Scenic Video Transcript

Recognition Decisions

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Transcript

We've already seen that recognition decisions determine whether and when assets and liabilities are recognized in balance sheets. In this scenic route, we're going to examine this concept more closely by defining recognition precisely and also by looking at the recognition criteria. We will then look at several examples that vividly demonstrate the challenges that decision makers, throughout the hierarchy discussed in scenic route 1, confront when they tried to apply these criteria to business activities. This will help you appreciate the extent to which experts can reasonably disagree on the outcomes and therefore the amount of judgment that's involved.

We're also going to look at several company disclosures that will demonstrate the concepts discussed in the examples and then we'll finish with some take-aways.

Terms and concepts:

We begin by looking at several recognition decisions that are quite realistic. A company has just purchased a building. Should the company recognize the building as an asset? We'll examine that later. 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 the liability for the expected clean-up cost? 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 the company? We'll be looking at all these examples after we establish a framework for analyzing them.

Recognition definition

We begin with the definition of 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. Here are some synonyms you're going to see repeatedly in the company disclosures that we'll be looking at later. Recognized is the word we'll be talking about a good deal here, but you often see "reported" as a synonym for recognized or "stated", and you'll see those on both the balance sheet and the income statement. On the balance sheet alone though, you'll see "carried", "held", or "capitalized". We'll be demonstrating these as we go through the company disclosures later.

So, what do we mean by a recognition decision, if this is what we mean by recognition? A recognition decision determines whether and when an item satisfies the definition and recognition criteria for the financial-statement elements.

Recognition criteria

Recognition criteria determine what goes on the balance sheet and what stays off the balance sheet. In establishing these criteria, standard setters and others have to think about well, just what are users of the financial information that's being reported on balance sheets and income statements — what are those users looking for in terms of the quality of the information? If that quality standard is met, well then probably it should be recognized.

Well, it turns out there are many desirable qualities that users are looking for in financial-statement numbers. One is that those numbers are understandable. That is, they can connect the concept that they're looking at on the balance sheet for a particular asset, say, back to some business activity and it makes sense to them.

A second attribute or desirable quality of numbers is that they're relevant both in nature and materiality. What does this mean? Well, relevant in nature means that the issue that you're looking at on the balance sheet pertains to the decision you're trying to make right now. Materiality pertains to the size of that. For example, if a company buys a pencil, you could say well the pencil has a future benefit and therefore should be recognized as an asset on the balance sheet. But no decision that an investor is going to make is going to depend on whether that pencil gets recognized on the balance sheet. It's said to be immaterial or it doesn't pass the materiality threshold and the benefits of putting it on the balance sheet just aren't worth the cost.

Now, numbers must be understandable and they must be relevant, but they must also be reliable. Reliable deals with the concept called faithful representation, which we'll elaborate on significantly with three examples. But for right now, there are three dimensions to it: Substance over form; neutrality, meaning the numbers are not biased one way or the other, for example through manipulations or careless errors; and they must be complete, meaning the numbers must capture the entire economics that the user expects them to capture, that is, they represent completely what the users are thinking they represent.

The fourth quality of numbers is they should be comparable. That is, if we look at the numbers reported by one company and we look at the numbers reported by another, and the business activities are similar for the two companies, the numbers should be similar and very comparable. We should be able to compare the numbers for one company to the numbers for another company.

Numbers can be understandable, relevant, reliable, and comparable and still not be timely. Timely means that when the company becomes aware of the information, the outsiders or investors also become aware of the information and therefore can make decisions in a timely manner.

All these qualities are desirable, but it's hard to get them all in any one item. So what the decision makers throughout the hierarchy, discussed in the earlier scenic route, must determine is how do we trade off between these various qualities when we can't get them all. And in particular, often there are trade-offs between relevance and reliability. Some numbers are much more relevant than others and yet they're not measured as reliably whereas other numbers are very reliable and yet they don't seem to be quite as relevant. We'll give examples as we go throughout *Navigating Accounting*.

Another important dimension is comparability. Often, standard setters pass standards to ensure comparability, that is, to ensure that similar business activities are accounted for in similar ways.

So these qualities are really important in thinking about recognition criteria. Because these are the things we're looking for that we'd love to get in all the numbers that are reported. So the criteria tries to keep as many of these qualities in the numbers that are reported as possible.

