COMMENTS ON
Selected Issues Relating to Assets and Liabilities with Uncertainties
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By Humphrey Nash

Disclosure: The author of these comments is a proponent of value based accounting as exemplified by the Accounting For The Future (AFTF) accounting model. The comments made support AFTF and should be understood within that context. See the Website:

http://home.sprintmail.com/~humphreynash/Index.htm
for more information.
INTRODUCTION

1. In October 2004, the FASB and IASB embarked on a joint project to develop a converged and improved conceptual framework by building on their existing frameworks. Initial efforts have focused on the objectives of financial reporting and the qualitative characteristics of financial reporting information. Considerable progress has been made in these areas. The purpose of this Invitation to Comment is to solicit input from FASB constituents for use in the next phase of the Boards' conceptual framework project.

There seems to be a subtle shift in emphasis as to the extent of development of the conceptual framework. Whereas before the talk was of a new conceptual framework to support the new principles based approach to standard setting, the current emphasis is on a “converged and improved conceptual framework” based on “existing frameworks”. Genuine improvement may be difficult if tied too tightly to “existing frameworks”. The existing framework has served well but it is now outdated, inconsistent and incomplete. It would be a shame to restrict this effort to convergence and whitewash. Convergence is desirable but it is more desirable to converge on real change and significant improvements. The current GAAP and European accounting models are essentially the same, unfortunately. If fundamental accounting change is not forthcoming then the conceptual basis and resulting principles should nevertheless be made general. If they are made general, I feel that they will open a wide door to future fundamental change. If the conceptual basis and resulting principles are targeted to specifically support the existing implementations, this will close and lock the door to an improved future.

I have previously provided comments on the “New Conceptual Framework Project” and in the paper The Mission and Success of FASB. These comments include explicit new suggestions for objectives and qualitative characteristics for financial reporting. In addition, the Accounting For The Future draft proposal and various follow-up papers implicitly contain valuable objectives and qualitative characteristics that should be considered. Hopefully the “considerable progress” already made in this direction does not indicate that the job is done.

2. As part of the project’s next phase, the Boards will discuss assets and liabilities, including the role of probability and uncertainty in defining, recognizing, and measuring assets and liabilities. The staff’s opinion is that the existing frameworks do not adequately address either probability or uncertainty as they relate to assets and liabilities. To some extent, either probability or uncertainty plays some role in defining, recognizing, and measuring assets and liabilities in both frameworks. However, that role is not always clear, and is at times inconsistent within or between frameworks.

The Accounting For The Future (AFTF) accounting model is a prospective value-based model. Assets and liabilities are defined simply as Present Values of Expected Cash Flows (PVECF), inflows and outflows, respectively. Expected cash flows take into account the full range of uncertainty. Future certain values, for example, the nominal return on US treasuries, are discounted only for the time value of money. Future uncertain values, for example, the proceeds of a life insurance policy, are also discounted for the probability of realization.

AFTF value is recognized as a two step process: the recognition of management-expected cash flows and their measure as present values. Accounting and accountants are not responsible for uncertainty or probability assignments. These are assessed by management within a validated cash flow model. This
model is subject to several disciplines including accounting audit. Similarly discount rates and the
resulting present values are subject to audit. These audits are exact and unequivocal and do not expose
the accountant or accounting to difficult and unwelcome judgments. Hence probability and uncertainty
are not a direct component of the accounting function. Difficult business judgments are left with
management where they belong and are welcomed. It is management’s responsibility to make and fulfill
its own expectations.

AFIF treats all cash flows as uncertain, to some degree. Hence uncertainty pervades the cash flow
model, as it does reality. The cash flow model is a reliable representation; it is exactly what it purports to
be, namely, an expression of management expectations. The role of uncertainty is uniform, clear and
consistent; it is not a direct component of the accounting model.

Accounting will struggle if it undertakes too much. It will continue to be overwhelmed if it attempts to be
expert in a multitude of business environments. This is the situation the Standard Setters currently find
themselves in. The 150+ FASB statements are industry/situation specific fixes to a basically deficient
accounting model yet the accounting model is increasing incomplete. General principles and a hands-off-
business-judgments approach would vastly simplify and improve accounting. Company cash flow
models, uncertainty, probability assignments, recognition, company decisions, company plans are best left
to the management experts. Accounting has a large enough role establishing and enforcing general
principles and measures.

3. Issues regarding the treatment of probability and uncertainty exist at the standards level as
well. Both the FASB and the IASB have a general standard relating to assets and
liabilities with uncertainties. However, there are many differences between the two
standards, some of which relate to the use of probability and uncertainty in recognizing
and measuring assets and liabilities. The FASB's standard also is inconsistent with its
framework, which was developed much later. The IASB's standard does not have this
problem as it was issued after its framework.

The existing solutions for uncertainty attempt to incorporate uncertainty directly within the accounting
model. This is a very difficult and hazardous task for auditors. There are many ways of using
probabilities and coping with uncertainty and related items, such as variance risk. It is also very difficult
to separate discount rates from risk or probabilities. Things like accounting allocations and “fair value”
may be inconsistent with probabilities. In my opinion, the best answer is for accounting is to leave the
responsibility for uncertain business judgments and projections with management. The AFIF model
makes strong use of probabilities but clearly defines probability assignments and cash flow projections as
a management function.

4. Another issue at the standards level is the change in the treatment of probability and
uncertainty that has occurred in more recent standards. The FASB has increasingly
favored the use of fair value measurement in its standards. In those cases where fair
value measurement has been required for liabilities with uncertainties, the change in
measurement attribute has been accompanied by a shift from the use of probability or
uncertainty as a recognition criterion to its use in measuring the fair value of the item
instead. Treating probability and uncertainty as a measurement problem is not
necessarily inconsistent with the FASB framework, but the framework only considers the
use of probability and uncertainty in measurement in the context of a present value
calculation. It does not assign a measurement role to probability and uncertainty as a
matter of principle.
There is a glaring inconsistency in FASB thinking; “Fair Value” as defined uses observable market prices when available. This is inconsistent to the treatment when market prices are not observable which uses expected values. It is also inconsistent with the fair value of the company as a whole which is well established for publicly traded companies. This is untenable as a basis for reporting to shareholders. I have written and commented extensively on this and provided an easy solution, but, to date, there has been no acknowledgement of the solution or of the problem!

As mentioned above, AFTF avoids questions of uncertainty by clearly assigning responsibility for expected cash flows to management. Management expectations then become the standard of performance which management must meet. Management will be judged by the quality of its judgments and/or by its ability to execute its visions. AFTF measurement is a two-step process involving recognition of management’s expectations and capital market scaling of those expectations through present values (the AFTF dual validation). It does not assign a measurement role to probability and uncertainty, as a matter of principle.

5. IASB standards are undergoing a similar shift. Current proposals by the IASB would not only converge their standards with FASB standards that have changed the role of probability and uncertainty, but also introduce that change to a broader set of situations.

FASB and the IASB should not take too much comfort in their ability to agree or converge. If they converge on an antiquated and fundamentally flawed set of accounting standards, it will make true improvements more difficult. If probabilities in the form of management expectations are applied to a broader set of situations both the IASB and FASB implementations will converge on AFTF.

6. The inconsistencies and changes mentioned above present issues that the Boards need to address as they consider probability and uncertainty in the definition, recognition, and measurement of assets and liabilities. Responses to this Invitation to Comment will be used by the FASB in the conceptual framework project to evaluate the relative merits of the various uses of probability and uncertainty in the Boards’ frameworks and standards.

I hope this is the case. But to be candid, it seems that directions and destinations are often solidified before comments are received. I would hope that FASB can revisit its work on present value measurements in accounting which lays a foundation for probabilities and expected values. This foundation can be extended to produce a unified accounting model, such as AFTF.

7. The FASB is seeking comments on these matters before they are deliberated by the Boards for two reasons:

a. To enrich those deliberations
b. To support an ongoing effort to streamline the standard-setting process and improve the effectiveness of FASB and joint FASB/IASB projects.

It seems to me that AFTF is not well understood. AFTF is a simple and natural accounting model, so the inference I draw is that it hasn’t been given adequate attention. Even if not adopted, AFTF can be a good litmus test to see whether concepts are truly fundamental and whether standards are truly general principles-based rather than industry or situation specific rules. If for no other reason than to enrich and broaden current efforts, an attempt to understand AFTF should be made.

This Invitation to Comment does not replace any part of the normal due process procedures for the conceptual framework project. Constituents will have the opportunity
BACKGROUND

The Frameworks

8. In the frameworks of both Boards, uncertainty is acknowledged as part of the definitions of assets and liabilities. FASB Concepts Statement No. 6, Elements of Financial Statements, uses the term probable to describe inflows and outflows of future economic benefits in its asset and liability definitions. The IASB Framework for the Preparation and Presentation of Financial Statements (Framework) uses the term expected in the same manner. However, neither framework imposes a threshold level of probability or expectation of cash inflows or outflows in order for an item to satisfy the definition of an asset or liability. Concepts Statement 6 (footnote 18) explains that probable is not used in an accounting or technical sense, but simply to mean not certain or proved, reflecting the nature of the environment in which business and other economic activities occur. Furthermore, Concepts Statement 6 (paragraph 47) classifies the consideration of probability and uncertainty as either a recognition or measurement issue.

The definition of an asset or liability using the term probable is in accord with the reality of business decisions and transactions. The word probable encompasses the entire range of probabilities from the certain or near certain economic benefit (+ or -) to the rare or highly uncertain benefit.

Repayment of a treasury instrument by the US Government would be a near certain event (asset) with a probability perhaps greater than .99. On the other hand, a one year term life insurance payment (liability) might have a probability of less than .001. The existence of the asset or liability does not depend directly on the magnitude of the probability. Whether we measure it or not is another matter which depends on its economic significance. For example, a renewable term life insurer with 100,000 policyholders each with a $1,000,000 face amount must take into account the rare event.

Obviously a probability threshold cannot be applied. A better approach is an economic significance threshold. AFTF defines the threshold for recognition as any cash flow which by itself or in combination with other similar cash flows could be reasonably expected, by its presence or absence, to affect shareholder capital allocation decisions. There is no direct reference to probability.

More importantly, the AFTF responsibility for satisfying the recognition threshold falls on management. Management is responsible for phrasing its expectations using a cash flow model. Under AFTF this model is subject to certain disciplines (including audit). These disciplines essentially guarantee that the model is complete, non-duplicative, and representative. There are further AFTF disciplines (also auditable) that insure that measures based on those cash flow models are economic values scaled to the capital markets, i.e., company fair values. The AFTF accounting model does not depend directly on probabilities. Of course management expectations within the cash flow model are nothing but probability assignments.

As mentioned above, recognition of value under AFTF is a two step process: recognition of management expected cash flows and their measurement as present values. Probabilities pair up with magnitudes to establish recognition. Measurement or at least scaling of measures is a function of the present value process. AFTF, unlike current accounting implementations, is able to clarify the issue of probabilities as recognition versus measurement components.
9. With respect to recognition of assets and liabilities, the IASB’s Framework explicitly includes a probability threshold criterion among its recognition criteria. No comparable criterion exists in the FASB framework, although FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, includes additional recognition guidance that is specific to revenues, gains, expenses, and losses. That added guidance, which addresses uncertainty in a limited way through the notion of conservatism, indirectly affects asset and liability recognition.

FASB’s work on present value measurement and probabilities has set the stage for cash flow modeling. FASB’s PVECF approach is a reflection and recognition of how economic decisions are made. This is a critical step in the development of an accounting model which can support the decision process. It is only necessary to incorporate this proven technology within a developed accounting model. This is what AFTF does.

A probability threshold as an ingredient or catalyst for conservatism is non-starter. It is now generally recognized and accepted that conservatism is undesirable in an accounting model. Conservatism hides or destroys information which is sub-optimal. Conservatism can preclude some bankruptcies but at a far greater cost in capital allocation efficiency. In fact, removing the natural selection of individual failure guarantees collective failure.

10. When it comes to the measurement of assets and liabilities, both Boards’ frameworks describe multiple measurement attributes or bases, including present (or discounted) value. Probability and uncertainty, therefore, have a measurement role in the frameworks to the extent that present value calculations impound uncertainties.

Probability and uncertainty also have a measurement role in the frameworks to the extent that recognition thresholds are employed. Probability thresholds are inconsistent with present value measures. The use of probabilities in present values affects the measure in the Boards’ frameworks but not in AFTF! AFTF measures are always scaled to economic (capital market) values. Since measures under the Board’s frameworks use probabilities directly, the accounting models are burdened with uncertainties.

If the Boards want a cohesive, consistent, and unified accounting model, it would be a good idea to base all accounting measures on disciplined PVECF. This is the AFTF approach. AFTF unifies far beyond the financial reporting model. 6

11. In FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements, probability and uncertainty are discussed explicitly. Concepts Statement 7 was issued 25 years after FASB Statement No. 5, Accounting for Contingencies. In Concepts Statement 7 the FASB acknowledged the tension between Statement 5, which is grounded in historical cost and treats probability and uncertainty as a recognition issue, and Concept Statement 7 itself, which focuses on the use of present value techniques to estimate fair value and treats probability and uncertainty as a measurement issue. The Board noted that the use of the term probable in Statement 5 refers to the likelihood that an asset has been impaired or a liability has been incurred, while the same term in Concepts Statement 7 refers to the likelihood of the cash flows or other factors that are considered in estimating the fair value of an asset or liability using a present value technique.
Concepts Statement 7 lays a foundation for a value based accounting model. It is the more modern approach in touch with modern technologies and decision processes. It has not been fully integrated into current accounting implementations such as GAAP because it is not consistent with current GAAP practices. It, like AFTF, is fully in accord with GAAP goals and purposes. In my view, Concept 7 can be applied more generally and would satisfy GAAP goals and purposes much better than GAAP.

