



Federal Accounting Standards Advisory Board

January 3, 2007

TO: Members of FASAB

FROM: Penny Wardlow, Consultant

THROUGH: Wendy Comes, Executive Director

SUBJECT: **Conceptual Framework: Elements—Probability—TAB A**

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BACKGROUND

One of the conceptual approaches followed in the Elements project is to divide the “path to recognition” of amounts for items resulting from transactions or other events into three stages. 1) *Definition stage*: Does the item meet the definition of an element of accrual-basis financial statements? That is, does the item possess the essential characteristics of an element? If so, 2) *Recognition stage*: Does the item meet the criteria for recognition (definition and measurability—i.e., is it quantifiable in dollars)? If so, 3) *Measurement stage*: What measurement attribute(s) (historical cost, current cost, fair value, expected value, etc.) and method(s) can or should be used to calculate amounts to be recognized in the financial statements? Note that measurability and measurement are not synonyms. *Measurability* is the capability of being quantified (quantified in dollars in the particular context of the ED). *Measurement* is both the act of measuring and the result of measuring something.

The measurement stage also may apply to items that for materiality or other considerations are not recognized but may be disclosed in the notes or as RSI. In practice, it may sometimes be difficult to separate the recognition and measurement stages (decisions) because, for example, an item meets the definition of an element and is quantifiable in dollars (i.e., meets the proposed recognition criteria) but the measurement of the item is judged to be not material or too unreliable to be reported on the face of a financial statement. Such items may be disclosed in the notes with a range of estimates of the amount.

Although the separation of recognition and measurement may not always occur in practice, treating them as conceptually separate stages can be useful to the Board’s deliberations and the Board effectively has adopted the conceptual distinction by deferring the consideration of measurement issues to a separate project (ED footnote 2). Thus, the Elements ED addresses the first two stages—definition and recognition criteria—but not the third stage, measurement. Nevertheless, measurement is mentioned in several places in the ED, generally in the context of measurement uncertainty and the possible assessment of probabilities at the measurement stage.

The Board has discussed at which stage(s) the assessment of probabilities should be required at most Board meetings since late 2003. A majority of Board members have consistently indicated that they believe assessments of probabilities should *not* be required at the definition or recognition stage, but may be appropriate at the measurement stage—for example, the inclusion in the measurement method of an assessment of the probability of future cash inflows or outflows, such as for accounts receivable and loan guarantees.

The three Board members who presented an alternative view (AV members) in the ED stated that an assessment of probability should be made at the definition stage (“existence probability”) and also at the recognition stage (“measurability probability”). Moreover, in their view, the Concepts Statement should state that there is a threshold of probability for both the existence and the recognition of an element.

. . . the Concepts Statement should explicitly state that, as part of determining whether an item meets the definition of an element, there is a threshold where *existence probability* is so low that an item would not meet the definition of an element (*probability threshold*). For example, if there is a low probability that a present obligation exists, an item may be deemed to not meet the definition of a liability. . . [par. A4, emphasis added].

. . . the Concepts Statement should explicitly state that, as part of determining whether an item is measurable, there is a threshold where *measurability probability* is so low that an item would not be measurable (*probability threshold*). For example, if there is significant uncertainty associated with the measurability of an item, an item may be deemed to not be measurable.¹¹ . . . [par. A6, emphasis added].

¹¹ For example, there may be sufficient uncertainty that the resulting quantification would not be reliable.

The AV members do not indicate how “existence probability” and “measurability probability” would be determined, nor do they indicate what would be an acceptable probability level—e.g., “likely,” “more likely than not,” 25% probable, 51% probable, 75% probable, etc. The AV members indicate that the Concepts Statement would go no further than acknowledging that threshold probabilities exist; “The actual thresholds to be applied in a particular situation would, as appropriate, be established in specific standards.” [pars. A4 and A6]

In support of their position on the definition and recognition stages, the AV members indicate in paragraph A8 that to explicitly require assessments of existence and measurability probability and acknowledgment of probability thresholds “would increase the consistency of

implementation of the concepts in this ED and in specific standards.” Also, the lack of such explicit acknowledgements in the Concepts Statement “is more likely to result in failure to consider such probabilities, leading to many more items being recognized in the financial statements (e.g., assets and liabilities on the balance sheet)” [footnote example omitted]. The resulting financial statements would, in the AV members’ view, fail to meet the qualitative characteristics of relevance, reliability, and representational faithfulness, as well as the cost-benefit constraint.

For ease of reference, a copy of the ED, including the AV (which begins on page 25), is provided as an attachment to this memo. Staff comments on the AV versus the ED proposals are discussed later in this paper. First, however, staff will review the responses received to Questions 8 and 9 in the ED’s Questions for Respondents and the views of various standard setters on whether an assessment of probability should be included in the definitions of elements and/or in recognition criteria.

VIEWS EXPRESSED BY RESPONDENTS TO THE EXPOSURE DRAFT

Questions No. 8 and 9 in the Questions for Respondents (pages 7 and 8 of the ED) ask whether respondents agree with the position taken in the proposed Concepts Statement or the position in the AV concerning requirements to assess *existence probability* (Question 8) and *measurability probability* (Question 9), and refer to related *probability thresholds*. As reported in the staff summary of responses presented at the September 2006 FASAB meeting, respondents are evenly divided in response to Question 8 and slightly more supportive of the ED position than the AV position in their responses to Question 9.

For **Question 8**, 13 respondents (4 federal auditors, 1 non-federal auditor, 4 federal preparers and 4 non-federal other) support the ED position; 13 respondents (8 federal preparers and 5 federal auditors) support the AV position; 1 federal preparer supports the AV concerning an assessment of probability but agrees with the ED concerning a probability threshold; and 4 respondents are non-responsive. For **Question 9**, 14 respondents (5 federal auditors, 1 non-federal auditor, 4 federal preparers, and 4 non-federal other) support the ED position; 12 respondents (7 federal preparers, 3 federal auditors, and 1 non-federal other) support the AV position; and 5 respondents are non-responsive.

There is considerable consistency between the responses to Questions 8 and 9. Many of the responses to Question 8, which refers to the *definition* stage, are repeated verbatim or almost verbatim in response to Question 9, which refers to *measurability* (the recognition stage). Twelve of the 13 respondents who agree with the ED position in Question 8 also agree with the ED position in Question 9; 11 of the 13 respondents who agree with the AV position in Question 8 also agree with the AV position in Question 9. Respondents who give a reason(s) for their support for one position or the other generally echo the reasons given in the preambles to Questions 8 and 9 or in the AV, or they state their disagreement with those reasons.

Examples of the responses to Questions 8 and 9 follow.

Question 8—Agree with ED position

We agree with the proposed Concepts Statement. “Probability” is implicit in determining an asset and liability. It is judgmental and should not be subject to a formula. [026—Non-federal Other]

We agree with the position taken in the proposed Statement and do not believe its adoption will result in many more items being recognized. While we agree that there may be an implicit assessment of probability, we do not agree that thresholds should be applied. We believe explicit definitions or formulas for assessing and measuring probability run the risk of excluding many more items from recognition.