Here are the recognition criteria at a very general level: An item that meets the definition of an element should be recognized — and that element could be for example an asset or a liability — should be recognized if it is probable — big word — it is probable that any future economic benefits associated with the item, for example a benefit associated with an asset, will flow to or from the entity; to the entity for example for an asset, from the entity for example for a liability.

The first criteria is this notion of probable and I'll come back to that in a second. The second criteria is the item has a cost or a value that can be measured with reliability and that cuts right back to what we just looked at. How do we think about reliability? Well, that's faithful representation.

So let's go back to this word "probable" and try to get a better sense of what it means. Well, it generally means there is reasonable assurance. For example, a reasonable assurance that the future economic benefit associated with an asset will be realized. But what does reasonable assurance mean? Well, in various standards that are more specific than this general rule, the IASB, which is the standard setting body we're looking at here, will have standards for which they'll say, "Well, probable means more likely than not." And that means more than a 50% probability of happening. Yet, there are other cases where the standards are not as specific and we're left with, well, just what is meant by probable? So here, all we want to drive home is that experts can reasonably disagree as to whether something is probable.

Even if we set a specific cutoff point like 50%, how do you know something has a 50% chance of happening in the future? Experts can disagree on that so that gives rise to a significant amount of judgment in applying this criteria. The same is true of course of measurement and we'll be looking at both of these. But the key here is, after you determine that something is probable then you measure it and that measurement may or may not be reliable.

Now, materiality also plays a role in recognition. Materiality should be considered when making recognition decisions. So what that means is when an item is not material, perhaps you won't recognize it on the balance sheet.

Examples:
Faithful representation

Now, we're going to look at several examples to get a better idea of what we mean by faithful representation, and the first thing we're going to do is show the importance of uncertainty in thinking about faithful representation.

Now, here's the fact pattern that we're looking at. Assume the distributions below are objective experts' — and that's a term we'll be using often — estimates; objective experts' estimates of the fair value of a company's marketable securities, buildings, and expected environmental clean-up cost. So, here, we see estimates and here are distributions of those estimates. Now, these distributions are going to play a pivotal role in how we think about measurement so we're going to spend a significant amount of time introducing them.

Here's what we have in mind. Imagine for these measures down here, 1,000 objective, and this is a hypothetical experiment, 1,000 objective experts are asked to measure the value of a company's marketable securities and in particular the fair value. And we'll come back to this definition in a second.

What we're looking at here is the distribution of their estimates. That is, we wouldn't expect them all to come up with the same measure. For the building, we're looking at the distribution of their measures and for the expected environmental cost, the distributions. So, why are these distributions different?

Well, to understand that, we've got to put ourselves in the place of these objective experts trying to make these measures. So let's see what it is they're trying to do. Well, the first thing they have to have is a measurement objective; that is, what is it we're trying to measure? And what they're trying to measure is this thing called fair value. Now, fair value is defined by the standard setter so let's go look at what it is.

Fair value is the amount for which an asset could be exchanged, for example the building or the marketable securities could be exchanged, sold, or liability settled, for example the environmental liability, what would it cost to settle, it between knowledgeable willing parties in an arm's length transaction.

What do we mean by willing parties? Well, it means you're not under severe pressure and arm's length means objective. It's an objective transaction between two parties. No one's got

a vested interest. These are not related parties. That's a fairly good definition of what it is we have to measure. So let's go about measuring it.

Now what do we mean by marketable securities? An example of a marketable security would be government bonds. Another one might be, for example if you were Siemens, you might be holding a marketable security in the form of shares in another company like General Electric.

So we've been asked to measure the fair value of marketable securities. Now the reason we have a rather tight distribution for our 1,000 experts, that is, they'd all go out and try to measure the fair value, think about what they have to do. Well, we're going to be looking at the balance sheet date; so we're right at, say, December 31st. And what we're asking is what is the fair value of the marketable securities on that date and in particular, at the close of the balance sheet?

Well, what the objective experts would do is they would take the security and they would try to find the price of the security on that date. And they might say, "Well, should we take the last transaction that occurred? Would that be the fair value?" That is, could the company have transacted at that last price? What about if the stock price was fluctuating a lot during the last 10 or 15 minutes of the market, should they take the average over that?