The Standards

12. Since 1975, Statement 5 has been the general standard in the United States for accounting for contingent items. Its principal international counterpart, IAS 37, Provisions, Contingent Liabilities and Contingent Assets, has been in place since 1998. The two standards are by no means identical. However, both Statement 5 and IAS 37 pertain to contingencies and both use the uncertainty of an item that may otherwise meet the definition of an element as a partial determinant of whether that item should be recognized in the financial statements.

As discussed above, a probability threshold for recognition is unworkable. Recognition depends on significance; significance depends on the probability of an event, the magnitude of the event, the number of events, the timing of the event, and related events, such as, hedges. There may be other factors as well. The point is that uncertainty, in all its forms (probability, variance, unknown probabilities), does not directly or by itself govern recognition. More importantly, probability judgments or assignments are a quagmire for accounting. Such judgments are best left to the professed and acknowledged experts, namely management.

AFTF removes all uncertainty from the accounting realm.

13. Statement 5 sets standards for assets and liabilities that are characterized by uncertainty about the amount or timing of future cash flows, though it does so indirectly through gain contingencies and loss contingencies. A contingency involves uncertainty as to whether a gain or loss has occurred in respect of an asset or liability that will be resolved by one or more future confirmatory events. Resolution of the uncertainty may confirm an increase or decrease in the existing asset or liability. Statement 5 requires that the uncertainty embodied in a contingency be dealt with when the contingency arises, not when the events resolve that uncertainty. The uncertainty is not addressed through asset or liability definition (because the asset or liability with uncertainty already exists) or in the measurement of the asset or liability. Instead, uncertainty is addressed in recognition. For a loss contingency, Statement 5 requires recognition of an estimated loss and corresponding asset reduction or liability increase if it is probable (meaning likely) at the reporting date that the future event(s) that confirm the loss will occur. Recognition of an estimated gain related to a gain contingency generally is not permitted even if it is probable that the future event(s) that confirm the gain will occur.

Statement 5 supports the use of expected or contingent values. It requires recognition when the contingency arises. This places the burden for identifying and evaluating contingencies on accounting. It places a great, unwelcome, and inappropriate burden on the auditing function. It continues an unfortunate accounting tradition of too much complexity, judgment and choice in accounting measures.

AFTF is focused on the unique beacon of economic value. AFTF accounting is supports rigorous audit functions. There is little or no room for variance in measures.

As mentioned above, conservatism in an accounting model is sub-optimal. Not recognizing gains and
losses in a balanced and neutral manner does not produce expected values or economic values. This impairs the decision utility of accounting. A conceptual basis should espouse neutrality. An accounting model should actually represent economic phenomena, not just say it does.

14. IAS 37 also addresses uncertainty through recognition, however, the use of terminology and the scope of IAS 37 differs from Statement 5. IAS 37 uses provision to refer to a present liability (either legal or constructive) with uncertain timing or amount of future cash flows. A provision should be recognized if it is probable (that is, more likely than not) that an outflow of resources will be required to settle the liability and a reliable estimate of the amount of the liability can be made. IAS 37 does not address present assets with uncertain cash flows.

I don’t believe that the reliability of the estimate should be used to escape accounting responsibility. In fact, the more unreliable the item seems, the more need there may be for a provision. It may have been difficult to estimate asbestos liability but it needed to be done and done at the earliest stage. Much financial hardship and personal suffering might have been avoided with a stronger accounting model and more courageous accountants.

"More likely than not" is an undesirable threshold condition, and a murky one at that.

15. IAS 37 also uses the terms contingent liability and contingent asset. Two meanings are assigned to contingent liability: (a) a possible present obligation whose existence can be confirmed only by the occurrence or nonoccurrence of one or more uncertain events not entirely within the entity’s control and (b) a present obligation that is not recognized either because an outflow of resources to settle it is not probable, or its amount cannot be measured reliably. The definition of contingent asset parallels the first meaning given to contingent liability. Under IAS 37, neither contingent liabilities nor contingent assets are recognized.

The IAS provision seems as unbalanced as Statement 5 in that it excludes contingent assets from the accounting implementation. Whether a liability is recognized seems to depend on a probability threshold for recognition using “contingent” as the label for the improbable cash flow. This doesn’t solve the problem since we then have to distinguish contingent from non-contingent cash flows. We have seen that very low probability event, like the death of a life insurance policyholder, can have substantial economic significance by itself or in combination with similar events. On the other hand, there may be an unlikely event like nuclear war or a large asteroid impact that are of great economic significance but so very low a probability as to be ignorable. I doubt this is the IAS intent however. The intent seems to be to avoid difficult recognition questions.

The phrase “not entirely within the entity’s control” is probably designed to exclude from consideration such nettlesome things as competition, obsolescence, currency fluctuations, inflation, tax legislation, and economic fluctuations. These external or macro items often have significant adverse effects and not anticipating or measuring them is bad management and bad accounting. “not entirely within the entity’s control” is a red flag for inclusion not exclusion just as is “cannot be measured reliably”.

Currently, this places a great burden on accounting but the burden must be borne. With AFTF this burden is management’s. AFTF has the additional advantage of being based on the long term so that fluctuations can be averaged out. Note also that changing circumstances can be countered with changing directions. AFTF cash flow expectations are perfectly reliable (are what they purport to be) and are measured (scaled to economic or capital market values) with perfect reliability. At the corporate scale control is usually
present but AFTF has a mechanism for coping and quantifying many residual uncontrollables. The discount rate implicitly incorporates the capital market consensus of the anticipated effect of uncontrollables, at least to the extent that they can be anticipated. For example, if there is an expectation of inflation, such inflationary expectations will increase the required cost of capital and lower (or possibly raise) asset or liability valuations appropriately.

16. While both Statement 5 and IAS 37 rely on a probability recognition criterion, the term probable does not have the same meaning in the two standards. Therefore, their recognition thresholds differ. Statement 5 uses the synonym likely for probable, although probable is often interpreted as meaning highly likely (a probability much greater than 50 percent). IAS 37 defines probable as more likely than not, interpreted as a probability of at least 51 percent. This inconsistency is increased by the use of the term probable in Concepts Statement 6, where probable means simply “not certain.”

Any probability threshold, 50% or 51% or whatever, is unworkable. For one thing it may be difficult to determine what the probability is near the threshold. As we have already observed even low probability events may be economically significant. A better answer is to consider expected cash flows wherein the sum of the product of probabilities times cash flow magnitudes defines the threshold, i.e., economic significance.

AFTF defines a more practical and purposeful threshold. But AFTF does far more; it leaves difficult recognition question and probability assignments in management hands. It does so with impunity.

17. In contrast to Statement 5, IAS 37 assigns a role to probability and uncertainty in the measurement, as well as the recognition, of liabilities with uncertainties. IAS 37 requires that a provision meeting the recognition criteria be measured at the best estimate of the expenditure required to settle the liability at the balance sheet date. When the provision involves a large population of items, IAS 37 prescribes the use of an expected value approach, which weights possible outcomes by their associated probabilities.

I’m confused by the above description. It seems that using a probability threshold for recognition eviscerates any attempt to use probabilities to produces expected values. Up to 50% of the probability may be missing if the recognition threshold is not exceeded. I doubt that probabilities used for two disparate or conflicting purposes can produce a rational or consistent accounting result.

The corporate scale usually involves large populations so the expected value approach can work quite well, either for similar items or for dissimilar items where the uncertainty of outcome is replaced by uncertainty of the underlying probabilities. In those cases where the number of items is small, joint ventures, hedges, risk sharing, pooling, insurance or reinsurance, or diversification can achieve the same result. It is generally possible to reduce risk and manage expected values.

I’m not sure why large numbers of items are singled out for an expected value approach. For example, the expected value approach works just as well for a single coin flip as for 100 coin flips. Outcome variance may be greater but expected values are controlled. I would guess that an accountant would be equally uncomfortable with a $1,000,000 coin flip liability of $0 or $1,000,000. Accounting cannot create certainty where none exists and shouldn’t try to.

18. In 2001, the year after issuing Concepts Statement 7, the FASB issued Statement No. 143, Accounting for Asset Retirement Obligations. Statement 143 requires that present obligations within its scope whose settlement amount and timing may be uncertain be recognized as liabilities in the financial statements at fair value, unless a reasonable
estimate of fair value cannot be made. Statement 143 makes explicit that which is implied in Concepts Statement 7, namely that the guidance in Statement 5 (and in FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss) does not apply to a liability for which the measurement objective is fair value. For the obligations within its scope, Statement 143 represents a change in the role of probability and uncertainty from liability recognition to liability measurement.

"Fair values", as espoused by FASB, are first and foremost observed market values. This is convenient for accountants; it eliminates difficult judgments and supports an audit approach. Only if such values are not observable are other approaches permitted, for example, a PVECF approach. Even then, the goal seems to be an imputed market value. The problem is that fair value is the value to others not the economic value to the company. This cannot support optimal economic decisions by shareholders or management. The fair value hierarchy is a Hobson’s choice and does not support a unified or consistent accounting model. Instead it continues the unfortunate complexity and license which so often leads to abuse. The many problems of fair value have been discussed at length\(^1\) and won’t be discussed further.

Retirement obligations are invariably valued by actuaries. They use expected values. At least in theory, two actuaries given the same data will arrive at the same answer. The company pension valuation should match the market pension valuation. Hence fair value reduces to a PVECF approach. In fact Statement 143 supports PVECF and only by happenstance fair value. This is frequently the case\(^1\) and this, I believe, has misdirected FASB.

19. In 2002, the FASB issued Interpretation No. 45, Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. Interpretation 45 clarifies Statement 5’s discussion of liabilities that embody uncertainty by refocusing attention from the loss contingency to the liability and refining the language used to discuss that liability. Interpretation 45 identifies a guarantee liability as containing a conditional obligation to perform in settling a liability if the debtor defaults and an unconditional obligation to stand ready to perform the conditional obligation (Interpretation 45 refers to “contingent” and “noncontingent” rather than conditional and unconditional, although the terms are meant to have the same meaning.). Both of the obligations are present obligations. Interpretation 45 requires that a liability within its scope be recognized when the event creating the two obligations occurs, rather than when the settlement of the conditional obligation reaches a certain level of probability. Furthermore, Interpretation 45 generally requires that the guarantee liability be initially measured at its fair value, with uncertainty about the amount and timing of settlement of the conditional obligation reflected in that measurement. Those requirements represent an extension of the role of probability and uncertainty found in Statement 143.

It is not necessary from an accounting standpoint to layer conditional obligations on top of nonconditional stand-ready obligation. The stand-ready obligation is simply the existing state not different from the basis of all other obligations. Why do conditional obligations need the support of an underlying nonconditional obligation base? Can we not simply observe that all obligations (or rights) are to some degree conditional; then there is no need for the layering.

With a PVECF, such as employed in defining AFTF liabilities, the unconditional obligation to ‘stand ready’ implies a probability of 1.00. Hence, there is only a contingent dimension; the noncontingent dimension evaporates. The FASB interpretation of “fair value” would not be used in AFTF, only entity specific economic values. It seems that conditional obligations have accounting measures and that the intended nonconditional obligations (stand-readies) have no direct accounting measure.

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20. The Boards' frameworks do not discuss the notion of unconditional and conditional obligations within a single liability. Although the notion of an obligation to stand ready to provide services or assets is identified in paragraph 36 of Concepts Statement 6, that notion is not developed. However, nothing in the Boards' frameworks is inconsistent with the idea that a liability can comprise both unconditional and conditional obligations.

In reality every obligation is contingent, sometimes highly probable, but still contingent. PVECF comfortably permits the use of highly probable expectations. The obligation to stand ready is inherent in PVECF and is well developed within AFTF as a management expectation. AFTF liabilities are directly the Present Values of Expected Cash (out)Flows.

21. In March 2005, the FASB issued Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations, which clarifies that Statement 143 applies to all asset retirement obligations (AROs), including those in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity (that is, conditional AROs). Interpretation 47 emphasizes that a conditional ARO is a present liability which, like the guarantee liability in Interpretation 45, comprises both a conditional obligation to perform asset retirement activities and an unconditional obligation to stand ready to perform the conditional obligation. Statement 143 did not make that point explicit. Because Statement 143 applies to conditional AROs, the liability must be measured initially at fair value, taking into consideration the uncertainty associated with its conditional component. One conceptual difference between the liabilities within the scope of Interpretations 45 and 47 is that guarantees are contractual liabilities while AROs are legal liabilities, a broader category that includes contractual liabilities.

It is not necessary to layer unconditional on top of conditional. This just adds complexity and may be confusing. For example, using the term unconditional seems to imply a degree of certainty which may not be present. Similarly, it is not necessary, from an accounting standpoint, to distinguish contractual from legal liabilities. Both have the force of law and neither is senior to the other. They may be essentially the same item in many instances, for example, legal reserves for insurance contracts.

22. In June 2005, the IASB issued an Exposure Draft, Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits. The Exposure Draft contains, among others, proposed amendments relating to assets and liabilities with uncertainties. If adopted, those proposals would:

a. Eliminate the term contingent asset from IASB standards and refocus analysis of assets with uncertainties on both the unconditional rights and conditional rights that comprise those assets.
b. Place such dual-right assets within the scope of the IASB’s current standard for intangible assets.
c. Eliminate the term contingent liability from IASB standards and refocus analysis of liabilities with uncertainties on the unconditional and conditional obligations that comprise those liabilities.
d. Refocus the scope of IAS 37 from provisions, contingent assets, and contingent liabilities to nonfinancial liabilities (including those with uncertainties).
e. Omit the probability recognition criterion for nonfinancial liabilities.
f. Clarify the measurement rules of IAS 37.