Furthermore, we suggest a review of FASB Concept No. 6 paragraph 25, and especially footnote 18 which states “Probable is used with its usual general meaning, rather than in a specific accounting or technical sense.” We do not believe that the FASAB Concept Statement should imply otherwise. [029—Federal Preparer] *Staff note: This respondent gives the same response to Question 9.*

We agree with the proposed Concepts Statement that the existence of an element is judgmental, based upon available evidence. Implicit in this statement is some type of measurement as to whether or not it meets the definition of an element. Explicit standards, thresholds and existence probability proposed in the Alternative View would force federal agencies into a "one size fits all" approach to the financial statements. Additionally, it would needlessly complicate the Concepts Statement. It is sufficient to let the individual federal agencies decide, after their own judgment, whether an item possesses the characteristics of an element, and assess the probability of future inflows or outflows from the item. [030—Federal Auditor]

It seems to us that the proposed ED adequately addresses the need for judgment in determining the existence of an asset or liability and the amount of such asset or liability. As stated in the AV, the need for an assessment and a threshold is implicit in the ED. We are concerned that if the ED explicitly requires an assessment and a threshold, preparers would be “forced” by auditors to specifically examine and document the existence and value of each asset and liability separately from the ordinary course of business. When there is a significant question about existence or value of an asset, such documentation is appropriate. However, new and separate documentation should not be required. Therefore, while we do not have a major problem with explicitly stating the need for such an assessment, we prefer the ED to imply the need (as written) with any explicit requirements included in separate standards as required.

It would be helpful if the proponents of the AV provided examples of the types of items that may be recognized that have a low probability of being assets or liabilities.

The example in footnote 12 [AV, par. A8] seems to be a contingent liability for which there are adequate standards and therefore does not require additional discussion in this ED. [039—Non-federal Other]

We do not believe that there is a need for an explicit requirement for an assessment of probability and a related probability threshold when determining whether an item meets the definition of an element. [040—Non-federal Other (standard setter)]

Question 8—Agree with AV position

[Entity] agrees with the alternative view. We believe that an explicit requirement for an assessment probability threshold should be included in the discussion. This would help agencies determine whether an item meets the definition of an element. The lack of a probability threshold could open the door for many items to be unnecessarily accounted and the result would make the financial statements less meaningful. [020—Federal Preparer]

We agree with the alternative view expressed in paragraphs A1 through A4 of the proposed Statement that the proposed Concepts Statement should clearly state that probability should be “assessed as part of determining whether an item meets the definition of an element (existence probability)...” Our view is that one probability standard applicable in all cases could be used.

As we stated in our response to Question #4, we propose that the word “probable” be included in the definitions of assets and liabilities. If the assessment of future probability is not included in the definitions, readers will have no parameters that can be used to judge whether an amount is an asset or liability or another element. Also, we believe that one result of adding the probability assessment to the Statement will be increased reliability and consistency in government financial statements. [016—Federal Auditor] *Staff note: This respondent disagrees with the AV position in response to Question 9.*

Incorporating as a recognition criterion the probability that the economic benefits associated with an item would flow from or to the reporting entity may be a compromise between the position put forward by the exposure draft and the alternative view. The exposure draft's position is that probability is implicit in the measurement of an item but does not require to be explicitly mentioned; the alternative view is that the concept of probability should be explicitly incorporated both in deciding whether an item meets the definition of an element and whether any such element is measurable. [031—Non-federal Other]

Question 9—Agree with ED position

We do not agree with the Alternative View that the Statement should be revised to explicitly state language about the application of thresholds to determine probability of measurement. We believe that readers understand the application of measurability. However, we suggest adding the following sentence to the Statement for further clarification: “An item is measurable if it can be determined with reasonable certainty or is reasonably estimable.” [016—Federal Auditor]

Again [as stated in response to Question 8], [Entity] believes that probability is always an issue that must be trusted to conservative professional judgment as stated above. Once again, the specific mentioning of probability in this Concept Statement seems directed toward keeping elements off of the basic financial statements. Further, if the probability of being unable to measure a recognizable element is grossly material, conservative professional judgment will require the financial report's auditors to consider an adverse opinion or disclaimer of opinion. [022—Nonfederal Other]

[Entity] disagrees with the Alternative View that the proposed Concept Statement should state that “there exists a threshold where such probability is so low that an item would not meet the definition of an element. Thresholds to be applied would, as appropriate, be

established in specific standards.” [Entity] believes that federal entities should have the latitude to exercise their judgment in determining if it is probable or not probable that an item is measurable. [023—Federal Preparer]

We agree with the proposed Concepts Statement. Implicit in the Concept Statement is the measurement of the probability of deciding whether an item meets the criteria for inclusion/exclusion in the financial statements. Also implicit in the Concepts statement is the consideration of a threshold at which an item is not measurable. The problem we have with the Alternative View is that some items, such as cash, may not have to be assessed as part of determining whether an item is measurable. Also, who is going to set the thresholds for the specific standards; and what are the standards to be applied? Do they evenly apply to all federal agencies? It is best left to the individual federal agencies to apply their own measurements of probability and thresholds. [030—Federal Auditor]

Question 9—Agree with AV position

We agree with the position taken in the Alternative View. We believe there would be instances where an assessment of probability would need to be made to determine if an item is measurable. Where items can be easily measured, a probability assessment may not be needed. However, for complex items, there is a need to assess the probability and to set a probability threshold so that items with a very low probability would not be considered measurable. For example, for social insurance, a probability assessment should be completed. To record a liability beyond what is currently due and payable, a detailed assessment would be required for what will be paid in the future. These payments are not readily known since there are many factors that could affect whether or not individuals ultimately receive benefits. [006—Federal Auditor]

We agree with the position taken in the Alternative View concerning the need for an explicit requirement for an assessment of probability and a probability threshold when determining whether an item is measurable. As part of the decision-making process (i.e., judgment), an individual would use the concept of “probability” to weigh various factors, based on available evidence, in order to conclude on whether an item is measurable. [013—Federal Auditor]

The alternative view (2) is the view of choice. The broad definition of “measurable” in view (1) raises concern that the definition is so expansive that anything could be deemed “measurable” when in fact it may not be relevant, reliable or measurable in the accounting sense of the word. [020—Federal Preparer]

Other responses to Questions 8 and 9 give similar reasons, or no reason, in support of their views. Although some of the responses echo the Board’s considerations in deliberating both the ED and the AV positions on the probability issue, they have not provided reasons or explanations that the Board has not previously considered. As such, the actual responses are not very useful to the Board’s redeliberations. Nevertheless, the fact that support for both positions is evenly divided suggests that the Board may wish to review the issue, including the views of other standard setters.

VIEWS OF VARIOUS STANDARD SETTERS

Definitions of Elements

The Board reviewed various standard setters' definitions of assets and liabilities during the development of its own definitions. Another review at this time may be helpful, particularly because the IASB/FASB's re-examination of their definitions of assets and liabilities is resulting in proposed changes to the two Boards' current definitions. Also, the GASB has issued an ED on Elements since the FASAB last reviewed other standard setters' definitions. The key issues are whether and, if so, how the different standard setters address probability at the definition stage and the recognition stage, and the reasons for their position, if available. There seems to be little doubt that standard setters address probabilities at the measurement stage, when appropriate. (It may depend on the attribute to be measured.) This subsection addresses various standard setters' definitions of assets and liabilities and will be followed by a subsection on their recognition criteria.

