Accounting Judgments: Basics

LEARNING OBJECTIVES

After completing this module you will be able to:

- Describe the decision-making hierarchy for accounting judgments.
- Identify company disclosures for four types of decisions that require accounting judgments: recognition, measurement, classification, and disclosure.

Key take-aways:

- Accounting decisions are made by organizations and individuals in hierarchies that stretch from the highest seats of government to record keepers. Decisions at higher levels in these hierarchies guide or restrict those at lower levels with varying degrees of latitude.
- Recognition decisions determine whether and when an item satisfies the definition and recognition criteria for a financial-statement element. Items that meet the definitions for assets or liabilities are recognized when their future benefits or settlement costs are probable and can be measured reliably.
- Measurement decisions determine the monetary amounts recognized in financial statements by specifying measurement objectives, techniques, and inputs. Fair value, value in use, net realizable value, and adjusted historical costs are very different measurement objectives with very different measurement techniques and inputs.
- Classification decisions determine where items that meet recognition criteria are located in financial statements and, in some situations, whether or when they are recognized and how they are measured.
- Disclosure decisions determine whether items are visible to users.
- When interpreting reported numbers and assessing their usefulness, you need to understand the profound effects of the recognition, measurement, classification, and disclosure decisions behind them.

Key terms:

- **Recognition**- 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.[1]

1 IASB Framework, ¶ 82

- **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.[2]
- **Measurement**- Process of determining the monetary amounts at which the elements of the financial statements are to be recognized and carried in the balance sheet and income statement.[3]
- **Fair value**- Amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.[4]
- **Value in use**- Current value of an asset's expected future benefits, assuming the entity will use the asset. Often the value in use of an asset can't be measured separately from the value in use of the entity's other assets because of interdependencies.
- **Net realizable (settlement) valu**e- Cash or other proceeds an entity would receive from disposing of an asset in an orderly transaction, net of the costs to prepare for and execute the disposal. The net realizable value of a liability is the cash or cash equivalents an entity would surrender to satisfy a liability in an orderly transaction.
- **Historical cost**- Cash or other consideration given to acquire an asset and ensure it's ready to use. Liability's historical cost is the amount recorded when the liability is recognized.
- **Adjusted historical cost**- An asset's historical cost less accumulated depreciation or amortization (where relevant) and accumulated impairment losses. Depreciation and amortization measure the portion of the historical cost allocated to usage or the passage of time during an asset's useful life. Impairment losses occur when the current value is no longer expected to be fully realized due to market forces.
- **Book value**- Value of assets, liabilities, and owners' equities recognized on balance sheets. Book values often differ significantly from fair values, which are amounts an unrelated party would be expected to pay. Also called carrying value.

2 IASB Framework, ¶ 83
3 IASB Framework, ¶ 99
4 IAS 32, ¶ 11

Figure 1 Four Accounting Decisions Requiring Judgment

This figure illustrates four types of decisions that require judgments: recognition, measurement, classification, and disclosure.