Unless conservatism is a goal (highly undesirable), then assets should be treated in the same way as
Eliminating the term contingent from IASB standards would be useful if this were a concession that everything is contingent (to some degree). Focusing on uncertainties can be useful if it leads to useful economic measures. Distinguishing conditional from unconditional may not lead to a more uniform or more consistent approach to asset or liability valuation.

Omitting the probability recognition criterion is a good thing generally since it use interferes with contingent measures.

The IASB standard for intangible assets should employ an approach consistent with that for tangible assets. The same applies to FASB. Today’s intangible assets are tomorrow’s cash flows and fully satisfy the “probable future benefits” definition. There should be a symmetrical treatment of intangible assets and liabilities but even the term “intangible liability” makes a mockery of any semblance of symmetry or balance.

Unfortunately the treatment of tangibles and intangibles is deficient under both sets of standards. In each case intangibles are recognized only when business combinations are formed. Generally, when a company is purchased, its purchase price reflects economic realities, the company fair value, if you will. The accounting at this stage is changed and made to conform to the economics. Obviously, it did not previously conform. This is a major failure of the current accounting implementations. Admittedly the purchase price or cost (or revalued amount if there is an active market) has the advantage of auditing convenience of an observable cost. But reporting observed costs is less useful (see AIMR) and excludes the economic value of most intangible assets.

AFTF does not have the discontinuity of suddenly recognition of an asset because of a business combination or ignoring assets without observable market values or observed costs. AFTF incorporates intangibles easily, completely and accurately.

23. The above proposals are based on two notions that also are reflected in Interpretations 45 and 47. These notions are:
   a. The existence of an asset or liability should be established before considering recognition and measurement of the asset or liability.
   b. The effects of probability and uncertainty surrounding an asset or liability should be reflected in the asset or liability’s measurement rather than in its recognition.

If the proposals are adopted, IAS 37 and Interpretations 45 and 47 will substantially converge insofar as the liabilities within the scope of the Interpretations are concerned. However, an amended IAS 37 would apply to all nonfinancial liabilities not otherwise addressed in IASB standards, thus extending the two notions to a much broader set of liabilities. In addition, an amended IAS 37 would apply the first notion to assets with uncertainties, a result not found in FASB standards.

I’m not sure what is meant by “The existence of an asset or liability should be established before considering recognition and measurement of the asset or liability”. Does this mean “possibility”, “any probability”, “high probability or certainty”, “past occurrence”, “of accounting materiality”, “of economic significance”, “useful in financial reports”. This a fundamental and important turning point having implications for recognition and measurement. It seems that probabilistic recognition is still lurking.
AFTF is based on PVECF wherein expected values are management expectations, measured and scaled by the capital markets. An AFTF asset or liability achieves existence and is recognized when management expectations are given voice.\textsuperscript{12}

It is not clear whether IAS 37 provides for similar treatment of assets and liabilities; it seems not to. It specifically excludes planned expenditures, even where authorized, from recognition. Thus the decision and the measure of the decision are separated in time.

AFTF measures decisions as expectations and hence decisions are measured when made. This has advantages for shareholders and management.

IAS 37 does not apply to financial liabilities such as insurance liabilities. This and other exceptions or exclusions are an indication of a less than robust accounting standard and accounting model. AFTF is a consistent model with a single recognition and measurement approach.

24. The IASB will redeliberate the proposed amendments to IAS 37 after it has reviewed the comments it receives from constituents. However, because the Exposure Draft represents the IASB's most current thinking on assets and liabilities with uncertainties, the notions and analysis in that Exposure Draft are expected to be relevant to the Boards' deliberations in the conceptual framework project. Therefore, the FASB is inviting comments from its constituents on the Exposure Draft proposals enumerated in paragraph 22.

See the above comments

INVITATION TO COMMENT

25. This Invitation to Comment addresses certain issues in the IASB Exposure Draft. While some of the questions asked here are identical to those in the IASB Exposure Draft, the numbering of questions in this Invitation to Comment does not correspond to the numbering in the IASB's document. The FASB is particularly seeking input on the questions presented below, although comments on any aspect of the issues underlying the questions are welcome.

26. Responses from interested parties wishing to comment on the Invitation to Comment must be received in writing by January 3, 2006. Interested parties should submit their comments by email to director@fasb.org, File Reference No. 1235-001. Those without email may send their comments to the “Technical Director—File Reference 1235-001” at the following address: Financial Accounting Standards Board, 401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116. Responses should not be sent by fax. Questions regarding this Invitation to Comment may be directed to the staff contact, Kevin H. McBeth, at (203) 956-3440.

27. The IASB's Exposure Draft invites comments on the questions posed in that draft. The FASB does not intend to comment on the IASB's Exposure Draft. Responses to this Invitation to Comment will not be treated as comments to the IASB Exposure Draft. Interested FASB constituents are encouraged to read and respond to all or any part of the IASB Exposure Draft by its comment deadline of October 28, 2005.
28. The IASB Exposure Draft proposes to eliminate the term contingent asset from IAS 37, as well as from other standards that use that term. IAS 37 currently defines a contingent asset as a possible asset and explains that a contingent asset arises when it is uncertain whether an entity has an asset at the balance sheet date, but it is expected that some future event will confirm whether the entity has an asset.

Both contingent assets and contingent liabilities should be accorded the same treatment. Different treatment will tilt accounting and will perpetuate the conservative bias that exists in the current accounting implementations. Different treatments may produce inconsistencies or anomalies. For example, related contingent assets and liabilities within the same company should cancel but would not. Currently FASB defines an asset as a “probable future economic benefit” which has a direct liability counterpart. There appears to be more fundamental symmetry in FASB’s approach.

The use of future events to “confirm whether an entity has an asset” does not address the need for anticipatory information based on probability assessments. Economic values are always based on the uncertain future. We cannot approach economic values without confronting the probabilities. This is not as onerous at it may seem since individual uncertain future events at the corporate scale generally become adequately predictable when aggregated, conglomerated, consorted, averaged or reinsured. If management decisions or capital market valuations can be successfully made using estimations then financial reporting can use the same technology. It may seem the easy way out, from an auditing perspective, to await confirmation but the easy way does not add value and does not produce a decision useful or relevant result.

With AFTF management expectations are reliable in that they are exactly what they purport to be. Under uncertainty a failure to meet expectations may mean that management has misjudged, failed to execute, monitor or adjust. It may also mean, in some few cases, that the company had a run of bad luck. For example, home insurers have been hit by an unusual number of hurricanes this season. In any event, performance can be compared to management expectations to insure accountability. Expected cash flows, actual cash flows and actual-to-expected cash flows all play a useful role in AFTF.

29. The IASB’s basis for eliminating the term contingent asset comes in part from the Framework, where an asset is defined as a resource that is currently controlled by an entity as a result of a past transaction or event. Because a contingent asset is not a resource that is currently controlled, but only a possible asset, and because whether it becomes a resource controlled by the entity depends on the outcome of a future event, not a past transaction or event, it does not meet the definition of an asset.

Absolute control of individual outcomes may be missing, but at the corporate scale essential control is generally present, at least to the degree need for relevant financial reporting. In practice, it is not necessary to await the outcome for meaningful control and expectation. If we insist on control that arises from completed outcomes then we revert to a retrospective accounting model. A prospective or anticipatory model is more useful. Today an increasing proportion of assets are intangible assets which only emerge from future transactions or events. These assets do not satisfy some current asset definitions. This problem points to its solution.

30. The IASB also bases its elimination of the contingent asset notion on its current thinking. The IASB has tentatively concluded that in contractual settings, assets may arise only
from unconditional or noncontingent rights and not from conditional or contingent rights. The IASB notes that the existence of a conditional or contingent right implies the existence of an underlying unconditional or noncontingent right, and that unconditional right may be difficult to identify. The unconditional right is a present asset; the conditional or contingent right is only a possible future asset and does not meet the definition of an asset. Therefore, the term contingent asset is confusing, misleading, and should be eliminated.

Within its current accounting framework, the IASB cannot logically cope with the reality and implications of “contingent assets” and wants to eliminate the term. This won’t eliminate the problem.

Actually I don’t like the term “contingent asset” because it is redundant. All assets are fundamentally contingent but this is not the IASB perspective. The IASB wants to assert that no assets can be contingent. The FASB definition of an asset as “a probable future benefit” at least permits expected (contingent) values to be recognized, even if FASB is reluctant to say so.

31. The IASB uses an insurance contract to illustrate the notion of related unconditional and conditional rights. An entity purchasing an insurance contract has two rights: (a) an unconditional right to insurance coverage and (b) a conditional right to reimbursement if an insured loss occurs in the future. The unconditional right to coverage is a present asset; the conditional right to reimbursement is not a present asset, but only a possible future asset.

This example reveals its own fallacy. Suppose, for a moment, that no insurance contract was purchased (let’s assume product liability insurance to provide a real setting) then the IASB would probably require some liability provision for expected liability claims in the absence of insurance. The purchase of insurance is an obvious asset or at least a negative liability. The IASB position would treat insurance versus self insurance differently no matter how economically equivalent they are. The same argument applies even if the insurance payoff is improbable (more contingent), such as with fire insurance. In practice, the product liability insurance asset would probably be allowed by the IASB as a reduction to the company’s expected liability, i.e., only the expected net after insurance liability would be required. Of course the asset should not be counted twice, but it must be counted once.

32. In the Exposure Draft, the IASB reasons that the conclusions it has reached about unconditional and conditional rights in contractual settings should apply in noncontractual settings as well. It gives three examples to illustrate its reasoning.

Why bother to separate contractual liabilities from legal liabilities or prudent liabilities at all? AFTF avoids this rat’s nest by using expectations without regard to origin or characterization.

33. Example 1: An entity has filed a lawsuit against a defendant for damages. The IASB identifies within the lawsuit an unconditional right of the plaintiff to have its claim heard by the courts and a conditional right of the plaintiff to receive compensation from the defendant that is contingent on the decision of the courts. The unconditional right is deemed to be an asset; the conditional right is not.

Why does the IASB concern itself with the unconditional legal right to sue which has no direct economic significance, yet not measure or value the expected compensation which has direct economic importance? Upside-down accounting is just as bad as backwards accounting.

I understand the IASB motivation. It does not want to address difficult valuation issues. But if
accounting is to be relevant it must confront and solve problems and thereby add value to the process.

AFTF directly addresses the valuation issue. Most difficult judgments involve expected values. Under AFTF, company expectations are delegated to management, subject to several disciplines. There are difficult issues but they reside with management. Management willingly trades the responsibility for judgments and decisions for the freedom to make those judgments and decisions. Management expectations become the standard by which management performance is measured, creating an additional discipline to augment other AFTF disciplines.

Present value measures of those expectations are then scaled by the capital markets. The accountant/auditor’s job is to ensure that the measures are properly scaled. This is an exact and unequivocal process, unlike current accounting implementations which allow management and auditors several degrees of freedom.

This division of labor places responsibilities where they belong and makes it possible for accounting to cope with difficult judgments. This adds value to the accounting end-product.

34. Example 2: An entity has applied for an operating license. The IASB classifies the operating license as a conditional right that is contingent on the decision of the awarding authority and does not qualify as an asset. The IASB also identifies an unconditional right to participate in the process of applying for the license that does qualify as an asset.

I would be astonished to see the “the unconditional right to participate in the process of applying for a license” listed as an asset in the Balance Sheet. I wonder whether even the unconditional asset of an awarded license would be a recognized asset, since it is an intangible (of future use, with perhaps no current use to others and with no market value). If so and if approval is likely, would not the applied-for contingent license have an economic value? Management and the capital markets would think so; they would support or encourage application for a license. If accounting doesn’t measure and support management or capital market views or decisions, what is it for?

Accounting should not stand on its head to avoid facing forward.

35. Example 3: An entity is negotiating a contract with a new customer. The IASB views the unexecuted contract as a conditional right that does not qualify as an asset. The IASB also identifies an underlying unconditional right to the economic value of the developing contractual relationship with the customer that does qualify as an asset.

Again a useless position. Consider a company, say Microsoft, whose value resides primarily in the future (some cash and real estate is owned). Most of the economic value (company fair value, if you will) is conditional and depends on such intangible things as: reputation, market share, patents, personnel, portfolio of products, solution integration, corporate culture, structures, knowledge, etc. Until accounting accounts for the conditional it will lack economic relevance.

AFTF is based on the conditional future and is scaled to economic values. AFTF captures intangibles easily and naturally since today’s intangibles are tomorrow’s cash flows.

36. In its discussion of contingent assets the IASB focuses on asset definition, not recognition or measurement. Although the notions of unconditional rights and conditional rights parallel those of unconditional and conditional obligations in Interpretations 45 and 47, their use in the IASB Exposure Draft is intended to refine the determination of when an asset
exists rather than to imply recognition or measurement treatment. If the proposals about assets are adopted, the term contingent asset will be eliminated from IAS 37 and language will be added to IAS 38, Intangible Assets, expanding the realm of intangible assets to include assets comprising both unconditional and conditional rights. Current recognition and measurement rules in IAS 38 will apply to those assets.

Conditional/nonconditional assets, recognition/measurement probabilities, financial/non-financial instruments, tangible/intangible, asset/liabilities, core/non-core, income statement/balance sheet are all examples of unnecessary and counterproductive distinctions. For example, treating assets and liabilities differently is inconsistent, generally introduces conservatism, and destroys information.