The following are current definitions and proposed new definitions of assets and liabilities by the standard setters indicated. All definitions are current—i.e., currently applicable in their jurisdiction—except those labeled “proposed.” (Bold-facing of the first use of the words *asset* and *liability* in each definition has been added for clarity.)

FASB

Assets are probable¹⁸ future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. [Concepts Statement 6, par. 25]

¹⁸ *Probable* is used with its general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, *Accounting for Contingencies*, par. 3) and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved. (*Webster's New World Dictionary of the American Language*, 2d college ed. [New York Simon and Schuster 1982], p. 1132. Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 44–48).

Liabilities are probable²¹ future sacrifices of economic benefits arising from present obligations²² of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [Concepts Statement 6, par. 35]

²¹ *Probable* is used with its general meaning, rather than in a specific accounting or technical sense (such as that in Statement 5, par. 3) and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved. (*Webster's New World Dictionary*, p. 1132.). Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 44–48).

²² *Obligations* in the definition is broader than legal obligations. It is used with its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility, and so forth (*Webster's New World Dictionary*, p. 981). Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 44–48).

Australia

Assets are future economic benefits controlled by the entity as a result of past transactions or other past events; and “control of an asset” means the capacity of the entity to benefit from the asset in the pursuit of the entity’s objectives and to deny or regulate the access of others to that benefit. [Statement of Accounting Concepts 4, par. 14]

Liabilities are the future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events [Statement of Accounting Concepts 4, par. 48]

New Zealand

Assets are service potential or future economic benefits controlled by the entity as a result of past transactions or other past events. [Statement of Concepts for General Purpose Financial Reporting, par. 7.7]

Liabilities are the future sacrifices of service potential or of future economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events. [Statement of Concepts for General Purpose Financial Reporting, par. 7.10]

IASB

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. [Framework, par. 49a]

A **liability** is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. [Framework, 49c]

Canada

Assets are economic resources controlled by an entity as a result of past transactions or events from which future economic benefits may be obtained. [CICA Public Sector Accounting Handbook, par. 1000.35]

Liabilities are financial obligations to outside organizations and individuals as a result of past transactions and events on or before the accounting date. They are the result of contracts, agreements, and legislation in force at the accounting date that require the government to repay borrowings or to pay for goods and services acquired or provided prior to the accounting date. They also include transfer payments due even where no value is received directly in return. [CICA Public Sector Accounting Handbook, par. 1000.44]

United Kingdom

Assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events. [Statement of Principles, Ch. 4]

Liabilities are obligations of an entity to transfer economic benefits as a result of past transactions or events. [Statement of Principles, Ch. 4]

IASB/FASB (Proposed)

An **asset** is a present economic resource to which the entity has a present right or other privileged access. [*IASB Update*, Nov. 2006. The definition is not final and has not been issued for comment.]

A **liability** is a present economic obligation of an entity. (*IASB Update*, April 28, 2006. The definition is not yet final and has not yet been issued for comment.)¹

GASB (Proposed)

Assets are resources that the entity presently controls. (Elements ED, Aug. 2006, par. 10)

Liabilities are present obligations to sacrifice resources that the entity has little or no discretion to avoid. [Elements ED, Aug. 2006, par. 17]

FASAB (Proposed)

An **asset** is a resource that embodies economic benefits or services that the federal government can control. [Elements ED, June 2006, par. 17]

A **liability** is a present obligation⁶ of the federal government to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand. (Elements ED, June 2006, par. 38)

⁶The term *obligation* is used in this Statement with its general meaning of a duty or responsibility to act in a certain way. It does not mean that an obligation of budgetary resources is required for a liability to exist in accounting or financial reporting or that a liability in accounting or financial reporting is required to exist for budgetary resources to be obligated.

Discussion of Current Definitions

The FASB's current definitions of assets and liabilities are the only definitions of those listed above that refer to probability. However, as indicated in footnotes 18 and 21 to Concepts Statement 6 (quoted with the definitions), the FASB did not intend preparers and users to apply a SFAS 5 notion of probability when considering whether an item meets the definition of an element. Moreover, it should be noted that SFAS 5 is not a concepts statement and does not address what "probable" means in *all* circumstances, including the definition of elements. Rather, the Statement is titled *Accounting for Contingencies* and establishes financial reporting standards for various kinds of loss contingencies and asset impairments. The FASB has been concerned for a number of years that, despite the admonition in footnotes 18 and 21 to Concepts Statement 6, entities are applying SFAS 5 notions of probability when determining whether an item is an asset or liability.² Partly for that reason and partly to resolve other differences between the two boards in their use of the word "probable" in their respective conceptual frameworks, the IASB and FASB are examining the concept of probability and its applicability to definitions, recognition criteria, and measurement in their joint project on the conceptual framework.

The IASB's current definitions refer to an *expectation* that the flow of future resources to or from the entity will occur. Staff is unsure about the meaning of "expected"—i.e., what degree of certainty might "expected" entail and is its use similar to the FASB's intended use of the word "probable"? FASAB staff was unable to review the IASB's *Framework* on this issue. However,

¹ Staff has not found a more recent version of the liability definition. Staff believes that since April 2006 the two Boards have given priority to other issues, including the distinction between liabilities and equity, without yet revising the proposed liability definition.

² See, for example, "The FASB's Conceptual Framework: Issues Involving the Definition of Liabilities," Financial Accounting Standards Advisory Council (FASAC), June 2004.

the IASB staff paper on the “Definition of an Asset” prepared for the November 16, 2006 IASB Board meeting states the following:

10. *Likelihood*—Likelihood (“expectation” in the case of the IASB and “probability” in the case of the FASB) was referred to in the existing definitions in response to constituents’ concerns on earlier proposals that the definition would require that an item be certain in order to qualify as an asset. Since few things in life are certain, they observed that few items that are commonly thought to be assets would qualify in accordance with the definition. Accordingly, the Boards included likelihood with the intent of indicating that the item in question need not be certain (that is, it could be less than certain) to meet the definition.
11. Both the IASB and FASB definitions have been misinterpreted as implying that there must be a high expectation (IASB) or high probability (FASB) of future economic benefits before the definition is met. Thus, some think that when there is a low probability, or expectation, of future economic benefits, the asset definition is not met. That is not the intent, as is made clear by a footnote [par. 25, footnote 18, cited earlier] to the FASB definition in CON 6 . . .

From the above excerpt, it appears that “probable” in the FASB definition and “expected” in the IASB definition have equivalent meanings. Early in the Elements project the FASAB considered including “expected” rather than “probable” in the definition of assets, given the Board’s reluctance to include “probable” when the FASB had articulated its problems with that term at the definition stage. However, some FASAB members were concerned that “expected” might be interpreted to mean that an expected value calculation was required, and a majority of members thought that notions of “expectation” or “probability” should not be included at the definition stage. This view is the majority FASAB decision included in the ED.

