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European Financial Reporting Advisory Group ■



Getting a Better Framework

UNCERTAINTY

Bulletin

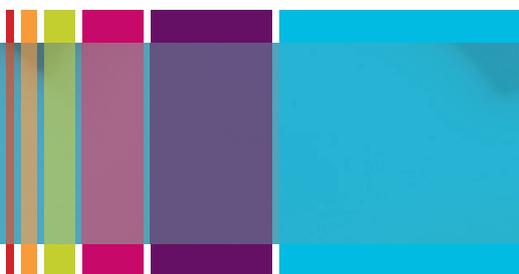


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Published bulletins:

- Prudence
- Reliability of financial information
- Uncertainty



The publication of Bulletins is part of the project partners' strategy to stimulate debate within Europe, and keep European Constituents informed, as the IASB develops its Conceptual Framework. Any views expressed are tentative: the issuing bodies will develop their final views after considering responses to this Bulletin and other developments in the debate.

Further information about the work of the project partners, including regular newsletters, is available on the partners' websites.

We welcome views on any of the points addressed in this Bulletin. Specific questions are given at the end of the document. Comments should be sent by e-mail to commentletters@efrag.org or by post to

*EFRAG
35 Square de Meeûs
B-1000 Brussels
Belgium*

So as to arrive no later than 5 July 2013.

All comments will be placed on the public record unless confidentiality is requested.

Introduction

- 1 This Bulletin addresses the issue of uncertainty.¹ Almost all assets and liabilities have some level of uncertainty relating to their inflows or outflows of economic benefits. In the current Framework that uncertainty is referred to in defining elements (inflows and outflows have to be expected) and in the recognition criteria (inflows and outflows must be probable). Uncertainty also inevitably affects the measurement of assets and liabilities. Some IASB projects have indicated that the IASB may be thinking that uncertainty is best dealt with solely as a matter of measurement.² This Bulletin considers that view, and an alternative view that uncertainty should continue to also play a role in either or both the definition of an element and the recognition criteria.
- 2 The way in which uncertainty is dealt with matters because it affects which assets and liabilities are recognised. If uncertainty is dealt with only as a matter of measurement, assets and liabilities that are unlikely to give rise to cash flows will be included in the statement of financial position. If a specified level of certainty is included in either the definition of assets and liabilities or in a recognition criterion, some assets and liabilities will be excluded from the statement of financial position.
- 3 The Bulletin tentatively concludes that a probability-based threshold in some form should continue to exist, and notes some different ways that this might be done.

¹ The discussion in this Bulletin starts from the existing Framework. The IASB is currently developing a Discussion Paper on a revised Framework. IASB Board papers setting out its initial thinking on this issue are available on its website.

² For example, the proposed revisions to IAS 37 proposed removing the probability-based recognition threshold for liabilities and including the effects of uncertainty in the measurement of the liability.

- 4 The Conceptual Framework defines assets and liabilities as follows (paragraph 4.4):
 - (a) An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
 - (b) A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits
- 5 The use of the word 'expected' in the definitions indicates that the inflows or outflows do not need to be 100 % certain before an asset or liability exists, they just need to be expected. There is no quantitative definition of the level of certainty required for inflows or outflows of economic benefits to be regarded as 'expected'.
- 6 The Conceptual Framework also includes criteria that must be met before assets and liabilities can be recognised: an item that meets the definition of an element should be recognised if (paragraph 4.38):
 - (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.³
- 7 Paragraph 4.40 explains that 'The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the entity. The concept is in keeping with the uncertainty that characterises the environment in which an entity operates.' However, paragraph 4.40 does not define the level of uncertainty under which elements are recognised in the financial statements and above which they are not, i.e. does not define probable. That is left to individual standards.
- 8 Probable is defined in IAS 37 and IFRS 5 as more likely than not.⁴ IAS 37 states that this interpretation of probable does not necessarily apply to other standards, IFRS 5 does not include this caveat. In practice, the term probable in other standards has been interpreted as meaning something other than more likely than not. For example, IAS 12 has been interpreted as allowing the use of a higher threshold than more likely than not when it requires future tax profits to be probable for the recognition of deferred tax assets.

³ The Bulletin *Reliability of financial information* discusses the issue of reliability.

⁴ But IFRS 5 defines probable only in order to be able to define highly probable as significantly more likely than not, see paragraph 10.

- 9 In addition to the term probable, IFRSs use a range of terms to indicate different levels of uncertainty, for the purposes of definition, recognition, classification and disclosure.