Now, the important point here is, if the company is holding US government bonds or if it's Siemens holding GE stock, then the distribution is going to be fairly tight on the marketable securities of the objective experts' estimates, regardless of whether they're measured over the last 15 minutes to take the average, for example, or they looked at the last transaction that was executed that day. So, we end up with a tight distribution and that's the important point. If we looked at another marketable security that was not traded frequently, then we'd expect the distribution to be wider.

What about if we're asked to calculate the fair value of a building? Well, now we don't have a market to rely on in the same asset. So if we said, what is the market value of a particular factory for example, well we'd have to go look for comparable factories, and we wouldn't be as confident in those comparable factories. In fact, we might expect different experts to go look at different factories to set up as their basis of comparison. And so we'd expect a little more distribution here in the buildings.

Now the key point here is as we move in this direction, the dispersion of the experts' estimates is getting wider and that's really what we want you to see. And what we want you to start thinking about as a user of financial statements or a preparer, in terms of broad descriptions, what is the dispersion of these hypothetical distributions that we're looking at, how do they differ? Because that's going to affect the confidence we have in the numbers that are coming out.

Now, let's look at one more example and let's try to make this very real. If we look at the expected environmental clean-up cost, in the summer of 2010 there was a huge problem with BP in the Gulf of Mexico, and that was the oil spill that everyone learned about worldwide. Now, imagine around that time, early on that BP hired 1,000 objective experts to go out and try to estimate what was going to be the cost of the environmental clean-up. Well, it turned out there was a tremendous amount of uncertainty as to how much oil was coming out of the well itself, let alone whether hurricanes would wash some of that oil ashore. So, the uncertainty was significant. So we might expect the objective experts to come to very, very

different conclusions as to what was going to be the environmental clean-up cost. So their experts' estimates could fall among a much broader range, than say for the marketable securities. That's the critical lesson here.

Now, let's go back and look at what the question is that we're going to ask. For which asset or liability would an objective experts' estimate be least likely to faithfully represent the value the asset would be exchanged for, the actual value the asset would be exchanged for, or the liability settled? And the answer is right here the environmental liability. Because an expert might come back with a very objective honest estimate right here, but in fact, the liability might be settled right here.

And the way to think about that is, suppose you were BP and you were trying to get rid of this liability. So you arrange for another party to settle the liability by paying them a certain upfront fixed fee. How much would you pay them to take over this liability? Well, when that deal finally came down, that would be after lots of negotiations with consideration for all these estimates. Where would that value fall? Would it be close to any one objective expert's estimate? And the answer is it had a pretty good chance of being far away.

Contrast that to marketable securities. What would be the value that could've been received if the company had sold their marketable security at the end of the year? Well, experts may disagree, but any one of their estimates is going to be a faithful representation of what the others were. So, uncertainty can have a significant effect on the degree to which numbers faithfully represent what will ultimately be realized.

Faithful representation can also relate to substance over form. Now, this doesn't happen very often, but when it does happen, the consequences can be very significant. So, let's look at an example of what's called a round trip sale. So, here, we have a timeline. Let's say this is December 31, 2012, so this right here is January 1, 2013, and let's suppose that this company Nifty Gadgets' fiscal year ends right here. So, they're going to put out balance sheets, income statements and cash flow statements at that point.

We're going to have Nifty Gadgets on December 31, 2012 — here's what's going to happen — here's Nifty Gadgets and over here is Trusty Supplier [fictitious companies]. Now, Nifty Gadgets is going to transfer product to Trusty Supplier, but they're going to give Trusty Supplier one more thing. They're going to give them a promise to repurchase. So, they're going to sell the products to them on December 31st and say, wait January 1st we'll buy them back, and we'll buy them back and give you 2% more than we sell them for. Now that might seem tricky to you, so stand by.

Now, what's going to happen is Trusty Supplier on December 31st is going to give, let's just say, cash for product. So they bought the product for cash. It could have been accounts receivable, but that's just one more issue to deal with. What's going to happen on January 1st? Well, Trusty Supplier and Nifty Gadgets are again going to have a deal. Nifty Gadgets is over here, Trusty Supplier is over here. The first thing we're going to see is the product is going to come back this way on January 1, 2013 and cash, the original cash that went this way from Trusty Supplier to Nifty Gadgets on December 31st, is going to come back plus 2% more. This looks crazy! Why would anyone ever do this?