The remaining definitions do not refer to a probability or an expectation. Some may believe that the Canadian definition of an asset is different because it states that future economic benefits “may” be obtained from the (current) economic resources that constitute the asset. However, “may” is not intended to mean that the inflow of future benefits is expected or probable. On the contrary, the Canadian document indicates that one of the essential characteristics of assets is that “they embody a future benefit that involves a *capacity*, singly or in combination with other assets, to provide future net cash flows, or to provide goods and services.” par. 1000.36(a) [emphasis added]. Thus, to be an asset, it must be *possible*—but it need not be probable or certain—that an economic resource will provide future economic benefits.

The United Kingdom ASB also refers to capacity or possibility, rather than expectation or probability, in the discussion of the asset and liability definitions in its Statement of Principles (emphasis added):

- 4.7 *Capacity* to obtain future economic benefits is the essence of an asset. Therefore, to be an asset the rights or other access must be *capable*, singly or in combination with other assets, of yielding economic benefits.
- 4.21 For there to be a liability there must be an obligation that *might* result in the transfer of economic benefits. . .

In sum, based on the standard setters' publications reviewed, staff found no support in *existing* definitions of assets and liabilities or in related explanatory material for requiring a probability assessment or a threshold probability at the definition stage.

Discussion of Proposed Definitions

With regard to the *proposed* IASB/FASB and GASB definitions of assets and liabilities, the most recent versions illustrate the direction the Boards appear to be taking. The revised definitions of the IASB/FASB (still subject to further revision and not yet issued for comment) are:

An **asset** is a present economic resource to which the entity has a present right or other privileged access.

A **liability** is a present economic obligation of an entity.

There is no indication that an assessment of the probability that an entity has a present economic resource or a present economic obligation is required, or of the probability that the resource or obligation will generate future inflows or outflows of economic benefits, or that a significant probability threshold should be required, in order to decide that the entity has an asset or liability. In fact, in the discussion of the proposed asset definition at the IASB's July 26, 2006 meeting the IASB asked the staff to work on clarifying some aspects of the definition and amplifying text, including:

... clarify that an economic resource exists when there is a *non-zero probability* of generating inbound cash flows or reducing outbound cash flows. [*IASB Update*, July 2006, emphasis added]

This view differs from the FASAB AV members' view that a probability assessment should be required at the definition stage and that there should be a "threshold probability" that, based on the AV discussion, would be considerably higher than simply "non-zero."

The following passage provides more information about the IASB/FASB's position on probability at the definition stage. The passage refers to the IASB/FASB's proposed definition of an asset, but to date the two Boards' work on a revised definition of liabilities does not suggest a different position will be taken. The passage is an excerpt from an IASB staff paper prepared for observers at the World Standard Setters meeting held in London in September 2006. It is based on a portion of a presentation by James Leisenring, IASB Board member and former FASB Board member, at the September 2004 meeting of World Standard Setters. Mr. Leisenring pointed out the following shortfalls, among others, of the asset definitions in the existing IASB and FASB conceptual frameworks, and proposed changes to remedy the shortfalls. (Underscoring is provided by FASAB staff for emphasis.)

Likelihood—both the IASB and FASB [current] definitions [of assets] have been misinterpreted as implying that there must be a certain probability (FASB), or expectation (IASB), of future economic benefits before the definition is met. Thus, some believe that when there is a low probability, or expectation, of future economic benefits, the asset definition is not met. That is not the intent, as is made clear by a footnote to the FASB definition. However, to avoid this continued misinterpretation, the working definition

removes any reference to likelihood. We [staff working on the asset definition] think it is sufficient that the economic resource in question has the ability to generate favourable cash flows to the entity. If there is any question of likelihood to be considered, that might be in assessing when an asset qualifies for recognition or in measurement (recognition and measurement will be considered at a later date)—not in the definition of an asset.

Future economic benefits—this phrase, used in both the IASB and FASB definitions, implies that there must be some future flow of economic benefits in order that an asset exists and directs attention towards seeking to identify those future flows. However, we think that is the wrong focus. What we should focus on is whether something with the capability of generating future cash inflows, or reducing future cash outflows—an economic resource—exists at the present time. That existence is not dependent on the future. For example, a lottery ticket, or an unexercised stock option, is a present economic resource, even though future economic benefits might not flow from that resource. We think that by focusing on present economic resources, rather than future economic benefits, this more appropriately captures the notion we need.

The GASB's proposed definitions of assets and liabilities also do not include a reference to probability or expectation. The definitions proposed in the GASB's 2006 ED are:

Assets are resources that the entity presently controls. [par. 10]

Liabilities are present obligations to sacrifice resources that the entity has little or no discretion to avoid. [par. 17]

The GASB does not discuss probability in the passages that explain the characteristics of assets and liabilities. However, aspects of uncertainty are discussed in paragraph 39 and the Board indicates the following. (Underscoring is provided by FASAB staff for emphasis.)

Assessment of whether or not an item meets the definition of a particular element often requires consideration of future events, which are uncertain. For example, to assess whether an item is an asset a determination is required to be made as to whether the item is capable of providing a future benefit.

Thus, no level of probability or certainty of future inflows or outflows of benefits is required when assessing whether an item meets the definition of an element. The GASB gives examples of inflows and outflows of benefits that are not realized: "Cash might be stolen before it can be used to acquire services. An investment might lose all of its value before it is sold. . . . Payment of a liability to a vendor may never be demanded if the vendor goes bankrupt leaving inadequate records to permit collections of its receivables." None of these future possibilities negates the existence of an asset or liability at the balance sheet date, if the item in question meets the definition of one of those elements.

Paragraph 39 of the GASB ED concludes as follows:

The definitions in this Concepts Statement do not require certainty regarding such future events because that would be impractical. Neither does this Concepts Statement specify a level of probability of an event occurring for an item to meet the definition of an element.

Consistent with that view, the GASB responded as follows to Question 8 of the Questions for Respondents to the FASAB ED on Elements, which asked whether respondents support the position taken in the ED or the position taken in the AV concerning the need for an explicit requirement for an assessment of probability and a related probability threshold when determining whether an item meets the definition of an element.

Response—We do not believe that there is a need for an explicit requirement for an assessment of probability and a related probability threshold when determining whether an item meets the definition of an element.

In sum, and as with the *existing* definitions of other standard setters, staff finds no requirement for a probability assessment or a threshold probability at the definition stage in the *proposed* definitions of the IASB/FASB and the GASB.

Recognition Criteria

The FASAB discussed recognition criteria at its June 2005 meeting. The Board concluded that two criteria should be established: In order to be recognized, an item should (a) meet the definition of an element and (b) be measurable. (See paragraph 5 of the Elements ED.) A majority of the Board said that the recognition criteria should not refer to probability, which they believe is a measurement concept. A majority also agreed that, in contrast to the FASB's current criteria (cited below), the FASAB's recognition criteria should not refer to relevance, reliability, or other qualitative characteristics of accounting information. The Board indicated that, because all the qualitative characteristics apply to all financial reporting, it is not necessary and could be confusing to repeat all or some of them in the recognition criteria. The FASAB reaffirmed this decision at the November 2006 meeting.

The AV members have indicated that the Concepts Statement should include a requirement to assess "measurability probability" at the recognition stage. Also, a threshold probability should apply. Specific thresholds would be addressed in individual standards. The AV does not indicate whether the threshold probability would be the same at both the definition and the recognition stages.