Under AFTF such complexities are unnecessary. The resulting simplicity unifies, creating an improved relevance and consistency. For example, there is a single coordinated Statement of Values which replaces both the income statement and balance sheet.

37. For a complete exposition of the IASB’s reasoning with respect to eliminating the notion of a contingent asset, see paragraphs BC7–BC18 of the IASB Exposure Draft (reproduced in the attached appendix).

Question 1: Do you agree with eliminating the notion of contingent asset? If not, why not?

No, assuming that the notion refers to the underlying idea or concept as opposed to the terminology. Only the past is certain. Shareholder value exists only in the uncertain (contingent) future. Reporting to shareholders should be forward-looking and cannot do so ignoring contingent assets (or liabilities). See above discussions.

Question 2: Do you agree with the IASB’s analysis of unconditional and conditional rights in contractual settings, as summarized in paragraphs 30 and 31 of this Invitation to Comment and paragraphs SC10–SC13 of the IASB Exposure Draft? If not, why not?

No. The analysis is a tangled web which ensnares itself. The analysis is smoke. Not at all useful; in fact, counterproductive. See above comments.

Question 3: If you answer yes to Question 2, do you agree that the IASB has appropriately applied the notion and supporting reasoning referred to therein in the analysis of Examples 1–3 in paragraphs 33–35 of this Invitation to Comment? If not, why not?

Why employ philosophical discussions of non-accounting assets while ignoring essential accounting values? Makes no sense.

Question 4: Do you agree with the IASB’s proposal to classify as intangible assets those unconditional rights that are associated with conditional rights and that satisfy the definition of an asset, without shifting the consideration of the uncertainty surrounding the conditional rights from recognition to measurement?

No. Useless. Relevant economic measures are needed.

Contingent Liabilities

38. The IASB Exposure Draft proposes to eliminate the term contingent liability from its
standards. The term contingent liability currently refers to either a possible obligation whose existence depends on a future event (paralleling the idea of a contingent asset) or an unrecognized present obligation. The reason for nonrecognition may be either that an outflow of economic resources to settle the obligation is not probable or that the obligation cannot be measured reliably.

Probabilistic recognition thresholds are of limited value. See above discussion. They are only slightly better than no threshold. They cannot be used with expected values and do not support economic measures. Banishing the term “contingent liability” does not eliminate the concept. Trying to avoid obligations that “cannot be measured reliably” is defeatism and does not add value to the accounting process. The goal of accounting should be to reliably measure all obligations.

AFTF is automatically reliable. It is complete and non-duplicative. There are no obligations (or rights) which are conveniently excluded. See above comments.

39. The IASB’s proposal to eliminate the term contingent liability from its standards is based on reasoning similar to that given for eliminating the term contingent asset. A contractual liability often comprises both an unconditional obligation that meets the definition of a liability and a conditional obligation that may indicate the presence of the related unconditional obligation but is itself only a possible future liability that does not meet the definition of a liability.

While eliminating both contingent assets and contingent liabilities is non-discriminatory, it does not insure balance or accuracy. I doubt that accounting wants to or actually would ignore contingent liabilities. This is hinted at with the qualifying or hedging phrase “that may indicate the presence of the related unconditional obligation.”

40. The IASB uses a product warranty to illustrate unconditional and conditional obligations in a contractual setting. The obligation of the entity issuing the warranty to repair or replace a defective product is a conditional obligation because it depends on whether the product develops a fault and the customer seeks repair or replacement under the warranty. The unconditional obligation is to provide warranty coverage; that is, to stand ready to repair or replace a defective product. When the entity stands ready to repair or replace, it is providing a warranty coverage service that represents an outflow of economic resources. This stand-ready obligation meets the definition of a liability. The conditional obligation or contingency does not determine whether a liability exists; it affects only the amount that will be required to settle the liability.

The IASB should look to the purpose of accounting. The purpose is to provide information useful in making economic decisions. It can do this best by using economic measures. This can’t be done by calling legal rights or obligations accounting assets and then ignoring the expected value of the resulting cash flows.

On one hand, the IASB seems willing to use expected values (those values which are conditioned on a uncertain or probable event). On the other hand it is stated that a contingent event does not determine whether a liability exists. This reasoning is exactly backwards. If a probability or contingency exists then the (unconditional) liability must exist. One cannot have a non-zero probability for a non-existent liability
41. The IASB has extended its reasoning on liabilities from contractual settings to noncontractual settings. For example, if an entity is the defendant in a lawsuit, the contingency is that entity's possible obligation to pay any penalties imposed by the courts. In the IASB's view, this conditional obligation does not meet the definition of a liability. However, it does point to an unconditional obligation (to stand ready to perform as directed by the courts) that does qualify as a present liability.

Management and shareholders are interested in the expected value of such penalties. They are not interested in the theoretical classification of an "obligation to stand ready to perform" as an unmeasured liability. Accounting should measure effects not classify causes.

42. The IASB's reasoning implies that a conditional obligation is always associated with an unconditional obligation in contractual settings. However, that reasoning does not imply that the same relationship always exists in noncontractual settings. The IASB considers as an example an entity that would be required to accept its previously sold products for disposal if a new law to that effect were enacted with retrospective application. The IASB concludes that an unconditional obligation (for example, an obligation to stand ready to accept its sold product for disposal) does not exist. It reasons that only the new law could create such an obligation, and until the new law is enacted, the entity cannot have a present obligation with respect to that law.

This is a strained example. It also is, to a large degree, unpredictable or unforeseeable. Accounting should not contort itself to cope with extreme uncertainty. Accounting can be very useful in measuring in the face of uncertainty, but it cannot eliminate all uncertainty in extremely uncertain situations.

Here there is a quadruple layer of complex analysis. A contingent new law which gives rise to the unconditional obligation which in turn gives rise to a conditional obligation which may be associated with or points to an unconditional obligation. Ignoring the unconditional items and taking the product of the probability of the law passing times the probability of disposal (times the unit cost) gives a reasonable answer, i.e., the unconditional layers are not needed. Expected values require only a single layer of probability, although this probability may be arrived at in a convoluted manner.

One reason for slashing this Gordian knot, at least from the AIFIT accounting perspective, is that confronting uncertainty is not an accounting function but rather a management responsibility. At a recent meeting of current and former SEC commissioners, this issue (accounting judgments) caused much discussion and anguish. A related point emphasized at the meeting was that accountants and accounting firms (only 4 majors left!) are subject to potentially devastating lawsuits due to management actions. With AIFIT the accounting responsibilities are well defined and well limited.

43. The IASB emphasizes that under its proposals, an entity is first required to determine whether it has a present obligation that meets the definition of a liability. If it does, then the entity proceeds to recognition and measurement issues. In other words, recognition and measurement considerations are not used to determine whether a liability exists. In the case of unrecognized present obligations, this reasoning implies that it is inappropriate to describe as contingent something that has already been determined to exist. If a present obligation is not recognized because of recognition or measurement issues, that obligation would properly be described as an unrecognized liability.

If a conditional liability is recognized and measured, does that imply an unconditional liability? The answer is surely "Yes". All conditional liabilities have a causative unconditional liability. So what?
There are myriad liabilities which exist but should not be recognized or whose measure is insignificant, for example, nuclear war.

I doubt that existence can be separated from recognition or measurement issues. For example, the sentence “If a present obligation is not recognized because of recognition or measurement issues,...” seems to be using recognition for existence rather than the sense of financial reporting recognition. It is more practical to define an accounting liability as a recognizable (decision useful) and measurable future cash outflow.

AFTF substantially simplifies the existence/recognition/measurement issue by delegating recognition to management and measurement to the accountant or auditor.

44. A more extensive discussion of the IASB’s reasoning about contingent liabilities is found in paragraphs BC19–BC30 of the IASB Exposure Draft.

Question 5: Do you agree with eliminating the notion of contingent liability? If not, why not?

No. Contingent liabilities (expectations) are the direct path to economic values. They need to be directly approached and measured. The “notion” of contingent liabilities is the essence of liabilities and similarly for assets. The term “contingent liabilities” is redundant and probably should not be used. The definitions of assets and liabilities are converging on expectations (probable rights or obligations) which always involve contingencies so the concept of “contingent liabilities” should not be eliminated. I don’t think this is the real intention, in any event.

Question 6: Do you agree with the IASB’s analysis of unconditional and conditional obligations in contractual settings, as summarized in paragraphs 39 and 40 of this Invitation to Comment and paragraphs BC24–BC28 of the IASB Exposure Draft? If not, why not?

Contractual versus non-contractual is a red herring. It is not the origin of a liability that determines its recognition or measurement. Expected payouts are already discounted with respected to probabilities. The certain (unconditional) or unlikely (conditional) character of a future payout is fully and proportionately recognized within the expected value. In this sense liabilities as expected values have been stripped of their conditional nature. No need for detailed etiological analyses.

Question 7: If you answer yes to Question 5, do you agree that the IASB has appropriately applied the notion and supporting reasoning referred to therein in the analysis of the example in paragraph 41 of this Invitation to Comment? If not, why not?

Probability Recognition Criterion

45. In the event that the proposals to eliminate the terms contingent asset and contingent liability are adopted, the IASB has concluded that the probability recognition criterion used in conjunction with those terms is no longer needed. One of the proposed amendments to IAS 37, therefore, would omit this criterion from the standard.

Dropping the probability recognition criterion or threshold is appropriate since it otherwise interferes with probabilities within expected values. Eliminating contingent assets or contingent liabilities as concepts will perpetuate or even increase the incompleteness of the current FASB and IASB accounting implementations.
46. Currently, IAS 37 specifies that a provision is recognized if it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, with probable being defined as more likely than not. The IASB notes that in many cases, an entity does not need to assess the probability of an outflow of resources to recognize an item because there is little or no uncertainty that settlement of the obligation will require some outflow of resources. This is the case even if there is significant uncertainty about the amount or timing of the outflow.

"More likely than not" seems inappropriately imprecise as part of a definition. It can be taken to mean a probability greater than 50%, but this would both include and exclude too much in unknown proportions. This is not a firm foundation from which to consider uncertain amount or uncertain timing. The recognition threshold, the timing, and amount can be simplified or collapsed into a discount. First, at any particular future time there is either a single possible outcome or multiple possible outcomes. We can multiple the outcome(s) by the probability(ies) of those outcome(s) and add to obtain a single expected outcome at that particular time. This removes or collapses the amount dimension. We can then sum the discounted values of all such expected outcomes for all possible times to obtain a present value. This removes or collapses the time dimension. The discount factors used may involve multiple contingencies as well as interest. These contingencies generally involve probabilities. This is the PVECF technology as described in the FASB publications Present Value Measurements in Accounting, No. 098-A, December 7, 1990 and in The FASB Project on Present Value Based Measurements, an Analysis of Deliberations and Techniques, No. 158-A February 1996. This technology is in wide use supporting financial decisions but not, unfortunately, for accounting statements.

"An entity does not need to assess the probability" for recognition only if recognition and measurement are separate functions. This is generally not the case for traditional accounting.

In AFTF "recognition of value" is a two step process: the recognition of management’s expected values followed by a discount that scales those values to the capital market (economic measure). Management’s expected values may involve probability judgments but this is not an accounting function.

47. For liabilities having both unconditional and conditional obligations, the IASB reasons that the probability recognition criterion is currently being applied to the wrong obligation, that is, the conditional obligation. This treatment is conceptually unsatisfactory because the purpose of a recognition criterion is to determine whether an item that meets the definition of a financial statement element should be recognized in the financial statements. The IASB has determined that in both contractual and noncontractual settings a conditional obligation fails to meet the definition of a liability. Therefore, it is inappropriate to apply the probability recognition criterion, or any other recognition criterion, to the conditional obligation. The IASB also has decided that an unconditional obligation associated with a conditional obligation meets the definition of a liability and always satisfies the probability recognition criterion. Because this criterion is not needed in the case of simple liabilities and the unconditional portion of more complex liabilities, and does not apply to the conditional portion of complex liabilities, the IASB proposes to omit it from the amended standard.

This reasoning is reminiscent of quantum mechanics. The theory may or may not be correct but operates on a different scale from the world of human experience. In the case of the IASB’s conditional/non-conditional analysis the conclusions reached may be correct in a similarly abstract sense. In practice, conditional probabilities (expected values) are necessary and sufficient for a relevant and useful accounting model. The IASB should focus on accounting liabilities, i.e., those liabilities which are
recognized and measured.

Conditional rights and obligations are not IASB assets or liabilities; non-conditional rights or obligations are recognized IASB accounting elements. In contrast, AFTF employs expected cash flows which are contingent and conditional. Expected cash flows are complete and accurate, or at least as complete and accurate as management can make them. The underlying rights and obligations focused on by the IASB have no direct place in AFTF. It is only the expected cash flows arising from those rights or obligations which are recognized within AFTF.

AFTF does not omit obvious resources which are not characterizable as rights or obligations. Hence human resources, intellectual capital, corporate structures, market share, patents, reputation, synergies, product portfolios and other intangibles are measured easily and accurately within AFTF.

48. Omitting the probability recognition criterion from IAS 37 would not mean that every obligation with uncertainty that qualified as a liability under IAS 37 would be recognized as a liability in the financial statements. Recognition criteria other than the probability recognition criterion might apply. However, discontinuing the use of the probability recognition criterion in the case of liabilities is consistent with shifting the consideration of probability and uncertainty from recognition to measurement as exemplified by Statement 143 and Interpretations 45 and 47.