Well, in fact, it did happen. What's going on is that Nifty Gadgets is trying to make their financial performance look really good in this fiscal year when they put out their financial

statements at this date. And a couple of things are going on when they make a sale. One is, and we'll learn this in the next chapter, they're going to get their recognized revenues and profits and the stock market is going to look at that and add valuation. The other is, they're going to take inventory off their balance sheet and they're going to replace it with either cash or accounts receivable, which is going to make their assets go up. Now all of that is really good for Nifty Gadgets. It'll make them look good. Actually, they're trying to manipulate the market.

Now you might say, what about Trusty Supplier? Is this an arm's length transaction? Hardly, because Trusty Supplier is actually part of this fraud. Trusty Supplier should be asking themselves, "Why is it we're going to make 2% for holding this inventory for 24 hours? There must be something going on here." So, this is essentially fraud.

But let's look at what we mean by substance over form. If we look at substance over form, we can ask where should the inventory be held at the end of the year? Should it be on Trusty Supplier's balance sheet? Well, strictly by form, it should be because Trusty Supplier on December 31st, they have the title to the property, so they own it. Yet, if you think about who gets the future benefits from this asset, I guess one could argue it's Trusty Supplier to a certain extent because they're going to make 2% the next day. But in reality, this inventory belongs on the balance sheet of Nifty Gadgets. So this is an example of where, if we actually look at the form of the sale, the legal form of the sale, and recorded one transaction here and recorded another transaction the next day, that would misrepresent, that would not be a faithful representation of what actually is going on.

This happened during the run up in the stock prices from 1996 to 2000 during the internet bubble. In those times, there were plenty of startup companies that weren't yet profitable. So, they were being valued by the stock market strictly on what's called their revenues or their sales. And they wanted to be able to establish that they have lots of sales in order to raise capital in the markets. And so, we had companies like Nifty Gadgets that actually exaggerated their sales in order to push up their stock price so they could raise more money to grow. That was all shutdown and those folks ended up getting into a good deal of trouble with the Securities and Exchange Commission in the United States.

Faithful representation and neutrality, now what does neutrality mean? Well, neutrality means basically that when we look at a number, we know it's free of bias. Now, how does bias come into a number? Well, if people don't know how to measure something and they all underestimate it, there would be bias in the measure. That is, it would be measured too low relative to what it should be, and that would simply be due to honest errors. But of course a lot of neutrality is violated because people try to misrepresent their numbers.

So, we're going to go back to the example we looked at before with the marketable securities, the buildings and the environmental liability class, and we're going to ask a simple question. Which one would you be most concerned about an opportunistic manager — that's somebody who has an incentive to misrepresent information — manipulating the measure to achieve the desired outcome? This is when neutrality is violated. Again, remember these are the desirable qualities we want in the number; we want them to be faithful. This is the number you'd be most concerned about.

For example, suppose someone had an estimate that was right here. That is, they're actually truthfully reporting environmental liability cost here. But, in fact, they decided they didn't want

to show that big of a cost, that big of a liability, so they reported it down here. They were not honest. They were misrepresenting what they actually believed. But they're reporting it here; they're well within the limits of what an honest objective expert could estimate the liability to be, so they could get away with that fraud.

Now, if we look up here and contrast that with marketable securities, there's very little range over which reasonable estimates could be expected and that's critical.

Now what we're going to see in accounting, and we see it frequently, and this is why this is so important to get an understanding of these curves, when lots of dispersion would be expected of objective experts' measures, then what we see is that standards are put in place to restrict the measurement possibilities. For example, items can't be recognized on the balance sheet and that's really an important understanding if you're out there using numbers.

And the other is, if they do get on the balance sheet, for example buildings and marketable securities, what you want to be able to do is say, well, look I'm going to have much more confidence in this measure at least for what it's trying to represent. I may not care about what it's representing, fair value, but if it says it's fair value and there're lots of trades going on, I'm going to be very confident in that number. And I'm going to put more confidence in that number than I might for example, in the fair value estimate of a building.