The following are the existing recognition criteria established by various standard setters. To date, the IASB/FASB project has not provided proposed recognition criteria, although the topic is included in the schedule for revising the Boards' conceptual frameworks and is under discussion. The GASB included a brief reference to recognition in its Concepts Statement No. 3.³ GASB plans to address recognition criteria further in a future statement, separate from its Concepts Statement on Elements.

FASB

"Fundamental criteria" that must be met for an item to be recognized in the financial statements:

³ GASB Concepts Statement No. 3 *on concepts related to Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements*, issued April 2005.

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.
[Concepts Statement No. 5,⁴ par. 63]

IASB

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 following criteria for recognition:
[Framework, pars. 82–83]

- It is probable that any future economic benefit associated with the item will flow to or from the enterprise; and
- The item's cost or value can be measured with reliability.

Based on these general criteria:

- An **asset** is recognised in the balance sheet when it is probable that the future economic benefits will flow to the enterprise and the asset has a cost or value that can be measured reliably. [Framework, par. 89]
- A **liability** is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. [Framework, par. 91]

GASB

Items that are elements of financial statements and are measurable with sufficient reliability are recognized in financial statements. [Concepts Statement No. 3, par. 34]

Australia and New Zealand

An **asset** should be recognised in the statement of financial position when and only when:

- (a) it is probable that the future economic benefits embodied in the asset will eventuate; and
- (b) the asset possesses a cost or other value that can be measured reliably. [AUS. SAC 4, par. 38 and NZ Concepts, par. 7.9]

A **liability** should be recognised in the statement of financial position when and only when:

- (a) it is probable that the future sacrifice of economic benefits will be required; and
- (b) the amount of the liability can be measured reliably. [AUS SAC 4, par. 65 and NZ Concepts, par. 7.9]

Canada

- (a) the item has an appropriate basis of measurement, and a reasonable estimate can be made of the amount involved; and
- (b) for an item that involves obtaining or giving up future economic benefits, it is expected that such benefits will be obtained or given up. [CICA, Public Sector Accounting Handbook, par. 1000.53]

⁴ FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, issued December 1984.

United Kingdom

If a transaction or other event has created a new asset or liability or added to an existing asset or liability, that effect will be recognised if:

- (a) sufficient evidence exists that the new asset or liability has been created or that there has been an addition to an existing asset or liability; and
- (b) the new asset or liability or the addition to the existing asset or liability can be measured at a monetary amount with sufficient reliability. [Statement of Principles, Ch. 5]

Discussion of Existing Recognition Criteria

None of the recognition criteria reviewed refers to “measurability probability.”

The IASB (current definition), Australian, New Zealand, and Canadian recognition criteria comprise the probability that future economic benefits associated with the item will flow to or from the entity, and that the item has an attribute that is reliably measurable. The GASB and United Kingdom recognition criteria are equivalent to the FASAB’s criteria, except that they refer to reliability of measurement: the item must be an element (that is, it meets the definition of an element) and must be reliably measurable. The first two recognition criteria of the FASB also are similar to the GASB’s, United Kingdom’s, and FASAB’s criteria. However, unlike the other standard setters’ criteria, the FASB’s third and fourth criteria refer to relevance, reliability, and the components of reliability.

The Australia and New Zealand texts explain the meaning of “probable” in their criteria as follows:

The term “probable” means that the chance of the future economic benefits arising is more likely rather than less likely. The term is used in this Statement with its usual meaning and refers to that which can be expected on the basis of available evidence or logic. [AUS, SAC 4, par. 40]

For the purposes of the recognition criteria set out in this document, the term “probable” means the chance of the service potential or future economic benefits arising on the basis of the available evidence or logic is more likely rather than less likely to occur. [NZ, Concepts, par. 7.5]

Both standard setters establish a threshold probability—“more likely rather than less likely” — for the future flows of economic benefits. However, the texts indicate that a conclusion about probability is a matter of judgment “on the basis of available evidence or logic.” They do not state that a more formal probability assessment, such as a probability measurement, is required. None of the other standard setters mentions a threshold probability.

The IASB (current) criteria also include the probability of the future flow of future economic benefits. However, staff has been unable to review the explanation, if any, of “probable.”

Discussion of Proposed Recognition Criteria

As the FASAB is aware, the IASB and the FASB are in the process of revising and converging their respective conceptual frameworks, including definitions of elements, recognition criteria,

and measurement considerations. Thus far, no decisions have been made on recognition or measurement. However, according to FASB staff, the FASB has been moving for some time toward including probability at the measurement stage rather than the recognition stage. For example, a FASB staff paper prepared for the FASAC in June 2004, states the following (p. 6, emphasis in the original):

The Board [i.e., FASB] increasingly is associating matters of probability with *measurement* as opposed to *recognition*. For example, FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, introduces the “expected cash flow approach,” which focuses on explicit assumptions about the range of possible estimated cash flows and their respective probabilities. By incorporating a range of possible outcomes, the expected cash flow approach accommodates the use of present value techniques when the timing of cash flows is uncertain.

As another recent example, [FASB] Interpretation 45⁵ incorporates the probability of a guarantor’s having to make good on a loan guarantee in measuring the obligation for that guarantee rather than in deciding whether the guarantee should be recognized if default is improbable.

A FASB senior staff member assigned to the conceptual framework project elaborated for FASAB staff as follows on the reference to Interpretation 45: Assume that an entity has a customer who needs financing and the entity agrees to guarantee the financing. There is only a remote possibility—say one percent—that the customer will default. Some would say that the entity has no liability because the entity only has to pay if the customer defaults and the probability of default is remote. These individuals are looking at the payout as the liability, which is the wrong unit of account. It is obviously wrong because if the probability of the entity having to make the payout were other than remote, the entity would not give the guarantee. The entity’s liability is not the payout, it is the guarantee, which the entity has little or no discretion to avoid.⁶

In sum, there is diversity in standard setters’ views concerning whether, in order to recognize an item that meets the definition of an element, future inflows or outflows of economic benefits should be “probable” (or, for Canada, “expected”). The IASB (current definition), Australia, New Zealand, and Canada say “yes.” Also, Australia and New Zealand define “probable” as “more likely rather than less likely.” In contrast, the FASB (current definition), GASB (current definition) and United Kingdom do not include the probability of future inflows or outflows of economic benefits as part of their recognition criteria. The IASB and the FASB have a project to reconcile their differences on “probability” in recognition criteria, as well as other differences in their conceptual frameworks. The outcome of that project is likely to be a modification of the recognition criteria of the FASB, the IASB, or both Boards. Current (anecdotal) information suggests that the resulting recognition criteria may not include a probability criterion; rather, probability will be more clearly established as a component of the *measurement* stage, when

⁵ FASB Interpretation No. 45, *Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34*, issued November 2002.

⁶ Personal communication, August 2004, concerning “probable” and other issues raised in the FASB staff memo to the FASAC of June 2004.

appropriate to the attribute being measured. The GASB's forthcoming project on recognition criteria also may alter its current criterion in a way that cannot be anticipated at the present time.