Using probabilities for measurement and not for recognition is a step forward. I'm not sure if the IASB has followed through on the implications of this seed-change. In my opinion probability based measures lead directly to an economic value based accounting model, such has been explored with AFTF.

49. Paragraphs BC36–BC48 of the IASB Exposure Draft discuss in detail the IASB's basis for conclusions on the probability recognition criterion.

Question 8: Do you agree with omitting the probability criterion for recognition of nonfinancial liabilities? If not, why not?

Yes. As explained above, thresholds don’t work.

Measurement

50. Along with proposing to eliminate the term contingent liability and omit the probability recognition criterion for liabilities, the IASB also proposes to amend the language of the measurement requirements of IAS 37 to improve clarity of meaning, increase consistency in application, and facilitate the measurement of stand-ready obligations.

The concept of a “contingent liability” seems useful and shouldn’t be abandoned because a probabilistic recognition threshold is no longer employed. I agree with eliminating the term since it is redundant. In the AFTF world all liabilities and assets are considered contingent since they are only "probable". The IASB should adopt the same perspective if it is converging on expected values.

51. IAS 37 currently requires that a provision be measured at the best estimate of the expenditure required to settle the present obligation or to transfer it to a third party on the balance sheet date. The IASB has concluded that the measurement principle would be more clearly stated by eliminating any reference to “best estimate” and requiring that an
entity measure a nonfinancial liability at the amount that it would rationally pay to settle the present obligation or to transfer it to a third party on the balance sheet date, which is the current description of best estimate in IAS 37.

Again the term “best estimate” is not the culprit. This is a simple understandable phrase within the context of a purposeful accounting model. That’s the real problem. There is no useful purpose identified in the current IASB or FASB accounting models. The IASB approach is very similar to the FASB approach to “fair value”. Both approaches value liabilities (and assets) from the wrong perspective. They are valued from the viewpoint of the counterparty not from the entity’s perspective. This does not support capital market or economic measures and creates a largely irrelevant accounting. The failure of the “fair value” concept has been repeatedly explored. The desire to eliminate “best estimate” and replace it by “fair value” or its equivalent may be an acknowledgement that “fair value” is not the best estimate.

Accounting must consider the purpose of financial reporting and ask and answer such questions as “What is the fair value of a publicly traded company”. AFTF values employ capital market values that at least resemble economic values.

52. The IASB notes that the price of many stand-ready obligations (that is, the unconditional obligation in a liability with both unconditional and conditional components) is not readily observable because that price is embedded in the price of a product. However, the IASB also notes that the amount an entity would expect to pay to settle or transfer the stand-ready obligation would reflect the likelihood, amount, and timing of the expected cash flows related to the associated conditional obligation. Thus, the most appropriate way to measure a stand-ready obligation is to use an expected cash flow estimation technique. The IASB has further determined that an expected cash flow approach is appropriate for measuring liabilities for both a large group of obligations and single obligations.

A stand-ready obligation is defined as an “unconditional obligation in a liability with both unconditional and conditional components” If we make the simple observation that everything is uncertain or “conditional” to a degree then we eliminate the need for the convoluted and often incomprehensible conditional/unconditional distinctions employed by the IASB. Collapsing assets and liabilities along the conditional/nonconditional dimension generalizes the accounting approach. Expected cash flows can be employed more generally, not only to stand-ready obligations. Accounting needs a more unified measurement approach, not the current melange of methods.

“The IASB has further determined that an expected cash flow approach is appropriate for measuring liabilities for both a large group of obligations and single obligations.” “When the provision involves a large population of items, IAS 37 prescribes the use of an expected value approach, which weights possible outcomes by their associated probabilities.” These statements don’t jibe, perhaps because the first statement updates the second?

53. Because of confusion in the past about the use of discount rates in measuring liabilities under IAS 37, the IASB has decided to clarify that when discounting is used to measure a nonfinancial liability, a current discount rate should be used both at initial recognition and subsequent remeasurement of the liability. This is equivalent to a mark-to-market requirement. The IASB also decided to eliminate from IAS 37 the requirement that future amounts be reflected in the measurement of a liability if there is sufficient objective evidence that they will occur. The reason for this decision is the new emphasis on an
expected cash flow approach when market prices are not directly observable. In the expected cash flow approach, the likelihood of future events occurring is reflected in the probability weighting of the cash flows, and the sufficient objective evidence criterion is meaningless.

I agree with this last observation or conclusion.

It is important to use entity specific measures if optimal entity specific decisions are to be supported, whether by management or shareholders or their representatives. To use observable or imputed market values is only appropriate for assets and liabilities expected to be traded in that market. This is the exception and should not guide the rule. It is not an exception to the rule. Entity specific measures easily accommodate market values where appropriate.

Just as entity specific values can and should be used generally, interest can and should be used generally. If the goal is to measure from different time points, then the time-value of money should be used. If the goal is to maximize shareholder value then the shareholder cost of capital is the measurement starting point. For short term cash flows, such as stocks held for immediate trade or immediate liabilities, interest is minor but should be used for consistency.

The new emphasis on expected cash flows is appropriate and most welcome. The use of a discount rate should be carefully considered. The discount rate serves a purpose and that should be clearly identified. In addition, some explicit method of determining a meaningful and unequivocal rate must be developed. The AFTF dual validation produces an appropriate rate, in fact, the appropriate rate.

54. The increased emphasis on an expected value approach in measurement as well as restriction of the use of probability and uncertainty to measurement, rather than recognition and measurement, would substantially converge IAS 37 with the principles of Interpretations 45 and 47. However, the proposed language of IAS 37 precludes recognition of a liability if the liability cannot be measured reliably.

A corporation should be and generally is structured to avoid unreliable liabilities. This can be and is done in a variety of ways: product diversification, hedging, insurance, options, reinsurance, consortiums, health and safety measures, redundancy, geographic spread, actions or plans to avoid or control situations or outcomes. Still there may be situations where unreliable liabilities exist. It is critical that these areas not be swept under the rug. They MUST be recognized and measured at the earliest time. The huge asbestos liabilities are a case in point. Ignoring the liability accounting for decades made the problem and the consequences much worse. If fact the health consequences, bankruptcies, and insurance losses were maximally bad. It may seem convenient from an auditing standpoint to classify difficult items as accounting non-entities but convenience does not add value or relevance.

With AFTF the burden of difficult or unreliable judgments is placed squarely on the responsible, professed and willing experts, namely, management. AFTF accounting has several responsibilities but expertise in an industry, for a particular company, for its environment, or its outlook are not among them. Nor should it be for any accounting system.

55. Details about the IASB’s reasoning relating to the proposed changes in the measurement of nonfinancial liabilities can be found in paragraphs BC77-BC88 of the IASB Exposure Draft.
Question 9: Do you agree with the proposed measurement requirements for nonfinancial liabilities? If not, why not?

Not completely, as explained above.

Appendix A
EXCERPTS FROM BASIS FOR CONCLUSIONS ON PROPOSED AMENDMENTS TO IAS 37

A1. The following are excerpts from the Basis for Conclusions of the IASB Exposure Draft, Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits.

Contingent Assets

BC7 A contingent asset is defined in IAS 37 as a ‘possible asset’. A contingent asset arises when it is uncertain whether an entity has an asset at the balance sheet date, but it is expected that some future event will confirm whether the entity has an asset. For example, the Standard explains that an entity pursuing a claim through legal processes (i.e. a lawsuit), of which the outcome is uncertain, has a contingent asset. Therefore, the lawsuit is not recognised as an asset until it is ‘virtually certain’ that it will result in the realisation of income and can then be regarded as an asset rather than a possible asset.

Both the FASB and IASB accept “probable” rights and obligations in the definition of assets and liabilities. Probable in a statistical sense means expected so that even a very rare event (such as the death of a life insurance policyholder) has an expected value which is the insurer’s probable obligation. Once the possible is discounted for the probability it becomes a legitimate obligation. The value of this obligation may change through time, for example, once the death claim payment is approved and imminent. In this way, there is not a discontinuity when the asset is “virtually certain”, whatever that means.

BC8 The Board considered this example of a lawsuit in the context of a business combination. The Board observed that a lawsuit of an acquiree would have a fair value and would affect the price that an acquirer would be required to pay for the acquiree. However, if the lawsuit was regarded as a contingent asset at the date of the business combination (because it was not virtually certain to give rise to income), the acquirer would not recognise it as a separate asset but would subsume its value into goodwill.

Not a good idea to sweep it under the rug. The sum of all such “goodwill” items must still be confronted. This can only be done by summing individual items.

BC9 The Board noted that in IFRS 3 Business Combinations it had concluded that goodwill satisfies the definition of an asset. Given this conclusion, the Board questioned the analysis of a lawsuit in IAS 37. The Board reasoned that if goodwill is an asset, any item subsumed within that goodwill (i.e. any item for which the acquirer paid a price, but which itself does not qualify for recognition separately from goodwill in accordance with IAS 38 Intangible Assets) must itself also satisfy the definition of an asset in the Framework. The Board noted that the lawsuit would be a specific item within goodwill, for which the acquirer would be required to pay, and therefore concluded that it must be an asset and
Therefore, the Board reconsidered the analysis of the lawsuit in IAS 37 and, to do so, it turned to tentative decisions it had reached in its Revenue Recognition project, particularly its decisions relating to contractual rights and obligations.

In its Revenue Recognition project, the Board noted that contractual rights and obligations can be divided into two types: conditional (ie performance is subject to the occurrence of an event that is not certain to occur) and unconditional (ie nothing other than the passage of time is required to make its performance due). The Board also noted that although unconditional contractual rights and obligations may exist on their own, conditional contractual rights and obligations are accompanied by associated unconditional rights and obligations. The Board tentatively concluded that assets and liabilities arising from contracts derive only from unconditional (or non-contingent) rights and obligations, and not from conditional (or contingent) rights and obligations. This is because a conditional right to future economic benefits is not a resource controlled by the entity. Similarly, a conditional obligation that may result in an outflow of economic benefits is not a present obligation. However, although a conditional right or obligation in a contract does not itself satisfy the definition of an asset or liability, it points to the existence of an accompanying unconditional right or obligation that may satisfy the definition of an asset or liability.

All future cash flows are conditional to some degree by virtue of their being in the future. Similarly, all future cash flows are uncontrolled to some degree. At one extreme, a future cash flow may be well controlled and virtually certain, in which case substantial if not full recognition is suggested. At the other extreme, a future cash flow may very unlikely and uncontrolled, in which case little or no recognition is suggested. In between there should be a continuity of recognition. This range of recognition may be accommodated with expected values or more precisely with the Present Value of Expected Cash Flows (PVECF). Uncertainty and lack of control can both be measured within PVECF. The degree of control can be incorporated within the probabilities which give rise to expected values. A control or lack of control recognition threshold is just as discredited as the probability threshold that the IASB seems willing to abandon. There are other reasons why control is not a useful recognition trigger.

This analysis of conditional and unconditional rights and obligations can be illustrated with an example of an entity that has an insurance contract. Some might describe the entity's asset as the possible reimbursement. However, the entity is entitled to reimbursement only if it incurs an insured loss. Therefore, its right to reimbursement is conditional (or contingent), because something other than the passage of time is required before the entity can benefit from the reimbursement. Because the right is conditional, it cannot satisfy the definition of an asset in the Framework—it is not a present right. However, the insurance contract has given the entity another right, one that is similar to an option on shares of a particular entity. The holder of an option on shares does not own the shares, but the right to buy the shares at a stipulated price and date. The insurance contact grants the entity a similar right, namely the right to insurance coverage, and, as with the rights in an option on shares, this right is unconditional. It is the unconditional contractual right to insurance coverage that satisfies the definition of an asset.

This is an unfortunate example, as analyzed elsewhere.

The Board noted that this analysis of an insurance contract highlights that determining
whether the entity has an asset (i.e., an unconditional right) is independent of the probability of the occurrence of the contingency (i.e., incurring an insured loss). Expressed another way, the contingency does not confirm or establish whether there is an asset, rather it affects the value of the future economic benefits embodied in the asset.

I would have said the opposite: the existence of a contingency (not a probability threshold) clearly establishes the existence of the asset. Furthermore, I would conclude that an accounting asset does not exist without a contingency (non-zero probability). I agree that the contingency affects the value. Recognition is another matter.

BC14 In its Revenue Recognition project, the Board made its tentative decisions about conditional and unconditional rights and obligations in the context of considering contractual rights and obligations. Nonetheless, the Board decided that its analysis of the relationship between conditional and unconditional contractual rights could be applied more widely. In particular, it could be used to refine the analysis of items described in IAS 37 as contingent assets. For example, the Board observed that a lawsuit could be analysed into two rights: the entity’s conditional right to compensation (i.e., conditional upon the outcome of the legal process) and its unconditional right to have its claim for recovery of damages caused by the defendant considered by the courts. In other words, although any compensation that the entity might receive as a result of successfully pursuing its claim is a conditional right, the pursuit of the lawsuit satisfies the definition of an asset.

What is the purpose of such an unconditional asset? It has no measure and will not appear in financial statements. Accounting assets and liabilities must have some quantitative monetary expression.

BC15 The Board concluded that the foregoing would be a better analysis of the lawsuit than that provided by IAS 37. This is because by analyzing transactions into unconditional and conditional rights, it is possible to identify the underlying asset better. In other words, it facilitates addressing the question of whether the entity controls a resource at the reporting date and, hence, has satisfied the definition of an asset. In contrast, an entity applying IAS 37 considers the possible inflow of economic benefits (i.e., the conditional right) and applies a ‘virtually certain’ probability recognition criterion to determine when those possible benefits have given rise to an asset. However, as noted above, a conditional right does not give rise to an asset and, therefore, regardless of the probability of an inflow of benefits, should not be recognised.