Asset recognition

Now we're going to start looking at some of those questions we framed earlier in the discussion.

When a company purchases a building, should the building be recognized as an asset? Let's try to apply some of the concepts that we've learned.

Here are some questions you'd want to address. Does the building meet the definition of an asset? 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? Well, I think everyone would agree the answer is yes. If you buy a building, you definitely control it; you own it. It certainly happened from past events because you bought it and generally, we'd expect the future economic benefits to be expected. So, we may not know how much those benefits are, but we definitely meet the definition. So there isn't any doubt about that. I think virtually all experts would agree on that.

Is it probable that the future economic benefits would flow to the entity? That is, is there reasonable certainty that we're going to get these economic benefits? Not how much, not reasonable certainty over a specific amount of benefits, but reasonable certainty that we will get future economic benefits, and I think the answer is yes.

Does the building have a cost or value that can be measured reliably? Well, this is the only place where there might be judgment needed. So for example, is there faithful representation? Is there reasonable uncertainty about the measure that we're looking at? Well, we saw there was. There's some uncertainty, but it seemed reasonable, especially compared to the environmental liability.

Is there substance over form? Yes, we definitely own that building.

Can we assume these measures are neutral? Fairly neutral. We'll get to this later when we look at measurement. There's always room for a little bit of manipulation, but reasonable neutrality is probably guaranteed. And for this reason, virtually all standards setters around the world allow buildings to be recognized on the balance sheet, and then the only question is how are they measured? Fair value or some other measurements; that we'll look at in the next scenic video.

Let's look at another example. 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? Well, let's look at the same questions.

Does the plan meet the definition of an asset? Is it a resource controlled by the entity? Well, yeah, it controls the plan. As a result of past events? It created the plan. From which future economic benefits are expected to flow to the entity? Well, you can bet if they made the plan up they thought they were going to get some future economic benefits.

Is it probable that the future economic benefits will flow to the entity? Well, now that's different because who's to say whether the plan is going to be developed? The company might not take the plan and actually turn it into a product, and that's really important.

So depending on the business concept, you know, this question of whether it's probable could vary. We can easily tell you a situation where companies had plenty of success with plans. And they've got a new plan, everyone's optimistic about it, they've done some projections around it and, yeah, it looks like its probable.

Does the plan have a cost or value that could be measured with reliability? Again, sometimes no, sometimes yes.

Is there faithful representation? Is there reasonable uncertainty? Well, we could look at a gamut of where there's lots of uncertainty to where there's reasonable uncertainty.

Is there substance over form? Yes.

And is there neutrality? Well, that depends on which of these we're looking at.

Now you might think, okay so in some situations we allow recognition of these plans and other situations we won't. In a world where there were no standards, that in fact is exactly what would happen. Some companies would decide to recognize this and others would decide not to. The problem with that though is people could take advantage. They could manipulate in situations where there is a lot of uncertainty.

So there are standards, and in fact, universal standards around the world. You can't recognize designs as assets.

So what do we learn from this example? Well, it goes back to that issue we discussed in a prior video about double-edged sword. Judgment is a double-edged sword. There are companies that could reasonably come up with data that would be convincing around their plans because they have lots of experience, lot's of background knowledge, and everyone

might agree, well for those companies, we can go forward and allow them to make an asset. And there are others where we wouldn't feel that comfortable.

And the standard setters have said, well, look you'd all be better off if we could identify the ones that could honestly go forward and put out that information, but it's hard to tell whether someone's got a plan that's going to work out or not work out. So we're going to form a standard that says no, you can't make an asset. You don't get the opportunity to show your private information even if you're honest, competent, and you've got the greatest plan in the world.

So that's what we lose, but what we gain is we have no manipulation, things stay neutral. Double-edged sword. Very tough judgment decisions on the part of standard setters; but nevertheless they get made, and there's a cost and a benefit to these decisions.

Liability recognition

So let's go from assets to liabilities. 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? Well, let's put this through a bunch of questions.

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? Well, possibly. At least there is a good chance that there's going to be an outflow. What do I mean by that? Well, when the government says you owe taxes, that means the government has taken a position. But you might later litigate this position or try to settle or negotiate this position and end up settling at a different amount and that amount could be zero.