ADDITIONAL DISCUSSION AND STAFF RECOMMENDATIONS

Probability at the Definition Stage

The responses to Question 8 of the Questions for Respondents in the FASAB ED concerning a probability assessment and a "probability threshold" at the definition stage are evenly divided. As previously noted, the reasons given echo the reasoning in the ED or the AV or the explanations in the preamble to Question 8. As such, the responses confirm that there are different views on the issues but staff has not found considerations that the Board has not previously discussed.

As discussed in a previous section, except for the FASB's current definitions of assets and liabilities, none of the current or proposed definitions of assets and liabilities of various standard setters include the word "probable," and none of the accompanying discussions, *including* the FASB's discussion in Concepts Statement No. 6, indicates or suggests that a probability assessment should be required at the definition stage. As previously noted, the FASB's inclusion of the word "probable" in its definitions was intended to indicate that the existence of the essential characteristics did not have to be certain or proved. The FASB did not intend entities to apply SFAS 5 notions of probability.

The discussions of the various standard setters also do not indicate or suggest that there is or should be a "probability threshold" below which an item would not meet the definition of an asset or liability. Rather, for all standard setters reviewed, an item is an asset or liability if it has the essential characteristics of an asset or liability. Those characteristics do *not* include a "probability threshold." Issues of probability are deferred to the recognition and/or measurement stages. This result does not lend support to the AV members' call for an explicit requirement for a probability assessment and a probability threshold at the definition stage. The following passage from FASB Concepts Statement 6 is illustrative of the FASB's and other standard setters' views:

47. To apply the definitions of assets and liabilities (and other elements of financial statements) thus commonly requires assessments of probabilities, but *degrees of probability are not part of the definitions*. That is, *the degree of probability of a future economic benefit* (or of a future cash outlay or other sacrifice of future economic benefits) *and the degree to which its amount can be estimated with reasonable reliability* that are required to recognize an item as an asset (or a liability) *are matters of recognition and measurement* that are beyond the scope of this Statement. The distinction needs to be maintained between the definitions themselves and steps that may be needed to apply them. *Matters involving measurement problems, effects of uncertainty, reliability, and numerous other factors may be significant in applying a definition, but they are not part of the definition*. Particular items that qualify as assets or liabilities under the definitions may need to be excluded from formal incorporation in financial statements for reasons relating to measurement, uncertainty, or unreliability, but they are not excluded by the definitions. . . . [italics added for emphasis]

One reason for some entities' belief that SFAS 5 notions of probability should be applied at the definition stage may be that the FASB's definitions state that it is the *future* economic benefits and *future* sacrifices of economic benefits that define assets and liabilities. Because the future is uncertain, it may seem appropriate to those entities to assess the probability that the future inflows and outflows will occur. However, except for Australia and New Zealand, the remaining standard setters—IASB (current), Canada, United Kingdom, IASB/FASB (proposed), and FASAB (proposed)—have concluded that an asset is a *present resource* and *not* a future inflow of resources; similarly, a liability is a *present obligation* and *not* a future outflow of resources. Although the IASB (current) definition also includes an expectation of future inflows or outflows of resources, a likely result of the IASB/FASB project on elements appears to be the adoption of definitions of assets and liabilities that refer to *present* resources and obligations instead of *future* flows, and that do not refer to probabilities or expectations. The following excerpt tends to support this conclusion. The excerpt is from the FASB and IASB "Project Updates" of March 10, 2006 on their joint conceptual framework, with reference to the development of a liability definition.

The Boards agreed that:

- a. Liability should continue to be defined directly, with reference to assets.
- b. *It is the present obligation, not the future sacrifice, that is the liability.*
- c. An obligation to forgo a cash inflow or to stand aside can be a liability.
- d. Only an obligation to one or more other entities can be a liability, or perhaps a reduction in an asset.
- e. The notion in the current definition of little or no discretion to avoid a future sacrifice should be replaced, perhaps by a notion of legal or equivalent compulsion.
- f. *The definition need not include being probable or other notions of likelihood, which instead belong in recognition criteria or measurement.*
- g. Explicit reference to past events is unnecessary (redundant) because a present obligation can only have arisen from past events.

[italics added for emphasis]

In contrast to proposal (f) in the conceptual framework deliberations on liabilities, in its project on amendments to IAS 37,⁷ the IASB is proposing to develop some "indicators" that could provide guidance to entities when the existence of a liability under IAS 37 is uncertain. In the context of IAS 37, indicators might include past experience with similar items, the experience of other entities, reference materials, and so forth. The IASB also has acknowledged that, if indicators give insufficient guidance, the Board might reinstate in IAS 37 a "more likely than not" criterion, similar to the criterion that was deleted from the previous version of IAS 37 when the ED of proposed amendments was prepared.⁸ Although this proposal is at odds with the conclusions to date in the IASB/FASB's elements project, it should be noted that in its project to amend IAS 37, the Board is working with the *current* IASB definition of a liability and not the proposed new definition in the conceptual framework project. As noted earlier, the current IASB definition includes an expectation of future inflows or outflows of resources that likely would

⁷ IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*

⁸ IASB staff paper prepared for IAS 37 round-table discussions in the U.S., the U.K., and Australia in November and December 2006, part A.

result in greater uncertainty than if the definition focused only on the present obligation, as proposed in the IASB/FASB elements project.

Staff believes that the focus of the IASB/FASB, GASB, and FASAB on present resources and obligations rather than future flows is conceptually sound. One reason is that the definitions of assets and liabilities should be expressed in terms of “stocks” rather than “flows,” because assets and liabilities are point-in-time balance sheet amounts not elements of flow statements. Secondly, to focus on future economic benefits and future sacrifices of economic benefits means that the existence of assets and liabilities is inappropriately dependent on future events, rather than on events that already have occurred.

In the staff’s view, when the asset and liability are defined as present resources and present obligations, as they are in the FASAB’s ED, an assessment of the probability that an item has the essential characteristics of an asset or liability generally should not be needed. An entity generally would know whether it has a resource at the balance sheet date, whether the resource can provide benefits or services in the future (in one year or more), and whether the entity can control the benefits and services in the sense of obtaining them for itself and preventing or regulating the access of other entities. The assessment of probabilities may be appropriate to drawing conclusions about the amount or value of benefits or services that may be used in the future and when they may be used. However, those issues are not part of the definition of an asset and the actual use of the benefits or services embodied in an asset is not an essential characteristic. These points are made in paragraph 18 of the ED:

18. The definition of an asset addresses only whether an asset exists. It does not address how an asset should be measured or whether or when it should be recognized . . . Nor does the definition address whether or when the economic benefits or services embodied in an asset will be used. . .

An item that has the two essential characteristics of an asset is an asset, even if the probability of future use of the economic benefits or services embodied in the asset is low or unknown, and even if the amount or value of the asset is not measurable. An example is natural resources under federal lands. The natural resources are federal assets because the government can obtain the economic benefits and deny or regulate the access of other entities. The natural resources are assets even if the government currently has no program or plans to extract them, and even if they are not measurable and therefore do not qualify for recognition.