Term	Standard	Use
Remote	IAS 37	Contingent liabilities are disclosed unless the possibility of an outflow is remote.
Highly probable (defined as significantly more likely than probable)	IFRS 5	Assets are classified as held for sale if their sale is highly probable.
Reasonably assured	IAS 20	Government grants are not recognised until there is reasonable assurance of the conditions being met and the grant being received.
Virtually certain	IAS 37	Assets are not contingent if the realisation of income is virtually certain. Reimbursements should be recognised when it is virtually certain the reimbursement will be received if the entity settles the liability.

- 10 Arguably, given this range of possible probability-thresholds, and their lack of definition, if a level of uncertainty is to be used as a threshold for the definition or recognition of elements, more consistent and clearer guidance on the threshold level will be needed.

- 11 Paragraphs 12-27 set out the view that uncertainty should be dealt with only in measurement. Paragraphs 28-39 set out the view that uncertainty needs to be incorporated in either or both of the definition of elements and the recognition criteria. Our tentative views are set out in the final section of this Bulletin.

VIEW 1: UNCERTAINTY IS A MATTER OF MEASUREMENT ONLY

- 12 If uncertainty is a matter of measurement only, it cannot be used as a threshold in either (a) the definition of assets and liabilities or (b) as a recognition criterion. We explore the arguments supporting this view below.

(a) Uncertainty should not be a threshold for definition

- 13 Under this approach, assets and liabilities either exist at the reporting date or they do not. There is no uncertainty over their existence. Consider first assets and liabilities arising from contracts. Contracts give rise to either unconditional rights and obligations, or conditional rights and obligations.⁵
- 14 Contractual unconditional rights and obligations by definition involve no uncertainty relating to their existence. Contractual conditional obligations include an unconditional obligation to perform now or over a period of time, and an associated conditional obligation for an entity to perform, if an uncertain future event occurs⁶. The unconditional obligation is a liability in its own right. The associated conditional obligation is linked to future events, and, therefore, it is not a liability. There is no uncertainty over the existence of the former (or non-existence of the latter). For example, a guarantee includes an unconditional obligation to provide the guaranteed services or money should the triggering event occur. The existing liability over which there is no uncertainty is the obligation to be obliged.
- 15 The same reasoning applies to contractual conditional (“contingent”) rights. There is an existing unconditional right to have the future right that will crystallise if future events so determine. That unconditional right is an asset. The future contingent rights are not assets, since they are contingent on future events and, therefore, are not present resources. For example, the holder of a lottery ticket has an unconditional right to claim the prize if the numbers on the ticket are selected.
- 16 Let us now turn to non-contractual settings. Some argue that in these cases there could be uncertainty over the existence of an asset or a liability. For example, a hospital is aware that the relative of a patient who died is considering suing for substantial compensation on grounds of negligence. The hospital believes that it followed all appropriate procedures.

⁵ This Bulletin does not consider the question of whether or when these rights and obligations might give rise to assets and liabilities or to a net asset or liability.

⁶ A combination known as a stand-ready obligation. *Information for Observers*. IASB. Paper 11A, June 20, 2008.

- 17 In this example, the hospital does not think it has done anything to create a liability but it is possible that it will be sued and be required to pay compensation. Some might argue that in this situation there is uncertainty over the existence of a liability. However, if the definition of a liability is such that it includes *any* possibility of unavoidable future outflows resulting from past transactions or events, then uncertainty over the existence of the liability is resolved. There is a possibility of an outflow arising from the hospital's treatment of the patient, and hence there is a liability. In other words, allowing for any uncertainty over outflows in the definition eliminates uncertainty about the existence of a liability.⁷ Exactly the same approach can be taken with assets.

(b) Uncertainty should not be a threshold for recognition

- 18 The effects of uncertainty can be fully included in the measurement of an asset or liability. Measurements taken from actual transactions (cost) include the effect of uncertainty, as do measurements taken from observed market transactions (fair value). Measurements based on estimates of future cash flows can include the effect of uncertainty about the future cash flows by techniques such as probability-weighted averages and risk adjustments.
- 19 Given that it is possible to include the effect of uncertainty in the measurement of an asset or liability, why not do that? Doing so includes all the information available about the asset or liability and avoids the following problems that arise if a recognition threshold is imposed.
- 20 The first problem with imposing a probability-based recognition threshold is that assets and liabilities that do not meet the threshold are not recognised, leading to a lack of information in the statement of financial position. This is a particular problem if there is an observable cost for the asset or liability. For example, consider an entity issuing for cash a derivative financial instrument under which cash outflows are possible, but not more likely than not. Not recognising the liability for the derivative leaves the statement of financial position incomplete.
- 21 Related to this is the unit of account issue. Applying a probability-based recognition threshold could give different results depending on the unit of account to which it is applied. For example, a car manufacturer may issue warranties each of which has cash outflows that are less likely than not, but when taken as a whole is almost certain to lead to an outflow.
- 22 The next problem is that a probability-based recognition threshold leads to a binary choice between recognising and not recognising. Comparability is negatively affected when a small change in the probability of inflows or outflows can cause disproportionately material differences in recognition (from nothing recognised to a substantial amount, or vice versa).