Is it probable there will be a settlement that results in the outflow of resources embodying economic benefits? Again, it depends on the context.

Do the taxes owed have a cost or value that can be measured with reliability? Is there faithful representation? Is there reasonable uncertainty about how much we're going to settle upon? Is there substance over form? Definitely. Is there neutrality? Are the numbers unbiased?

All the issues we looked at before come out, but here in most situations you would recognize a liability. But there are situations, depending on the standard setting you're looking at, where there could be a significant amount of uncertainty about the settlement, and then whether you recognize the liability or not would differ across different countries.

Here's another example. 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 the liability for the expected clean-up costs? Well, what's important here is they're saying we caused the problem: caused the extensive damage. So, we know they caused the damage. There's no doubt about that — and there could be doubt about that. The company might disagree, for example, with public sentiment that they caused the damage.

But here we're going to go one step further and assume, okay, no doubt they've caused the damage. So do we recognize the liability? What do you think?

Do the expected clean up costs meet the liability definition? Does the entity have a present obligation arising from past events? Well, yeah, they seem to have a present obligation.

Expect an outflow of resources embodying economic benefits? It certainly looks that way.

Is it probable there will be a settlement that results in the outflow of resources embodying economic benefits? Well, it certainly looks that way and we would think — and again we'd have to have more details on the context, context really matters in judgment — we'd have to know a good deal more about the situation. But given the facts up here, it certainly looks that way. So you think it's probable — so we met this criteria.

Do the expected clean-up costs have a cost or value that can be measured with reliability? Faithful representation again. Well again, this depends on the context. In most contexts the answer would be no. That is, if we'd just found out that we had caused environmental damage, we wouldn't really know how we could measure that reliably and that gets back to our BP example that we looked at earlier. So you could meet the first couple of criteria here and still not be able to measure it reliably enough to recognize a liability.

Now here's our final example. 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. So should the company recognize a liability for the guaranteed salary upfront? This is an example of what's called an "executory contract", and that's a stage in the life of the contract when both parties still have significant things to perform. They sign the agreement right here, but she's not going to start working 'til right here. And as she begins to work, going this way, then she'll begin to perform under the contract.

So the question is what do we have here? Do we recognize the liability? Because the company said, we're going to pay you a certain amount of money and she said I'm going to come to work. Let's look at it.

Does the guaranteed salary meet the liability definition? Does the entity have a present obligation arising from past events for which it's expected to result in outflow of resource embodying economic benefits? And the answer by standard setters is a definite no. As to whether they're recognized or not recognized, and that is where there is something called the executory contract, hinges on very fine lines, but the concept is defined by the standard setters.

Here we have a quote, "In practice obligations under contracts that are equally proportionally underperformed". Now that's a mouthful. Here's an example that'll help: liabilities for inventory ordered, but not yet received. So a company orders inventory and maybe it's a non-cancelable order. Well, suppose the inventory never shows up, suppose something happens to the supplier, are they really obligated? And what the standard setters have said is that's an executory contract. The supplier still has to perform, they have to deliver. And you have to perform; you have to pay for that product. And so neither company has done enough performance and the under-performed activities are proportional in this situation. So no asset and no liability are recognized in that situation.

Now it goes on to say, you know, there are situations where it might look a little bit like an executory contract, but in fact there you are obligated. So the critical thing is do we meet the

definition. And the standard says, well the key is, are you obligated? And you're not obligated to pay for the inventory until it arrives, and you're not really obligated to pay this employee if something happens to her, for example, and she gets sick. So these are what are called executory contracts, and in general, executory contracts are not recognized as assets and liabilities on the balance sheet.

Company disclosures

So let's look at some company disclosures starting with British Airways.

The first thing we want to indicate is in the summary of significant accounting policies for British Airways and it's under the basis of preparation. The basis of preparation in accounting policies set out in this report and account have been prepared in accordance with the recognition and measurement criteria of IFRS. So, what British Airways is saying right up front is, we're going to follow the rules of IFRS and in particular, recognition and measurement; which is in the next scenic route video. And then they're going to go on to describe all the various ways in which they're going to do this.