Similarly for liabilities, the assessment of probabilities may be appropriate to drawing conclusions about the amount or value of the assets or services that may be provided to another entity in the future in settlement of the government’s obligation. But, again, those issues are not part of the definition of a liability and the actual provision of assets or services is not an essential characteristic. These points are made in paragraphs 39 and 46 of the ED:

39. The definition of a liability addresses only whether a liability exists and not how it should be measured or whether or when it should be recognized . . .
- 46 . . . Uncertainty regarding the amount or timing of settlement [of a liability] is addressed through measurement of the liability.

Staff believes that the ED position is conceptually sound and should be retained. The AV position of requiring a probability assessment at the definition stage and stating that a “probability threshold” exists is inconsistent with the most current concepts of the IASB/FASB and other standard setters.

In addition to conceptual difficulties with the AV members’ proposal, staff believes there are practical problems with assessing “existence probability” and establishing a “threshold probability” at the definition stage. How would an entity measure the probability that a resource exists, that it embodies economic benefits or services, and that it can be controlled by the entity? How would a probability threshold be established? If an item meets the definition of an asset or liability, including the threshold probability, would an entity be required to perform a second probability assessment and apply a threshold probability at the recognition stage? Would a third probability assessment and application of a threshold probability be required at the measurement stage? Would the same threshold probabilities apply at all stages?

The AV indicates that threshold probabilities would be established in standards, “as appropriate,” and not in the Concepts Statement on Elements. However, staff foresees problems for constituents if the Board acknowledges in the Concepts Statement that there is a threshold probability to be met in determining whether an item meets the definition of an asset or liability, but does not say what the threshold is. Such a situation can only result in confusion and, possibly, the arbitrary selection of different thresholds by different entities.

On the other hand, for the Board to decide in the Elements project what the threshold probability should be and state it in the Concepts Statement would require considerable Board and staff resources and a delay in issuing the final Statement because of the variety of possibilities to be researched and discussed. For example, FASAB Statement 5 (SFFAS 5) defines “probable” as “more likely than not to occur” (par. 36). However, that interpretation refers to loss contingencies, not to potential liabilities in general. Would the Board wish to extend it to all potential liabilities? What would be the implications of doing so? In contrast to SFFAS 5, FASB Statement 5 (SFAS 5) defines “probable” as “likely to occur.” That definition also applies to loss contingencies, not to potential liabilities in general. Staff believes that “likely to occur” signals a lower level of probability than “more likely than not to occur,” but this is something the Board would need to deliberate, if either phrase were to be included in the Concepts Statement. Staff believes also that it would be appropriate to research what “threshold probabilities” different entities use, if they do, and for what purposes. For example, do they use a quantified threshold, such as 51% probable or 75% probable? Do different entities tend to use the same probability threshold? Do entities use the same threshold for all kinds of transactions, or are different thresholds used for different kinds of transactions?

Staff Recommendations for the Definition Stage

Staff recommends that the Board retain the ED decisions on this topic. The Board should *not* require (but should not preclude) a probability assessment at the definition stage and should *not* state that a threshold probability conceptually exists and will be established in specific financial reporting standards. Instead, **staff recommends** that the Board retain the references in paragraph

7 to uncertainty and judgment in determining whether an element exists, as well as the following statement which is included in paragraph 18 (for assets) and paragraph 39 (for liabilities):

Those paragraphs [that is, paragraphs 5 through 9] also acknowledge the possibility of uncertainty about whether an item meets the definition of [an asset][a liability] and the need for judgment based on the available evidence. However, those paragraphs do not establish a threshold to be assumed in applying judgment.

Staff also recommends retaining the discussion of the “Effects of Uncertainty” in paragraphs 57 through 61 of the ED.

Does the Board agree?

Probability at the Recognition Stage

Staff’s conclusions concerning the responses to Question 9 are similar to those concerning the responses to Question 8: The respondents are evenly divided in their support for the ED position or the AV position, but have not provided reasons for their views that the Board has not previously considered.

As previously discussed, none of the standard setters reviewed requires a probability assessment or the application of a threshold probability at the definition stage. Three of them—FASB (current), GASB (current) and United Kingdom—do not include a probability requirement in their recognition criteria. The remaining four standard setters—IASB (current), Australia, New Zealand, and Canada—include in their recognition criteria a probability notion related to the future inflows and outflows of future economic benefits.

None of the standard setters requires an assessment of “measurability probability” and none refers to a threshold probability in that regard. Staff has not found any reference in the conceptual framework literature to a probability assessment of whether an item is or is not measurable. “Measurable” simply means “can be measured” or “is capable of measurement.” In an accounting sense, these meanings are limited to “can be measured in monetary units” or “is capable of measurement in monetary units,” because monetary units are the method of communication of financial statements. Indeed, the “monetary unit assumption” is one of the basic assumptions that underlie financial accounting, on a par with the economic entity, going concern, and periodicity assumptions. The monetary unit assumption has been defined as follows:

The monetary unit assumption means that money is the common denominator of economic activity and provides an appropriate basis for accounting measurement and analysis. This assumption implies that the monetary unit is the most effective means of expressing to interested parties changes in capital and exchanges of goods and services. The monetary unit is relevant, simple, universally available, understandable, and useful.⁹

⁹ Kieso, Donald, Jerry Weigandt, and Terry Warfield, *Fundamentals of Intermediate Accounting*, John Wiley & Sons, 2003, p. 35

Consistent with the monetary unit assumption, the FASAB ED includes as a recognition criterion that the element must be measurable and defines measurable as “quantifiable in monetary units.” All of the standard setters’ recognition criteria examined for this paper also include a criterion that the element must be capable of measurement and none states that a “probability of capability of measurement” should be assessed. The only differences between the FASAB’s criterion and those of other standard setters are that most of them require that the element be measurable with reliability, or similar, and some of them indicate that the element must have an attribute (e.g., cost or value) that can be measured reliably. As discussed earlier in this paper, the FASAB decided that references to qualitative characteristics, such as reliability, apply to all reported financial information, should not be included in recognition criteria, and are more appropriately associated with the measurement stage—that is, the amount that is the result of measuring the element.

The AV does not explain how “measurability probability” would be assessed or why. It would seem that any uncertainty about whether an item is measurable would be resolved by measuring the item—that is, at the measurement stage—not by previously assessing whether it is or is not “probably measurable.” Staff believes it is at the measurement stage, when an attribute has been measured, that the entity would decide whether the resulting amount is sufficiently reliable (and material) to be recognized in the financial statements or whether an estimated amount, or range of estimates, should be disclosed, with an appropriate explanation.

Staff also wonders whether the “probability measurability assessment” and “threshold probability” that the AV members are proposing would be the same for the recognition of all assets and liabilities (and other elements) arising for all kinds of transactions or other events? If so, might not there be a potential conflict among (a) a required probability assessment and established threshold probability as part of recognition criteria; (b) the choice of measurement attribute, some of which (e.g., expected value) would include their own probability assessments and potentially a different probability threshold; and given that choice, the role of probability, if any, in measuring the attribute? By establishing threshold probabilities at the recognition stage, would the FASAB be restricting its ability to consider alternative attributes and measurement methods in its forthcoming project on measurement?