⁷ The only uncertainty left about the existence of assets and liabilities under this approach would be whether the entity has identified all the past events and transactions that could lead to future inflows or outflows. For example, the entity may have done something in the past that will lead to future cash outflows but of which it is as yet not aware at all (neither directly nor as a result of experience from similar events in the past such as incurred but not reported insurance claims). This is unavoidable, the entity cannot account for items it does not know about. But note that an event which may have occurred, but over which there is doubt, e.g. possible negligence in the care of a patient, gives rise to a liability under this approach because the uncertainty is allowed for in the definition.

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- 23 Next, as discussed above, the Framework does not define probable. Doing so would be necessary to create a robust recognition threshold, but the threshold would inevitably be arbitrary. In contrast, if uncertainty is left to measurement, there is no need to define arbitrary levels of probability, provided measurement is based on a probability-weighted average approach.
- 24 Difficulties may also arise irrespective of the method used to evaluate the probability of an event. There are two methods for assessing probabilities.
- 25 The first method draws on personal or subjective judgment without reference to any particular data. Using subjective – as opposed to empirical – probabilities at the recognition stage may introduce biases which detract from the requirement that financial information be representationally faithful. For example, there is academic evidence that events that have a low probability of occurrence are subjectively perceived as having a higher probability, while those with a high probability of occurrence are subjectively perceived as having a lower probability. Obviously the same biases may manifest themselves when accounting for uncertainty in measuring elements, but their impact is likely to be less, since measurement is not a binary choice.
- 26 The second method relies on historical data. This requires knowledge of the shape of the probability distribution function of events, which may not be a given. It is true that such knowledge is needed not only when applying a recognition criterion but also when measuring the impact of uncertainty, but, again, since the outcome of measurement is not binary, errors in estimating the probability distribution function in measurement may be of less concern.
- 27 In summary, it can be argued that allowing uncertainty to act as a threshold in the definition or recognition of assets and liabilities causes the arbitrary exclusion of effects of past transactions and events from the primary financial statements. More complete and comparable information (i.e. more relevant information) is given if uncertainty affects only the measurement of assets and liabilities.



VIEW 2: UNCERTAINTY IS NOT ONLY A MATTER OF MEASUREMENT

- 28 If uncertainty is a matter only for measurement, as described above that implies that the definition of assets and liabilities would allow an asset or liability to exist no matter how uncertain the future inflows or outflows. Further, any such asset would be recognised in the primary financial statements (possibly subject to a reliable measurement threshold, see Bulletin *Reliability of financial information*). Hence the statement of financial position could include assets and liabilities that represent inflows and outflows that are very unlikely to occur.

- 29 Recognising highly improbable inflows and outflows is unlikely to provide useful information to users of financial statements in assessing the prospects for future cash flows. It also is likely to clutter the financial statements, obscuring more relevant information.
- 30 Further, the measurement of such assets and liabilities is likely to be less reliable than that for assets and liabilities with more likely inflows and outflows. As stated above, there is a substantial body of evidence that events that have a very low probability of occurrence are subjectively perceived as having a higher probability, and the financial crisis has exacerbated the debate on the measurement of low probability events. In addition, errors in estimating the probability of low probability events are proportionately more significant than identical errors made in estimating high probability events. For example, a difference of 4 percentage points for an element whose probability ranges between 2 % and 6 % causes a potential measurement error of 300 % (6 % /2 %). An error of the same size for an element whose probability ranges between 70 % and 74 % would cause a measurement error of only 6 % (74 %/70 %).
- 31 The implications of this are particularly evident in profit or loss. What relevant information is provided by recognising a gain when the probability of a major lawsuit has apparently declined from 10 % to 5 %? Disclosure of information about the lawsuit is more useful than an unreliable single figure estimate.
- 32 Making judgments about probabilities is needed both for measurement and for a probability-based recognition threshold. As noted above, making those judgments difficult. However, making the judgments necessary to determine whether a recognition threshold has been met is inherently simpler than making the judgments necessary to determine a measurement based on all possible expected outcomes.
- 33 Further, just because the effects of uncertainty can be included in measurement is not a good reason to eliminate probability as a recognition criterion. Measurement at fair value, or other approaches that use a probability-weighted average and risk adjustment, are not the only measurement approaches that could be used. They may well involve complex and costly methodologies. Of course, modern financial reporting increasingly relies on complex methodologies, simply because transactions have become more complex. However, the more complex the calculations the less reliable the result will likely be. An approach that combines a simpler measurement approach with a probability-based recognition threshold may well provide information that is more reliable and easier to understand. In any event, it is not appropriate to base a decision to eliminate the probability-based recognition threshold on an assumption about measurement approaches.
- 34 It is also open to question whether recognising elements with a remote likelihood of occurrence, which requires tracking, collecting, processing, verifying and disseminating financial information, would accord with the cost constraint on useful financial reporting.