Control directly affects the probability of realization: it is part of the measure not a recognition threshold. This is a direct analogy and may be the same thing as the probability threshold, which by IASB’s own analysis and admission is a flawed concept.

BC16 The Board considered some other examples of contingent assets. Two examples are an entity that has applied for an operating licence and an entity that is negotiating a significant contract with a customer with whom it has had no prior contractual relationship. In these two examples, the Board concluded that the operating licence and the contract are conditional rights. This is because the rights are conditional (or contingent) on a future event (i.e., decision of the awarding authority or the customer signing the contract). However, in both cases the entity has an asset. In the case of the licence application, the asset arises from the entity’s unconditional right to participate in
the process of bidding for the licence. In the case of a pending customer contract, the asset arises from the entity's unconditional right to the economic value of the developing contractual relationship.

The “right to participate in the process of bidding for the license” is not an accounting asset and may not even be an asset since it is so ubiquitous. The expected value of the marginal benefit of the applied for license is the accounting asset.

With AFTF the expected value of the license is the PVECF arising from the license. It is valued from the time-point the decision to apply for the license is made. In this way, decisions are both supported (by cost/benefit analysis or equivalent) and visibly valued. Thus management decisions and expectations are made public.

BC17 As a result of analysing items previously described as contingent assets into conditional and unconditional rights, the Board decided to eliminate the term ‘contingent asset’. The Board concluded that the term was troublesome and confusing. As already noted, assets arise only from unconditional (ie non-contingent) rights. Hence, an asset, which embodies an unconditional right, cannot be described as contingent or conditional. Furthermore, because conditional or contingent rights do not by themselves give rise to assets, it is inconsistent with the Framework to recognise them, even if it is virtually certain that they will become unconditional or non-contingent. Therefore, instead of using the term ‘contingent’ to refer to uncertainty about whether an asset exists, the Board decided that the term should refer to one or more uncertain future events, the occurrence (or non-occurrence) of which affects the amount of the future economic benefits embodied in an asset.

I agree that contingencies as probability thresholds should not be used to establish asset existence any more than asset recognition (the two are related). On the other hand a contingent asset (meaning an asset with a non-zero probability) certainly implies the existence of an asset. Why not skip a step and just look at contingent assets. All assets may be considered contingent.

BC18 The Board also decided that it would be more logical to include in IAS 38 the discussion about assets with contingencies. This is because such an asset would be a non-monetary asset without physical form. Hence, if it is identifiable (i.e. if it is separable or arises from contractual or other legal rights) it would, by definition, be an intangible asset. The Board acknowledged that if an intangible asset arising from an unconditional right accompanied by a conditional right is within the scope of IAS 38 and has not been acquired in a transaction, the requirements of IAS 38 impose a high recognition threshold. (If acquired in a business combination or otherwise, the intangible asset is recognised at fair value. Therefore, uncertainty about the conditional right is reflected in the measurement of the asset.) However, the Board decided that it was outside the scope of this project to revisit the requirements in IAS 38.

Today’s intangible assets are tomorrow’s cash flows. They are also today’s expected cash flows or, more precisely, PVECF. The employee work force may be such an intangible (with physical form, by the way) whose value becomes apparent when absent.

Traditional accounting struggles with intangibles, especially how to measure them completely and without duplication. AFTF handles intangibles easily and reasonably accurately.
Contingent Liabilities

BC19 The Board then considered contingent liabilities. The Board observed that in contrast to the definition of a contingent asset, the present definition of a contingent liability includes two notions. The first notion, a possible obligation, is symmetrical with the definition of a contingent asset and arises when the existence of a present obligation at the balance sheet date is uncertain, but some future event will confirm whether the entity has that obligation. The second notion, an unrecognised present obligation, arises when the entity has a present obligation, but that obligation is not recognised as a liability, because either an outflow of economic resources to settle the obligation is not probable or the entity is not able to measure the obligation reliably.

The phrase "... in contrast to the definition of a contingent asset ..." is a bad start. Assets and liabilities need to be treated symmetrically, especially if expected values form the new paradigm, which seems to be the case. An expected value is neutral. Assets and liabilities are two sides of the same coin (liabilities are negative assets). The suggested treatment of assets does not support optimal economic decisions by management, shareholders or their representatives.

Possible obligations

BC20 The Board had previously considered such obligations in the context of a business combination. In IFRS 3, it specified that an acquirer should recognise at the acquisition date the acquiree's contingent liabilities—and hence its possible obligations—if their fair values could be measured reliably.

Why and how contingent assets and liabilities suddenly Big Bang into existence because of a business combination is a mystery. Actually the mystery is what came before and wasn't measured. Of course, there can be synergies suddenly created from business combinations but those aren't the main issue. Most intangible assets recognized upon business combination existed before. Accounting discontinuities are an indication of an incomplete or internally inconsistent accounting model. A complete accounting model has a 360 degree view, looking forward as well as backward. A forward-looking model is anticipatory and naturally avoids major discontinuities.

BC21 In arriving at this requirement in IFRS 3, the Board took the view that the existence of possible obligations in an acquiree point to the existence of present obligations and, therefore, if their fair value could be measured reliably, the possible obligations should be recognised as liabilities. Furthermore, the Board concluded that it was appropriate that an acquiree's possible obligations should be recognised as liabilities as part of the process of allocating the cost of the business combination, because they have the effect of reducing the price that an acquirer is prepared to pay for the acquiree. In effect, the acquirer is paid to assume an obligation by paying a reduced purchase price for the acquiree.

Again the purchase or sale price of a company is an observable market value (fair value) which can't be ignored. But the observable market price of the company's stock is ignored until acquisition. There is no more established or active market than the stock market so why does accounting ignore this well established fair value?

BC22 In the light of its observations about unconditional and conditional rights and obligations
and its conclusions about contingent assets described above, the Board decided that it could refine its conclusions in IFRS 3. It reasoned that its revised analysis of items previously described as contingent assets was also applicable to items previously described as contingent liabilities (possible obligations). The Board also noted that if it refined the analysis of items described as contingent liabilities in IAS 37, there would be no need to specify different requirements for such items in a business combination. Furthermore, all such items would be treated consistently, regardless of whether they are acquired in a business combination or generated internally (subject to the different measurement requirements of IAS 37 and the revised IFRS 3).

This is a pleasant surprise. Removing the discontinuity upon combination is highly desirable. Does this imply that intangibles (internally generated assets) will be assigned an economic or expected value? Seems at odds with what I understood was the IASB position?

BC23 Accordingly, the Board decided to eliminate the term 'contingent liability'. Instead of using 'contingent' to refer to uncertainty about whether a liability exists, the Board decided that the term should refer to one or more uncertain future events, the occurrence (or non-occurrence) of which affects the amount that will be required to settle an obligation.

This is the common use of the word. Contingencies are the probabilistic components of the discount applied to future cash flow. They are commonly used in measuring not in determining existence. Perhaps I agree with the elimination for two reasons: redundancy (all liabilities are contingent) or because the introduction of contingencies (probability and interest discounts) removes the contingent aspect, i.e., the discounted value is an unconditional liability.

BC24 These conclusions mean that, for example, an entity that issues a product warranty has a liability arising from its unconditional obligation to provide warranty coverage over the term of the warranty (i.e., to provide a service). Uncertainty about whether the product will develop a fault, and hence require repair or replacement (i.e., the contingency), relates to whether the entity's conditional obligation to repair or replace the product if it develops a fault will become unconditional. (The entity's obligation to repair or replace the product is conditional because it depends on whether the product develops a fault.) Hence, the contingency does not determine whether the entity has a liability to provide warranty coverage. Rather, it affects the amount that will be required to settle the obligation. Similarly, in the case of an entity defending a lawsuit, the entity has a liability arising from its unconditional obligation to perform as directed by the courts. The contingency relates to the entity's conditional obligation to pay any penalties imposed by the court and affects the amount that will be required to settle the liability.

BC25 The Board's conclusions about the nature of the unconditional obligation in a warranty contract are consistent with the conclusions of the US Financial Accounting Standards Board (FASB) in Interpretation No. 45 Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (FIN 45), although the recognition and measurement requirements of FIN 45 do not apply to product warranties issued by an entity. FIN 45 describes the unconditional obligation as an 'obligation to stand ready to perform over the [contract] term'. Whilst the notion of an obligation to stand ready is derived from FASB Concepts Statement No. 6 Elements of Financial Statements (Concepts Statement 6), the Board decided to introduce the term into IAS 37 because it regards it as a helpful way of capturing the nature of the liability.
BC26 The Board acknowledged that its analysis of unconditional and conditional rights and obligations may appear complex and that some constituents may already have regarded some examples of liabilities arising from unconditional obligations accompanied by conditional obligations (e.g., product warranties) as examples of liabilities. Indeed, the Board noted that many financial liabilities within the scope of IAS 39 Financial Instruments: Recognition and Measurement could be analysed as containing both a conditional and unconditional obligation. However, as noted with assets, the objective of analysing transactions into unconditional and conditional obligations is to assist in identifying precisely the liability in existence at the balance sheet date, rather than relying on an assessment of some uncertain future event to determine whether a liability exists at that date. The Board concluded that if the liability is identified and accounted for, there is no need to identify the two obligations. Nonetheless, the Board observed that in practice the conditional obligation is sometimes the more readily identifiable obligation. Thus it can be used as a pointer to any associated unconditional obligation. Furthermore, the Board noted that it can be important to distinguish between the two obligations because, as discussed below, the probability recognition criterion in the Framework should be applied to the liability (i.e., unconditional obligation) rather than to the conditional obligation.

This last sentence is puzzling since the probability recognition criterion has been abandoned. As noted previously it interferes with the probabilities within expected values. Probabilities affect measures not recognition, assuming a non-zero probability.

BC27 The main difference between the approach in the draft Standard to items previously described as contingent liabilities and that in the current version of IFRS 3 is that an entity is required to determine whether it has a present obligation that satisfies the definition of a liability before considering recognition and measurement. Put another way, the draft Standard does not use either recognition or measurement as a means of resolving uncertainty about whether a liability exists. As discussed in paragraph BC41 below, this is consistent with the Framework. In contrast, in the current version of IFRS 3, the contingent liability itself is recognised, and the measurement of the contingent liability reflects the uncertainty about whether the contingent liability had given rise to a present obligation. Therefore, the approach in the draft Standard places greater emphasis on determining whether the definition of a liability has been satisfied and does not allow recognition of possible liabilities. This is consistent with the overall objective of the second phase of the Business Combinations project in which an acquirer recognises the assets acquired and liabilities assumed at the date control is obtained. The Board also noted that the approach is consistent with recent standards of the FASB on liabilities that have adopted a fair value measurement basis. For example, both Statement No. 143 Accounting for Asset Retirement Obligations (SFAS 143) and Statement No. 146 Accounting for Costs Associated with Exit or Disposal Activities (SFAS 146) prohibit the recognition of obligations that do not satisfy the definition of a liability in Concepts Statement 6.

If we define accounting liabilities as those obligations which are recognizable and measurable then we eliminate the disembodied existence precursor to recognition and measurement. We can safely assume, for example, that a measurable obligation, in fact, exists.
However, although the proposed approach is different from that in IFRS 3, the Board emphasises that its proposals should not be regarded as a reversal of the requirement in IFRS 3 to recognise contingent liabilities. Rather, they should be viewed as a refinement of that earlier decision. Indeed, the Board observed that in most cases there would be no change in obligations recognised in accordance with the existing and proposed revised versions of IFRS 3. This is because some obligations previously described as contingent liabilities were, in fact, unrecognised liabilities and, therefore, will be recognised in a business combination in accordance with the proposed revised IFRS 3. In addition, in many cases, items previously described as possible obligations will be analysed more precisely into two obligations: an unconditional obligation and a conditional obligation. The effect of recognising the liability resulting from the unconditional obligation at fair value in accordance with the proposed revised IFRS 3 would be similar to recognising the contingent liability at fair value in accordance with the existing version. This is because the measurement of the liability will reflect the uncertainty about the conditional obligation.

Ironic that the term “contingent liabilities” continues to be used.

Nonetheless, the Board observed that not all items previously described as contingent liabilities satisfy the definition of a liability in the Framework. This is because some such items contain only a conditional (or contingent) obligation and no unconditional obligation. Therefore, an item that might have been recognised in accordance with the current version of IFRS 3 will no longer qualify for recognition in accordance with the draft Standard or revised version of IFRS 3. For example, the Board considered a scenario in which an entity would be required to take back previously sold products for disposal if a new law were passed (in other words, the new law would have a retrospective effect). The Board noted that until the new law is substantively enacted, the entity would have no present unconditional obligation (unless the entity by its own actions created a constructive obligation before the law was enacted). Hence, the entity would have only a conditional obligation to take back products and, therefore, no liability. Expressed another way, the Board concluded that an entity does not have a stand ready obligation with respect to a possible change in the law. This is because it is the new law that creates new obligations and until the law is substantively enacted those obligations do not exist. Accordingly, an entity cannot have a present obligation with respect to that law.

For the above example, “an entity cannot have a present obligation with respect to that law”. Despite the lack of legal obligation the company must anticipate what might occur. If the proposed legislation is frivolous and unlikely to pass, this probability would be reflected in a small or non-existent accounting obligation. If the legislation is highly likely to pass, a substantial, if not complete, accounting obligation is required. To do otherwise is not prudent from a managerial standpoint and doesn’t disclose significant information to shareholders. Providing timely anticipatory information is the essence of financial reporting, or at least the essence of AFTF. The above IASB position seems strangely at odds with its willingness to embrace expected values.