As previously noted, other standard setters have included a notion of probability in their recognition criteria, but it is associated with future flows of economic benefits, and not with measurability of the element. The current IASB definitions of assets and liabilities take this approach. It is unknown at this stage whether the IASB/FASB project will include a reference to the probability of future flows of economic benefits in their recognition criteria, although as noted earlier there are some indications that the two Boards may conclude that notions of probability belong in measurement. Also, the Boards’ current position favors concluding that if an item meets the definition of an asset or liability, it is an asset or liability, regardless of whether or when future flows of economic benefits may occur. This same position is taken in the FASAB ED.

Another indication of the IASB’s leanings is its proposal for omitting the “probability recognition criterion” in its amendments to IAS 37. The project refers to the probability notion in the current IASB recognition criteria, which are included in IAS 37, namely that “an entity should recognize

a liability when it is probable (more likely than not) that an outflow of resources embodying economic benefits will be required to settle a liability.”¹⁰

FASAB staff believes that the following excerpts from the IASB’s current thinking are relevant to the FASAB’s deliberations, even though FASAB has not proposed a recognition criterion that refers to the probability of future resource flows. The thinking is relevant because it updates and differs in its implication from footnote 13 of the AV, which refers to objections by respondents to the IASB’s proposed amendments to the recognition and measurement principles in IAS 37 as support for the AV preference to include an assessment of “measurability probability” in the FASAB’s recognition criteria.

The passages below also mention some pitfalls of a probability recognition criterion—for example, points (b), (c) and (e), of which the FASAB should be aware. The IASB’s current thinking on amendments to IAS 37 is consistent with the apparent direction of the IASB/FASB conceptual framework project. It is also consistent with the view of the majority of the FASAB when deliberating the Elements ED, that notions of probability belong at the measurement stage and not at the definition or recognition stage.

In its IAS 37 Round-Table Discussion paper of November and December 2006, the IASB acknowledges that many respondents to the ED of amendments to IAS 37 objected to the proposal to remove the probability recognition criterion because the IASB *Framework* includes a probability criterion or because they believe that the probability recognition criterion is a practical means of addressing uncertainty about the existence of a present obligation. In its redeliberations of the issue, the IASB concluded the following (part B, par. 29, footnotes omitted—underlining added for emphasis):

The Board acknowledges that its proposal to omit the probability recognition criterion creates tension with the *Framework*. It has therefore reconsidered but tentatively affirmed its proposal. In the Board’s view, there is no need for a separate probability recognition criterion in IAS 37 because any uncertainty about the amount or timing of the economic benefits required to settle a present obligation should be reflected in measurement, not recognition. This is because:

- (a) the Framework does not define “probable.” Moreover, IAS 37 has established a unique interpretation of probability (“more likely than not”).
- (b) other standards do not apply a probability recognition threshold. For example, IAS 39 *Financial Instruments: Recognition and Measurement* does not permit a writer of an option to delay the recognition of its obligation to deliver a commodity at a fixed price in the future until it is “more likely than not” that the holder will exercise the option. Similarly, IAS 19 *Employee Benefits* does not permit an employer to delay the recognition of its obligation to provide long-term compensated absence to employees completing x years service until it is “more likely than not” that an employee will complete x years service.

¹⁰IASB staff paper prepared for IAS 37 round-table discussions in the U.S., the U.K., and Australia in November and December 2006, part B, based on the IASB *Framework*.

- (c) a probability recognition criterion may result in inconsistent accounting for identical liabilities within the scope of IAS 37. For example, such a criterion would mean an entity would not recognise a liability arising from a single product warranty if it is 30 per cent likely that a fault is reported during the warranty period. But the same entity would recognise a liability if the entity had issued one hundred identical product warranties (even though it remains 30 percent likely that a fault is reported for each individual product). This is because it is “more likely than not” that at least one product will develop a fault during the warranty period.
- (d) applying a probability recognition criterion creates tension with the measurement requirements in IAS 37 and might delay the reporting of useful information about items which satisfy the definition of a liability. For example, paragraphs 39 and 40 require an entity to consider all possible outcomes in the measurement of a liability, regardless of whether each possible outcome is “more likely than not.”
- (e) a probability recognition criterion might detract from the first step in accounting for liabilities: does a liability exist on the balance sheet date?

Staff Recommendations for the Recognition Stage

Staff has covered a range of considerations for the Board in deciding whether to retain the ED position on recognition criteria or to adopt the AV position. Staff acknowledges that some of these considerations—e.g., the apparent current views of the IASB/FASB in their joint conceptual framework project and the IASB in its amendments to IAS 37—are a work in progress and different considerations may emerge as the projects develop further. Nevertheless, staff believes that there is a similarity of thought between the IASB/FASB projects and the FASAB (ED position) on recognition criteria which it would seem desirable to maintain, including especially the view that notions of probability are measurement issues rather than recognition issues.

An additional important consideration, in staff’s view, is that none of the major standard setters includes a “measurability probability” in their recognition criteria, even though all of them include a requirement that an element be measurable (i.e., quantifiable in monetary units) in order to be recognized.

Staff also questions how and why a “measurability probability” would be assessed for an item as part of meeting recognition criteria, when uncertainty about measurability can be addressed by selecting an appropriate measurement attribute and method and measuring the item.

Staff also has raised the issue that to establish a probability notion and threshold probability at the recognition stage may restrict the range of options available to the FASAB in its forthcoming measurement project.

For all of these reasons, **staff recommends** that the FASAB retain the two recognition criteria in paragraph 5 of the ED, namely (a) The item meets the definition of an element of financial statements and (b) The item is measurable—with “measurable” defined as “quantifiable in

monetary units.” **Staff recommends** that the FASAB should not add a probability assessment requirement to the recognition criteria and should not consider related threshold probabilities.

Does the Board agree?

CONCLUSION

Staff has reviewed various considerations concerning the differences between the ED position and the AV position on the role of probability assessments and related threshold probabilities at the definition stage and the recognition stage. Staff recommends that the Board retain the ED position for both stages. The reasons for the Board’s decisions will be explained in the Basis for Conclusions.

Future Meetings

The scheduling of other topics depends initially on the Board’s decisions on the probability issues. If the Board decides to accommodate requirements for probability assessments and threshold probabilities at the decision and/or recognition stages, the document may require considerable changes in rationale as well as modifications to the definitions and recognition criteria. It is possible that a full session would be required for the Board to reach agreement on the implementation of agreed changes.

If the Board decides to reaffirm the ED position with regard to *not* including requirements for probability assessments and *not* establishing threshold probabilities, staff believes that the next step should be to review the wording of the definitions and supporting discussions. There are few comments on these issues in the responses to the Questions for Respondents, but there are some that the Board may wish to consider.

Some respondents also made editorial suggestions that the Board may wish to consider. Staff believes that these do not need to be addressed in a specific paper. Rather, they can be discussed as needed in the Board’s review of the first draft of a final Concepts Statement on Elements. That first draft also should include a draft of a Basis for Conclusions, which would explain the Board’s rationale for any changes from the ED, as well as clarifications requested at previous Board meetings or by respondents.

Staff believes that, depending on the time available for the Elements sessions, it should be possible to review the definitions and supporting explanations and to begin to review the first draft of a final Statement at the same meeting. This would mean a total of at least three sessions to reach agreement on a final Statement.