- 35 The problem with the current Framework is not so much that probable is a matter for recognition, but that the term is undefined. In addition, a number of Standards have in substance eliminated probability as a recognition criterion (for example, the requirement under IFRS 9 to recognise a financial guarantee contract issued, and the elimination of the probability test in business combinations under IFRS 3). Consistent application of a clearly defined threshold would result in a transparent understandable approach to the issue.

Include probability-thresholds in definition and recognition, or just one or other?

- 36 One question that arises if uncertainty is regarded not only a matter of measurement, is whether it should be factored into the definition of an element, or a recognition criterion, or both.
- 37 Uncertainty can affect the definition of assets and liabilities in two ways. First, as discussed in paragraph 16 above, the definitions could allow an asset or liability to exist, no matter how uncertain the future inflows or outflows. Doing so would remove uncertainty from the assessment of whether or not an element exists. Second, the definitions could include a threshold relating to uncertainty, so that assets and liabilities were deemed only to exist if there is a specified level of likelihood of inflows or outflows. The first approach can be taken even if uncertainty is regarded as an issue broader than measurement alone, but would make a probability-based recognition threshold a necessity. If the second approach is taken, then there may not be a need for a separate recognition threshold.
- 38 The role of a definition is to identify elements that exist, whereas recognition is the process of formally incorporating an element in the financial statements. Some think that the clearest way of separating these processes is to include any uncertainty threshold as a recognition criterion only, not as part of the definition. This approach is consistent with that defended by those who see definitions of elements, their recognition and measurement as distinct issues that merit separate attention. Doing so also allows for consideration to be given to disclosures about unrecognised assets and liabilities. If a probability-based threshold is included in the definition of assets and liabilities, it becomes much harder to identify the scope of any disclosures considered necessary for items that do not meet the definition of assets and liabilities because of the threshold.
- 39 Others argue that there is merit in combining the processes of definition and recognition to avoid entities having to consider potentially huge numbers of assets and liabilities with very remote outcomes. What is the benefit of defining assets and liabilities that will clearly not pass a recognition test? Doing so simply imposes a burdensome and redundant analysis on preparers.

Tentative conclusions

- 40 There are problems with both approaches. Not recognising a liability (and hence recognising a gain) when an entity has been paid to provide a guarantee seems inappropriate even if the outflows under the guarantee are remote. Recognising a potentially unreliable amount for a liability for a lawsuit with only a remote likelihood of outflows also seems unhelpful.
- 41 On balance, however, the recognition of assets and liabilities for *all* possible inflows or outflows no matter how remote cannot provide the most useful information for users of financial statements. Hence some sort of probability filter would be beneficial.
- 42 There are a number of ways in which this could be done. The threshold could be included in the definition of elements, or as a recognition threshold, or in both, or by combining definition and recognition. The level of the threshold also needs to be considered, for example it could be set at more likely than not, or at a lower threshold such as reasonably possible. Finally, there may be situations in which a probability threshold should not be used, for instance if the asset or liability has an observable measure (for example a payment for a guarantee), or has cash flows with a significant risk of substantial change (for example an insurance contract). This Bulletin does not reach conclusions on these issues



Questions

We would welcome your views on any aspect of this Bulletin. In particular we are interested in your views on the following questions:

- (i) Are there any arguments for either of the views set out in the Bulletin that we have not discussed?
- (ii) Which view do you support? Why?
- (iii) What are your views on the different ways in which a probability-threshold could be applied?

Comments should be addressed to: commentletters@efrag.org, so as to be received before 5 July 2013.



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