Here are some examples and largely what we would like you to see here are the various synonyms that are used for the concept of recognition. So here's goodwill. Now, you don't really need to know what goodwill is, I just want to make the point of a synonym that's used for recognition. So, Goodwill — where the cost of a business combination exceeds the fair value attributed to the net assets acquired.

So for example, British Airways went out to buy another airline. They look at all the assets that they bought and they say, "Well, we paid more than that." And you might say, "That's crazy." No, it's actually not because when you buy another airline, you're not just paying for the airplanes they have, you're paying for the way they use those airplanes. So there's a whole bunch of synergies across the way they used the airplanes that you're paying for and all that is captured in goodwill. So if we look at the assets acquired, the resulting goodwill is "capitalized". Capitalized is just a synonym for 'we're going to recognize an asset' called goodwill.

Here's another example: landing rights acquired from other airlines are capitalized. So there're only so many airplanes that can fly into a given airport so the landing rights are sold to various airlines. And what British Air is saying here is if we buy landing rights from another airline, we make an asset out of that cost.

Software — the cost of purchase or development. So they either go out and buy, or they develop internally, computer software that is separable from an item of related hardware is capitalized separately.

Here's an example for Qantas. Again, we're looking at the statement of significant accounting policies and we're looking under software, and intangible, and brands. So, here's for software: software development expenditures, including the cost of materials, direct labor and other costs — so we're developing our software for internal use — is only recognized as an asset when the Qantas Group controls future economic benefits as a result of costs incurred. It is probable those economic benefits will evaluate and the cost can be measured reliably. And otherwise, we meet the recognition criteria under IFRS that we looked at earlier in this module.

How about brand names? Brand names and trademarks are carried at cost. Now here, what I'm trying to emphasize is that "recognized" and "carried" are synonyms on the balance sheet. So when we say we're carrying something on the balance sheet, it means we're recognizing it on the balance sheet.

US GAAP

So, here are some things to think about with regard to recognizing items under US GAAP. First of all, the definition must be met which we saw before. Second, there has to be a measurability threshold. It has to be a relevant attribute that's measured with sufficient reliability. So, again, these are very similar with what we saw for IFRS. Information must be relevant, reliability is important, it must be representation of faithful and it must be verifiable. You've got to be able to verify the measures over here instead of over here. And it has to be neutral, again neutrality, underneath the curve. So all of these concepts are quite similar. And just for one more point to emphasize, generally assets and liabilities associated with executory contracts are not recognized under US GAAP, just as they weren't under IFRS.

Having said all these similarities, there are quite a few places where recognition differs from US GAAP, but those tend to be more at the specific standard level.

Take-aways

So what should you know at this point? So remember at the start of the chapter we said, people often say that balance sheets are like pictures at a point in time and we said, well, we think they're really fuzzy images. Well, one of the reasons the 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 and liabilities are not recognized, either because related future inflows or outflows are not probable or they can't be measured reliably. Either one of these criteria will throw it off the balance sheet.

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. All of those parties are making recognition decisions. Sometimes standards allow recognition with a lot of leeway and companies restrict the leeway significantly for their employees.

Some other things you should know. A second reason a balance sheet is a fuzzy image is some items that meet the reliability threshold, that is, you can recognize them, but they can still fall considerably short of being perfectly reliable. So we saw some assets are very tightly measured. Other assets not so tightly measured. Remember the marketable securities versus the buildings. So, when you look a balance sheet, we don't get perfect reliability over here. We just get enough reliability to make the threshold that we talked about earlier.

Determining whether an item meets recognition criteria can require substantial judgment especially when there's a high degree of uncertainty associated with the item.

So where are we going with all this? Recognition criteria preclude certain items from being reported to ensure the ones that are reported are as relevant and reliable as possible given the cost benefit considerations.

However, recognition decisions do not ensure comparability, another desirable quality of reported numbers. There can be multiple ways to measure items to meet the recognition criteria and we're going to see this in the next scenic route video.

The *Judgment: Measurements Decisions* video, which is the next one, examines the measurement objectives, techniques and inputs associated with these alternative measurements and the company disclosures users must understand when assessing comparability across companies, industries, and countries.

And so there are lots of ways you can measure things and we're going to look at three or four of them in the next scenic route video. And that'll help you interpret numbers when you're looking at financial statements.

Hope you've enjoyed this video. See you in the next one.

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