Unrecognised Present Obligations

Having decided to eliminate the term ‘contingent liability’, the Board considered the notion
of an unrecognised present obligation in IAS 37, which is also described as a contingent liability. As noted above, liabilities arise only from unconditional obligations. Hence, something that is a present obligation cannot be described as being contingent. The Board also noted that there was no need to define liabilities that fail to qualify for recognition because they can be described as unrecognised liabilities. Therefore, the Board does not propose to define such liabilities. Consistently with the current requirements in IAS 37 for contingent liabilities, liabilities that are not recognised in accordance with the draft Standard are required to be disclosed.

"The Board also noted that there was no need to define liabilities that fail to qualify for recognition because they can be described as unrecognised liabilities." But the board did exactly this! And the the board states that they “are required to be disclosed”!

To be candid, the IASB positions are complex and seemingly contradictory and seemingly not in accord with fundamental accounting purposes or principles. This may be partially due to the manner and order in which their ideas are summarized. It may also be due to my inability to appreciate or understand the finer points, in which case, I apologize.

**Probability Recognition Criterion**

BC36 Having refined its analysis of items previously described as contingent liabilities, the Board concluded that it would need to reconsider the probability recognition criterion in IAS 37.

BC37 Paragraph 14(b) of IAS 37 specifies that a provision is recognised ‘if it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation’, ‘probable’ being defined as ‘more likely than not’. The Board noted that in many cases, an entity does not need to make any assessment of the probability of an outflow because there is little or no uncertainty that settlement of the obligation will require some outflow of resources embodying economic benefits, even if there is significant uncertainty about the amount or timing of the outflow. An example is an entity that has an obligation to decommission a nuclear power station.

Does the existence of a contingency (the decommissioning cost) imply recognition and therefore existence? If so we can skip the unconditional existence requirement.

BC38 However, the Board noted that in some other cases application of the probability recognition criterion in IAS 37 was more troublesome. For example, in the case of a guarantee, Example 9 in the Standard explains that a guarantor applies the criterion by considering the probability of having to make a payment under the guarantee. This means that if the guarantee is issued in exchange for a fee, and it is not probable that a payment will be required under the guarantee, the guarantor does not recognise a liability. In the absence of the revenue recognition requirements of IAS 18, the entity would recognise a gain. This accounting is counter-intuitive, because an entity that has been paid to assume an obligation would recognise a gain on initial recognition, followed by losses if payments under the guarantee are made.

This seems to be a probability threshold recognition problem. This has been dispensed with.
The Board acknowledged that in practice many guarantees within the scope of IAS 37 would be recognised because the Standard requires entities to consider recognition by reference to a portfolio (or class) of similar obligations. Thus, although it might not be probable that a payment will arise from a single guarantee, it is probable that some payment will arise in a portfolio of guarantees and, therefore, a liability is recognised. However, the Board decided that resolving a troublesome recognition issue in this way (ie by requiring recognition on a portfolio basis) is conceptually unsatisfactory. It would be better if the probability recognition criterion could be applied consistently for single guarantees and portfolios of guarantees.

Agreed

Having analysed the obligations in transactions such as guarantees and warranties into conditional and unconditional obligations, the Board observed that the probability recognition criterion in IAS 37 is sometimes applied to the 'wrong' obligation. This is because it is applied to the conditional obligation (ie the contingency) rather than the unconditional obligation (ie the contractual stand ready service obligation). For example, in the case of a guarantee, it is applied to the guarantor's conditional obligation to make a payment under the guarantee. Similarly, in the example of a product warranty (Example 1 in the Standard), the criterion is applied to the entity's conditional obligation to repair or replace the product.

The Board concluded that applying the probability recognition criterion to the conditional obligation conflicted with the Framework. This is because paragraph 82 of the Framework describes recognition as 'the process of incorporating in the balance sheet or income statement an item that meets the definition of an element' (emphasis added). In other words, the Framework requires an entity to determine whether a liability exists before considering whether that liability should be recognised. As explained in paragraph BC24, in the case of a guarantee or a product warranty, the liability that is being considered for recognition is the unconditional obligation to stand ready to provide a service over the period of the guarantee or the product warranty. It is not the conditional obligation to make a payment under the guarantee or to repair or replace the product. Hence, the question is whether settlement of the present obligation (ie the unconditional obligation) to provide a service will probably result in an outflow of economic benefits, and not whether the conditional obligation to make a payment or to repair the product will probably result in an outflow of resources.

The probability applied to the unconditional obligation is the measure of the conditional obligation. It certainly is not the measure of an unconditional obligation which has, by definition, a probability of 1. This is always the case since “liabilities arise only from unconditional obligations.” We can and should scrap the conditional/nonconditional analysis. It adds nothing but complexity. The danger with such complexity is that incorrect analyses or conclusions may result.

AFTF may arrive more directly at the IASB's target. With AFTF a liability is defined as a probable future sacrifice. This is in accord with the FASB and IASB definitions. This liability is and is measured as the Present Value of Expected Cash Flows. This liability is an unconditional accounting obligation because the conditional nature of the future cash flows has been removed. In a sense, the AFTF liability is a construct for which existence, recognition and measure are all expressed in PVECF. This is much
like the flip of a coin where the unequivocal and correct number of expected heads is \( \frac{1}{2} \). This is not even a possible outcome but it well serves its purpose. Similarly, expected values exist as unequivocal and recognized expressions of management expectations. The conditional nature of cash flows is removed within the **expected cash flows**. The AFTF present value of expected cash flows further discounts the expected cash flows for the time value of money and other factors that would otherwise be intractable. The result of this process (the *dual validation*) is an economic value as judged and scaled by the capital markets.

The AFTF model unifies and simplifies the accounting model and easily solves most of the difficult problems facing accounting today, including issues relating to assets and liabilities with uncertainties.

**BC42** The Framework articulates the probability recognition criterion in terms of a flow of economic benefits. It also explains that the outflow required to settle a liability can occur in various ways. In particular, it explains that the outflow of resources can be the provision of services. The Board reasoned that because an entity that issues a guarantee or a product warranty has an obligation to provide a service—because it is contractually obliged to honour claims—the outflow of resources that is required to settle this obligation should be regarded as the provision of services over the term of the contract, and not the possible payments under the guarantee or product warranty.

It seems that the IASB is trying to separate the present unconditional liability from the future conditional payments. PVECF does this in a measured way. The **discounted expected payments** are no longer contingent. This does not mean that expected outcomes are certain to be realized only that they are reliable expected outcomes. This is similar to saying “the probability of heads from a coin flip is \( \frac{1}{2} \), an accurate and useful statement.

Under AFTF expected values are recognized as management expectations. They are reliable in that they are what they purport to be. They are subject to several disciplines not the least of which is unequivocal independent measure.

**BC43** Viewing the outflow of resources as the provision of services means that an entity that issues a guarantee or a product warranty satisfies the probability recognition criterion by definition. This is because it is certain that the stand ready obligation would require an outflow of resources in settlement. The assessment of the probability of an outflow of resources is independent of the likelihood of a claim arising under the guarantee or product warranty. In other words, even if it is highly unlikely that a claim will arise, the probability recognition criterion is still satisfied. As noted above, the probability of a claim arising relates to the likelihood of the conditional obligation becoming a present obligation. Accordingly, the Board concluded that the probability of a payment or claim arising under a guarantee or warranty should not determine whether the entity's present obligation to provide a service should be recognised. Rather, the likelihood of claims arising should be reflected in the measurement of that present obligation.

Recognition is weakly related to the probabilities in that a future cash flow with a zero or negligible probability wouldn’t be recognized and a future cash flow with a high probability would be recognized. The probability is more strongly related to the expected value or the economic value and hence should be applied there as a measure. Furthermore, using a probabilistic recognition threshold eviscerates the expected value approach.
The Board's conclusions about the application of the probability recognition criterion in the case of warranties and guarantees are consistent with FIN 45. This Interpretation explains that a guarantor has incurred a liability on issuing a guarantee that qualifies for recognition, even if it is not probable that the specified triggering events or conditions that would cause payments under the guarantee will occur. The FASB concluded that the outflow of resources associated with the unconditional obligation to stand ready to perform over the term of the guarantee is the requirement to 'stand ready to provide services' and not the possible payments required under the guarantee.

I agree that the unconditional obligation is the requirement to "stand ready to provide services" but it seems that the outflow of resources are the payments (discounted for probability, interest and possibly other contingencies). It is strained to consider a provision an "outflow of resources". One could, with less strain, state that a provision is a "retention of resources".

The Board observed that its analysis of the application of the probability recognition criterion to a guarantee or product warranty could be extended to any liability arising from an unconditional contractual obligation accompanied by a conditional obligation. This is because such liabilities arise from the contractual obligation to stand ready to provide a service. For example, an entity that is jointly and severally liable with another entity, but expects that other entity to be responsible for the obligation, is providing a service to the counterparty because the counterparty has the right to look to the entity to honour the obligation (ie the entity is standing ready to honour the obligation). Similarly, a retailer that is obliged, contractually or constructively, to offer refunds to dissatisfied customers is providing a service to its customers because those customers have a right to return their products (ie the retailer is standing ready to accept returns).

"probability recognition criterion"? I thought this had been dismissed. (dismissed below).

The Board then considered liabilities that accompany non-contractual contingent liabilities. As noted above, the Board decided that the relationship between conditional and unconditional contractual obligations could be extended to non-contractual obligations. For example, in the case of a lawsuit, the Board observed that although the penalties that a defending entity might be required to pay are a conditional obligation, the entity has no discretion to do otherwise than perform as directed by the court. Therefore, the Board concluded that the entity also has a present (ie unconditional) legal obligation, namely an obligation to stand ready to pay any penalties awarded by the court. Because the outflow of resources is the standing ready (ie the provision of a service), rather than the possible damages, the Board concluded that the probability recognition criterion is satisfied. It is certain that the entity is obliged to accept any obligation imposed by the court. In effect, the court's ability to impose settlement stands in the place of a contract.

Why is "standing ready" equated with "the provision of a service"?

The Board observed that the above conclusions about the application of the probability recognition criterion mean that in practice the criterion would have no effect in determining whether a liability should be recognised, because in all cases in which an unconditional obligation exists the criterion would be satisfied. Therefore, the Board
Good

BC48 The Board acknowledged that the criterion is derived from the Framework and, therefore, not including the criterion in the Standard might give the impression of inconsistency with the Framework. Indeed, the Board was aware that many of its constituents regard some of its recent Standards as inconsistent with the Framework because they do not contain a probability recognition criterion. However, the Board concluded that there would be no inconsistency. The apparent inconsistency arises only if the conditional or contingent obligation is being considered rather than the unconditional obligation. Having refined the analysis of liabilities in IAS 37 to focus on the unconditional obligation, the Board concluded that it was inevitable that the current interpretation of the probability recognition criterion in IAS 37 would need to be reconsidered. Nonetheless, the revised interpretation is consistent with the Framework. Furthermore, it results in consistent recognition of contractual obligations in accordance with IAS 37 and IAS 39, because the probability recognition criterion in the Framework is being applied in the same way in both Standards. For example, in considering the recognition of an option in accordance with IAS 39, an entity does not consider whether it is probable that the option will be exercised. Rather, the probability recognition criterion is applied to the unconditional obligation.

Only the most convoluted logic can make sense of the last sentence above.

Measurement

BC77 The Board observed that the FASB has adopted a fair value measurement objective on initial recognition of a liability in some of its recent Statements (including SFAS 146). This is because the FASB believes fair value is the most relevant and faithful representation of the underlying economics of a transaction. IAS 37, on the other hand, requires provisions to be measured at the best estimate of the expenditure required to settle the present obligation or to transfer it to a third party on the balance sheet date.
It appears that neither the FASB or IASB positions reflect entity specific (value in use) measures. They are essentially liquidation values which reflect the value or sacrifice of the counterparty. These are not economic value measures and cannot optimally support economic decisions. Fair value or liquidation value are a wrong path for accounting. One only needs to ask the central question “What is the fair value of a publicly traded company?” to see the basic problem. Accounting should not be based on an obvious inconsistency.

BC7a The IAS 37 requirement can be interpreted as being similar to fair value, but the Board acknowledges that the requirement leaves some issues unresolved. The Board concluded that it would be inappropriate to make fundamental changes to the measurement objective of the Standard in this project given the Board’s more far-reaching project on the conceptual framework. Nonetheless, the Board noted that it would be awkward to apply some of the present measurement requirements to stand ready obligations (ie unconditional obligations accompanied by conditional obligations). In addition, the Board was concerned that the measurement requirements are not always consistent and can be interpreted in different ways. Therefore, the Board proposes some amendments to these requirements.

It may be appropriate to soft-peddle some issues pending a more far reaching project, provided and only provided the project is far reaching and not anchored to prior developments.

It seems unbalanced and inconsistent to consider assets and liabilities separately and not equally. AFTF applies exactly the same methods and measures to assets and liabilities. This produces a simpler, more consistent and more unified accounting.

Amount that an entity would rationally pay to settle or transfer the obligation

BC79 The Board concluded that the present explanation of best estimate in paragraph 37 of IAS 37 as ‘the amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time’ should be the measurement objective of the Standard. The Board believes that this phrase sets out a clearer principle for measuring liabilities and is less likely to be misinterpreted than the notion of ‘best estimate’.

“The amount that an entity would rationally pay” seems to be based on expected values (a good approach) but for the wrong entity. The expectations of the counterparty are not the basis for an economic assessment of the entity expectations, prospects or economic values. Furthermore “best estimates” are not necessarily different from expected values or economic measures. It misses the point to banish the term “best estimate”. Note there is a difference between “best estimate” and most likely outcome (the statistical mode).

