
Where as[...]
arrangem[...]
of owner[...]
as if they[...]
the cost [...]
aggregat[...] purchase term. The corresponding obligation, reduced by the appropriate proportion of lease or hire purchase payments made, is included in borrowings.

"The cost of purchase or development of computer software that is separable from an item of related hardware is **capitalized** separately ..."

The amount included in the cost of property, plant and equipment is depreciated on the basis described in the preceding paragraphs and the interest element of lease or hire purchase payments made is included in interest payable in the income statement.

Total minimum payments, measured at inception, under all other lease arrangements, known as operating leases, are charged to the income statement in equal annual amounts over the period of the lease. In respect of aircraft, certain operating lease arrangements allow the Group to terminate the leases after a limited initial period (normally 10 years), without further material financial obligations. In certain cases the Group is entitled to extend the initial lease period on predetermined terms; such leases are described as extendable operating leases.

Inventories
Inventories, including aircraft expendables, are valued at the lower of cost and net realisable value. Such cost is determined by the weighted average cost method.

Company disclosures

Qantas 2009 Annual Report, page 95. www.qantas.com.au

Notes to the Financial Statements

for the year ended 30 June 2009

1. Statement of Significant Accounting Policies continued

(Q) INTANGIBLE ASSETS continued

Airport Landing Slots

Airport landing slots are stated at cost less any accumulated impairment losses. Airport landing slots are allocated to the relevant CGU and are not amortised as they are considered to have an indefinite useful life and are tested annually for impairment.

Software

Software is stated at cost less accumulated amortisation and impairment losses. Software development expenditure, including the cost of materials, direct labour and other direct costs, is only recognised as an asset when the Qantas Group controls future economic benefits as a result of the costs incurred, it is probable that those future economic benefits will eventuate and the costs can be measured reliably. Amortisation is charged to the Income Statement on a straight-line basis over the estimated useful life of three to 10 years.

Brand names and trademarks

Brand names and trademarks are carried at cost less any accumulated impairment losses. Brand names and trademarks are allocated to the relevant CGU and are not amortised as they are considered to have an indefinite useful life and are tested annually for impairment.

Customer contracts/relationships

“Brand names and trademarks are **carried** at cost ...”

from 10 to 15 years.

(R) PAYABLES

Liabilities for trade creditors and other amounts payable are carried at cost.

(S) EMPLOYEE BENEFITS

Wages, Salaries, Annual Leave and Sick Leave

Liabilities for employee benefits for wages, salaries, annual leave (including leave loading) and sick leave vesting to employees expected to be settled within 12 months of the year end represent present obligations resulting from employees' services provided to balance date. The calculation of this liability is based on remuneration wage and salary rates that the Qantas Group expects to pay as at balance date including related on-costs, such as workers' compensation insurance, superannuation and payroll tax.

Employee Share Plans

The fair value of equity-based entitlements granted to employees after 7 November 2002 is recognised as an employee expense with a corresponding increase in equity. The fair value is estimated at grant date and recognised over the period during which the employees become unconditionally entitled to the equity instrument. The amount recognised as an expense is adjusted to reflect the actual number of entitlements that vest, except where forfeiture is only due to share prices not achieving the threshold for vesting.

Long Service Leave

The provision for employee benefits to long service leave represents the present value of the estimated future cash outflows to be made resulting from employees' services provided to balance date.

The provision is calculated using expected future increases in wage and salary rates including related on-costs and expected settlement dates based on staff turnover history and is discounted using the rates attaching to Australian Government bonds at balance date which most closely match the terms to maturity of the related liabilities. The unwinding of the discount is treated as a finance charge.

Defined Contribution Superannuation Plans

The Qantas Group contributes to employee defined contribution

“ Software development expenditure, including the cost of materials, direct labour and other costs, is only **recognized** as an asset when the Qantas Group control's future economic benefits as a result of the costs incurred, it is probable those economic benefits will eventuate and the costs can be measured reliably.”

When the benefits of a plan are improved, the portion of the increased benefit relating to past service by employees is recognised as an expense in the Income Statement on a straight-line basis over the average period until the benefits become vested. To the extent that the benefits vest immediately, the expense is recognised immediately in the Income Statement.

All actuarial gains and losses as at 1 July 2004, the date of transition to IFRS, were recognised. With respect to actuarial gains and losses that arise subsequent to 1 July 2004, in calculating Qantas' obligation with respect to a plan, to the extent that any cumulative unrecognised actuarial gain or loss exceeds 10 per cent of the greater of the present value of the defined benefit obligation and the fair value of plan assets, that portion is recognised in the Income Statement over the expected average remaining working lives of the active employees participating in the plan. Otherwise, the actuarial gain or loss is not recognised.

Where the calculation results in plan assets exceeding plan liabilities, the recognised asset is limited to the net total of any unrecognised actuarial losses and past service costs and the present value of any future refunds from the plan or reductions in future contributions to the plan.

Past service cost is the increase in the present value of the defined benefit obligation for employee services in prior periods, resulting in the current period from the introduction of, or changes to, post-employment benefits or other long-term employee benefits. Past service costs may either be positive (where benefits are introduced or improved) or negative (where existing benefits are reduced).

Various actuarial assumptions underpin the determination of Qantas' defined benefit obligation and are discussed in Note 30.

Employee Termination Benefits

Provisions for termination benefits are only recognised when there is a detailed formal plan for the termination and where there is no realistic possibility of withdrawal.

US GAAP

- Under US GAAP, an item and information about it should meet four fundamental recognition criteria to be recognized and should be recognized when the criteria are met, subject to a cost-benefit constraint and a materiality threshold. Those criteria are:
  - *Definitions*—The item meets the definition of an element of financial statements.
  - *Measurability*—It has a relevant attribute measurable with sufficient reliability.
  - *Relevance*—The information about it is capable of making a difference in user decisions.
  - *Reliability*—The information is representationally faithful, verifiable, and neutral.

  FASB Concept Statement 5, ¶ 63

- Generally assets and liabilities associated with executory contracts are not recognized under US GAAP.

Take-aways

What should you know?

- One reason a balance sheet is a fuzzy image of a company's financial condition at a reporting date is some items that meet the definitions of assets or liabilities are not recognized either because related future inflows or outflows are not probable or can't be measured reliably.

- More precisely, they can't be measured reliably enough to meet the threshold for recognition determined by decision makers in the decision hierarchy that stretches from legislative bodies to record keepers.

Take-aways

What should you know?

- A second reason a balance sheet is a fuzzy image is some items that meet the reliability threshold can still fall considerably short of being perfectly reliable.
- Determining whether an item meets recognition criteria can require substantial judgment, especially when there is a high degree of uncertainty associated with the item.

Take-aways

Where are we heading?

- Recognition criteria preclude certain items from being reported to ensure the ones that are reported are as relevant and reliable as possible, given cost –benefit considerations.

- However, recognition decisions do not ensure comparability, another desirable quality of reported numbers: there can be multiple ways to measure items that meet the recognition criteria.

- The *Judgment: Measurement Decisions* video examines the measurement objectives, techniques, and inputs associated with these alternatives and the company disclosures users must understand when assessing comparability across companies, industries, and countries.