RECOGNITION

Relevance × **Reliability**

There is a core trade-off between Relevance and Reliability, such that the more one recognizes everything that concerns the firm's ability to generate value to stakeholders, the degree to which an asset and related cash flows can be measured and presented in an unbiased manner decreases.

Recognition Criteria in Accounting Standards

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

1) it is probable that any future economic benefit will flow to or from the entity; and

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

'Probable' [never clearly defined by the standards]

⇒ There is a heterogeneity in IFRS accounting because of the different definitions. Consequence: lack of comparability of financial reports.

⇒ Both probability and reliability criterion create a downward bias for both assets and liabilities.

⇒ Be aware of assets with low probability but high payoffs, that remain unrecognized.

Revenue recognition criteria

⇒ AASB 115

1) Earned [delivered a service or a good]

2) Realized or realizable [probable that the entity will collect]

Expense recognition criteria

1) Costs directly associated with revenue must be recognized as expenses in the period when a firm recognizes revenue [product costs, i.e. COGS]

2) Costs not directly associated with revenues must be recognized as expenses in the period when a firm consumes the services or benefits [period costs].

Contingent Assets and Liabilities

Provisions with expected cash flows of probability less than 50%.

AASB 137

An entity shall not recognize a contingent liability and a contingent asset.

In the period in which contingent liability arises:

⇒Net assets is overstated

⇒Net income is overstated

⇒ The impact on the ROE is rather ambiguous

In subsequent periods:

⇒ As long as the contingent liability remains contingent, then the net assets will remain overstated.

⇒ There is no longer any effect on net income

⇒ The ROE is understated

Intangible Assets

An identifiable non-monetary asset without a physical substance

AASB 138

An intangible asset shall be recognized if:

1) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity, and

2) the cost of the asset can be measured reliably.

Varies across different means of acquisition.

Internally generated assets

⇒ Not recognized, because the cost of developing them is seen to be indistinguishable from the cost of developing the business as a whole.

Research expenditure

⇒ Not recognized. They will be expensed as incurred.

Development expenditure

⇒Recognized, but subject to specific criteria (para 57).

By external separate acquisition

⇒ Recognized [initially] at cost. Satisfies AASB 138.

As part of a business combination

⇒ Recognized [initially] at fair value.

There is a lack of reliability in the measurement value of intangible assets, because

there is a lack of full control over the benefits,
there is an absence of markets,
they are internally generated, and
they are high risk.

For many companies, there is a substantial difference between their financial position (book value) and market capitalization (worth on the stock market), particularly because not all of its assets are recorded in the balance sheet.

Measurement of intangible assets subsequent to initial recognition

Cost model | **Revaluation model**

- Where the revaluation model is applied, the fair value must be determined by reference to an active market.
- Because there is no active market for unique assets, they must be measured under the cost model.
- Subsequent expenditure on intangibles must then be expensed.

Consequences of non-recognition of intangibles

1) Measurement error in financial reports.
    - Net assets are understated.
    - Net income can either be understated or overstated, depending on a) the rate of growth of investment, and b) timing of future benefits.
    - Depending on the direction and the relative magnitude of the biases in the net assets and the net income, the ROE can either be understated or overstated.
2) Non-comparability of performance across two entities with the same fundamental investment in intangible assets but have acquired them differently. There is inconsistency in the accounting for intangibles between internally generated intangible assets and externally acquired intangible assets.
3) Lack of accountability for investment in intangible assets in the balance sheet. Does not achieve stewardship objective.
4) Influence on managerial incentives.
    - Research expenditure will be an earnings management tool, resulting in a lower level of research and innovation in the economy.
5) Macroeconomic consequences, including increases adverse selection and misallocation of resources.

Potential benefits of non-recognition of intangibles

1) Conservative financial reports may guard against managerial optimism and opportunistic behavior.
2) Efficient contracting as numbers that are reported become more reliable.