Use of expected cash flow estimation technique

BC80 The Board noted that in some cases, a stand ready service obligation might be separately priced, for example, in the case of some product warranties. However, the Board noted that in many cases there would be no directly observable market price for such obligations, for example in the case of a disputed lawsuit or a warranty included in the price of a product. The Board noted that in such cases an entity would need to use a
surrogate for measuring the service obligation. The Board noted that the amount an entity would expect to pay to settle the service obligation (ie stand ready obligation) would reflect the likelihood, amount and timing of the expected cash flows attaching to the conditional obligation. Thus, the most appropriate way to measure such an obligation is to use an expected cash flow approach.

The expected cash flow approach is the most appropriate way to measure an obligation, even when a market price is observable. Such a market price may be used as a ceiling or a check on the expected cash flow approach but the market price lacks relevance to the entity (it is, of course, relevant to the counterparty). Another consideration is whether obligations can ever be completely transferred to a third party. For example, a product warranty might not be fully satisfied by the counterparty in which case the purchaser would fall back on the entity. Another example might arise from the failure of a reinsurer. Hence it is not appropriate or prudent to value obligations by market prices when available.

BC81 However, IAS 37 suggests that using an expected cash flow approach is most appropriate for a large population of items. In contrast, it specifies that ‘the individual most likely outcome may be the best estimate of’ a single obligation. Hence, if an entity has a 60 per cent chance of losing a court case at a cost of £1 million and a 40 per cent of winning at no cost, the Standard could be interpreted to require the liability to be measured at £1 million. The Board, however, observed that measuring a liability at the ‘most likely outcome’ conflicts with the principle of measuring liabilities at the ‘amount that an entity would rationally pay to settle the obligation ... or to transfer it to a third party’. The Board reasoned that if management concluded that there was a chance of settlement at no cost, it would not settle the obligation for the maximum amount that might be required. Rather, management would take into consideration the expected value of the potential outcomes. The Board also noted that measuring a liability at its most likely outcome fails to reflect the uncertainty inherent in the obligation. This can therefore result in two obligations with different risks and uncertainties being measured at the same amount.

It is encouraging that the Board’s thinking seems to be converging around expected cash flows. It is not a great leap to adopt expected cash flows more generally, i.e., for all types of liabilities as well as assets. This is the AFTF approach

BC82 Accordingly, the Board decided to emphasise that an expected cash flow approach, which is currently cited as an estimation method that can be used as a basis for measuring liabilities for a large population of items, is also appropriate for single obligations.

As mentioned before single outcomes are more variable. Corporations are formed, in part, to assemble risks (and rewards) so that operations are stabilized by the law of large numbers. Failing that, there are risk management techniques (discussed above) that can be employed. Single outcomes generally should not be a major concern. In the rare cases of irreducible uncertainty, the expected value approach is the best that can be done; this is generally well understood by management and investors. A further point is that the investor can and generally does either diversify enough or employ some hedging to ameliorate and make acceptable individual company risk.

**Discount rate**

BC83 The Board noted that in practice, before IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities was issued, there was some confusion about whether
IAS 37 required a current discount rate to be used both on initial recognition and on subsequent measurement. Therefore, in the draft Standard, the Board decided to clarify that when discounting is used, the rate is a current rate at each balance sheet date. The Board acknowledges that in relation to subsequent measurement of a liability this is different from SFAS 143 and SFAS 146. However, the Board believes that the use of a current rate is both more representationally faithful and consistent with the existing requirements of IAS 37.

The use of a current discount rate reflects the current environment and provides some consistency between initial and subsequent measurement. However, the use of a current spot rate would create overwhelming fluctuations. Reported net income would be buried by even small discount rate changes, assuming net income is sensitive to the balance sheet. Another problem is giving an interpretation or meaning to a current rate. There seems to be little rhyme or reason cited. There appears to be little guidance as to how to determine an “appropriate” rate.

AFTF, in contrast, incorporates a natural and unequivocal discount rate. This rate has several desirable characteristics, not the least of which is relevance to shareholders.

**Future events**

IAS 37 currently specifies that future amounts should be reflected in the measurement of a liability if there is sufficient objective evidence that they will occur. Therefore, for example, in measuring an obligation to clean up environmental contamination, an entity should not anticipate the development of a completely new technology for cleaning up unless that technology is supported by sufficient objective evidence. However, it would be appropriate for the entity to reflect the expected benefits of the effects of increased experience in applying existing technology.

This example seems to emphasize that judgments should be realistic and not self-serving or without a firm support basis. I think it is sufficient to require expected values.

With AFTF management assumes responsibility for expected cash flows and their realization. Failure to meet its own expectations is strictly a management failure. AFTF accounting is essentially unaffected by the accuracy of management projections. On the other hand, the stock will pay a steep price for any management misjudgments or miscues.

The Board noted that this requirement conflicts with measuring obligations using an expected cash flow approach. For example, an entity that is measuring a product warranty obligation with no observable market price would consider the likelihood that claims will occur, and the amount and timing of the cash flows that will be required to meet those claims. Read literally, IAS 37 suggests that the likelihood of future claims arising would be reflected in the measurement of a liability only if there is sufficient objective evidence that they would occur. Accordingly, some (possibly all) of the cash flow scenarios that should be considered in measuring the liability might be inappropriately disregarded.

It would be highly unlikely for a product warranty to produce no claims. The “objective evidence” clearly supports some provision for claims. It is only a matter of determining the “best estimate” for such claims. This would seem to be the expected value of claims. The fact that an expected cash flow is a
contingent future flow does not demote it to objective nonexistence. Nor can a total liability be examined or sliced thin enough to ignore each slice as immaterial. The lack of observable market value also does not diminish the obligation. In my opinion, the example cited is weak and the warranty liability would, in practice, not be “inappropriately disregarded”.

BC86 The Board reasoned that if an expected cash flow approach is used appropriately, there is no reason why an entity should not use assumptions about future events that affect the amount required to settle an obligation, regardless of whether there is ‘objective evidence’ about those events occurring. This is because in an expected cash flow calculation, the likelihood of those events occurring will be reflected in the probability weighting applied to the cash flows. Thus, for example, an entity measuring a clean-up obligation should make assumptions about future changes in technology, as long as the probability weighting applied to those assumptions appropriately reflects the likelihood that the change in technology will occur.

An important observation. Expected values incorporate all contingencies. The actuary is familiar with contingencies affecting outcomes directly or indirectly. The actuary often applies probabilities to cash flows and to the events that lead to or prevent such cash flows. Often such multiple contingencies are incorporated into a total discount which includes interest or is incorporated into the interest discount rate. For example, junk bond cash might be evaluated using default probabilities applied to bond coupons and maturity value or by using a sufficiently high interest rate which implicitly reflects the risk. Admittedly such analyses are complex and rest on assumptions but experts routinely do this work. A company in business should have the expertise to form reasonable business expectations.

The AFTF accounting model has the distinct advantage of not placing the burden of expectations on accounting but rather on management (the willing and delegated experts).

BC87 Therefore, the Board decided to withdraw the requirement for future events that affect the amount that will be required to settle the obligation to be included in the measurement of that obligation only if there is sufficient objective evidence that they will occur. Although some may be concerned that this could result in unrealistic assumptions being used in the measurement of a liability, the Board noted that the measurement requirement in IAS 37 encompasses a settlement notion. This enforces discipline in measuring a liability because an entity is required to consider what a counterparty would demand to assume the liability.

Counterparty prices enforce a discipline but a very weak one. The price a counterparty would charge would generally be higher (ceiling) than the entity expected cost whereas the danger is understatement for which a floor is a stronger discipline. Counterparty prices are only a discipline if “fair value” is the goal. Unfortunately “fair value” is not an entity expected or economic value.

BC88 The Board also decided to amend former paragraph 50 to specify that the effect of possible new legislation should not be reflected in the measurement of a liability. The Board reasoned that if, as discussed in paragraph BC29, there is no obligation until the law is substantively enacted (ie until the new law exists), it would be inconsistent to measure an existing obligation taking into account a possible change in the law. Accordingly, an entity that has an existing legal obligation to clean up contamination in a country in which the government is considering amending the law and requiring a higher standard of clean-up, should treat the change in the law as changing the nature of the
underlying obligation. Therefore, it gives rise to a new obligation rather than changing the amount required to settle the existing obligation.

This “new obligation” approach doesn’t affect the total liability and is a matter or presentation within account records. It is more explicit to separate the liabilities, which maintains a better audit trail, but it may be more difficult, in some cases, to value related or overlapping liabilities separately.

There is a greater issue represented by BC88. Why should an accounting model focus on such a narrow issue in the first place? Detailed prescriptions or proscriptions are not the proper scale of focus for a concept based accounting model. AFTF, in contrast, does not get mired in detail. There are no industry or situation specific rules. Instead AFTF has general methods and purposes to guide financial reporting along the proper path. For example, the expectations concept anticipates the future for any industry or company.

In the following notes reference to essays are to essays by Humphrey Nash. They appear on the website: http://home.sprintmail.com/~humphreynash/index22.htm. References to submissions are submission by Humphrey Nash to FASB. These are available on the FASB website or on file at FASB.

1 A standard is part of a simple, cohesive and consistent set of principles. A standard must not refer to a specific industry or situation. Few of the 150+ FASB statements are standards. It would be a very useful exercise to study the statements to extract the fundamental principles which the statements exemplify.

2 It would be a good idea to distinguish uncertainty from statistical measures such as probability and variance. The result of an honest coin flip may be uncertain but the probability is not uncertain. In a sense the coin flip is maximally “uncertain” (50% chance of head or tail). The result of several coin flips may exhibit some variance (random risk) but again this is statistically certain and measurable. Variance may be a problem in that certain outcomes may be preferred and there may be a risk premium associated with such variance. It is extremely difficult to quantify this risk premium (for example, as an interest discount rate); it may not even be positive (for example, lotteries or even stocks may attract risk seekers). In fact, the risk premium is not a company parameter; it is a function of the shareholder’s risk tolerance, diversification, hedging, knowledge, financial status, etc. AFTF handles this (and other related issues) easily and precisely by observing market prices which implicitly and unassailably express the consensus risk premium.

Most often, however, variance is not the important ingredient; not knowing the underlying probabilities is the larger difficulty. This type of uncertainty is generally irreducible (by diversifying, repetition, hedging etc.). This type of uncertainty requires experience, judgment and courage to overcome and is rightly a management responsibility. It has no place in accounting. Probabilities (expected values), YES. Variance, POSSIBLY. Uncertainty, NO.

3 With AFTF accounting measures are nevertheless disciplined.

4 The expression of management expectations is a well established and valuable capital market mechanism. Management expectations or “guidance” becomes the standard by which the quality of management is measured. It makes management accountable. AFTF formalizes and extends this mechanism in a natural way using PVECF.

5 For example, if expected cash flows are exaggerated by management then the dual validation forces the discount rate up so that present values are not exaggerated. In this sense expected cash flows are scale-less and measurement is independent of expected cash flows and the underlying probabilities. Note that it is difficult for management to exaggerate cash flows since the cash flow model must be validated and audited. Hence the motivation and ability to exaggerate cash flows is absent. Additionally, AFTF requires the reporting of actual to expected cash flows. The capital markets extract an immediate and steep penalty for failure to meet expectations.

6 The PVECF approach is useful in management decisions. For example, there is (or should be) no difference between AFTF measures and traditional management cost benefits analyses.

7 Under AFTF the cash flow model is validated unequivocally and to the penny. The discount rate (historic cost of capital) is
also precisely auditable. AFTF measures are uniquely determined and rigorously auditable.

8 See the essay Control.

9 I'm reminded of a quote from the AIMR's publication Financial Reporting in the 1990s and Beyond.

"... analysts prefer information that is equivocally right rather than precisely wrong. Inexact measures of contemporaneous economic values generally are more useful that fastidious records of past exchanges."

10 See the essay Fair Value and submissions to FASB on this subject.

11 For example with actively traded short term investments.

12 Management expectations are exactly what they purport to be and hence are completely reliable. They are also highly disciplined within AFTF.

13 See the essay Control.

14 Liabilities are current provisions for future cash flows. The future is contingent. Admittedly liabilities like probabilities can exist without an outcome (for example the probability of flipping heads on a coin) but the purpose of the distinctions made by the IASB seem to serve different purposes (to “require” completeness and avoid certain difficult asset and liability issues).

15 Expectations, in the absence of deliberate bias, are accurate. Even with bias they are reliable; they are what they purport to be, i.e., management expectations. Similarly they are complete, with or without of deliberate omission. One could argue that omission due to lack of knowledge might produce incompleteness retrospectively. But such hindsight is not useful. AFTF scales expectations to economic values so that AFTF financial reporting is immune to imperfect expectations.

16 AFTF is complete and non-duplicative, at least to the extent that AFTF represents economic values as scaled by the capital markets. This is guaranteed by the dual validation.

17 See the essay “Fair Value” and related submissions to FASB.

18 The most secure assets, e.g., US treasuries, are only “highly probable” not unconditional. Treasuries may be affected by such conditions as inflation, devaluations, moratoriums, embargoes, pre-maturity price fluctuations, tax policies, or outright repudiation or default.

19 For financial reporting (to shareholders) the discount rate should be the shareholders required cost of capital.

20 See the essay Control.

21 Market prices have direct meaning to the seller but are not appropriate to the buyer who values the purchase differently.

22 See the essay The Historic Cost of Capital