

Perspective

This is one of a series of articles where experts in assurance, reporting and regulatory matters discuss recent technical and policy developments in these areas.



Confused with terms such as ‘probable’, ‘reasonably possible’ and ‘possible’? You’re not the only one.

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English is an expressive language. But is it necessary for the range of expressions in IFRS relating to “terms of likelihood”, such as probable, reasonably possible and possible, to be so diverse and potentially confusing to interpret?



Terms of likelihood are critical for recognition and measurement judgments. So, helping to ensure that there is consistency in application of terms of likelihood is important to producing high quality financial information to users for decision making. Difficulty in applying these terms might result in lack of comparable financial statements if accounting professionals do not interpret the terms consistently – both within a jurisdiction, and across jurisdictions.

To investigate these issues, the AASB recently completed a joint research project with the Korea Accounting Standards Board to investigate preparers’ and auditors’ interpretations of terms of likelihood used in IFRS. The purpose of the research was to gain an understanding of how terms of likelihood are interpreted by accounting professionals within and between Australia and Korea and to make recommendations to the IASB and other standard setters. The overall findings show there are diverse views on how terms of likelihood are interpreted. However, these findings do not provide an indication of whether these differences in interpretation would lead to materially different financial results.¹

¹ The research was conducted via a survey of Australian and Korean accounting professionals and required a probability quantification (0%-100%) to be applied to 13 terms of likelihood, which were provided with both in no context (e.g. listing of terms) and as the term is used within an IFRS (i.e. in context relating to either a type of asset or liability). The results reflect the input of 88 Australian auditors and 120 Australian preparers, and 327 Korean auditors and 177 Korean preparers. The findings reported in this paper are those of the survey participants and do not reflect the views of the AASB or the KASB.

The research report Accounting Judgments on Terms of Likelihood in IFRS: Korea and Australia (July 2016) can be downloaded from the AASB website at www.aasb.gov.au/Research-Centre/Research-Reports.aspx.

What were the research findings?

Variations in interpretation

Our research finds that there is significant variation in how Australian accounting professionals interpret terms of likelihood. For example, as shown in Table 1, 'reasonably possible' was described as being anywhere between 50% to 73%. This is a considerable range when you consider how the term is applied in IFRS. For example, AASB 7 *Financial Instruments* (incorporating IFRS 7) requires disclosure of a market risk sensitivity analysis showing how performance would have been affected by changes in the relevant risk variable that were reasonably possible at the reporting date – is it clear to all parties which possible movements are a 'reasonably possible' change?

The results of our research also show that Australian accounting professionals tend to be less certain of what a term of likelihood that is obviously *not* at either end of a likelihood scale represents (i.e. the probability range for terms such as 'remote' or 'virtually certain' at the end of a likelihood scale are relatively narrow, but terms such as 'probable' or 'likely' have a considerable range). These findings suggest that, while professional judgment is required when applying principle-based Standards, guidance may be needed to provide clarity so that the intent of the terms of likelihood in the Standards are clear.

Table 1: Range estimate of terms of likelihood²

Table 1 shows the mean probability range ascribed by research participants to terms in the study, when the term was not associated with a specific IFRS requirement.

Terms of likelihood	Australia	
	Minimum %	Maximum %
Virtually certain	91.2	98.3
Substantially all	86.8	97.4
Highly probable	79.6	93.6
Reasonably certain	76.0	91.0
Reasonably assured	75.5	90.7
Probable	60.3	84.5
Likely	60.0	83.6
Reasonably possible	49.7	72.7
Possible	35.3	64.5
Unlikely	9.6	33.3
Highly unlikely	8.9	21.1
Extremely unlikely	4.6	12.0
Remote	3.2	12.1

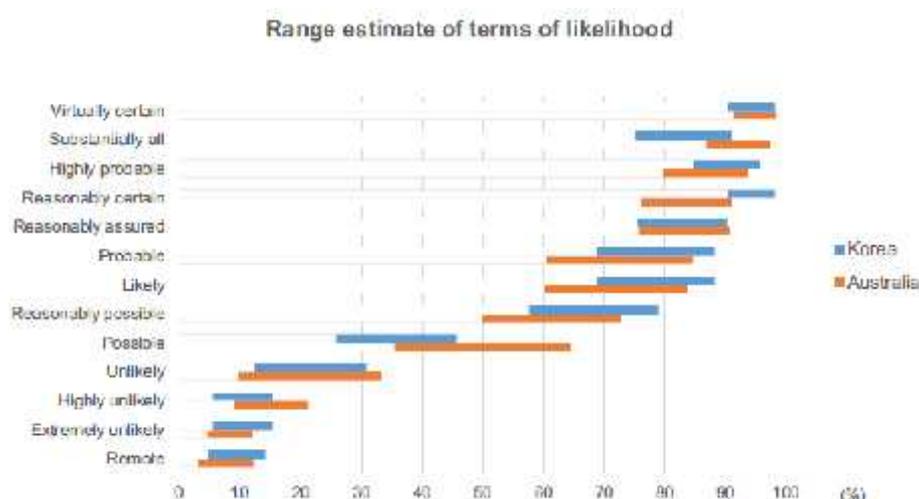
But is diversity in interpreting terms of likelihood an Australian-specific issue, or a global

2 Extract from Table 5 *Range estimate of terms of likelihood – in isolation of IFRS context* in Research Report *Accounting Judgments on Terms of Likelihood in IFRS: Korea and Australia* (July 2016)

one? As reflected in Figure 1, Korean accounting professionals generally associated each term with a narrower probability range compared to their Australian counterparts, suggestive of greater consistency in practice. However, similarly, broader spreads were reported for those terms falling in the middle of the likelihood scale.

Figure 1: Results for range estimate of terms of likelihood³

Figure 1 shows the mean probability range ascribed by research participants from Australia and Korea to terms in the study, when the term was not associated with a specific IFRS requirement.



Perhaps more interestingly, Australian and Korean practitioners have ascribed different probability ranges to terms. One of the most surprising results is that some terms have very little overlap in interpretation. For example, 'possible' has a range of 35% – 65% for Australian respondents, and 26% – 46% for Korean respondents. The findings suggest that it is conceivable an Australian entity is less likely to report contingent liabilities – possible obligations – compared to a Korean entity. Or an Australian entity might possibly continue capitalising borrowing costs for a longer period of time than an equivalent Korean counterpart. However, the study was not designed to assess whether these interpretation differences resulted in materially different assets and liabilities being recognised.

Terminology overlap

In addition, the research shows that some terms of likelihood in IFRS are understood to mean similar things – that is, they could perhaps be used interchangeably without any change in the intent of the standard-setter. For example, the findings in Figure 1 (and Figure 2) suggest the terms 'extremely unlikely' and 'remote' would generally be considered to mean the same thing in practice, as is 'probable' and 'likely'.⁴ One of the key recommendations to the IASB is to consider reducing a number terms of likelihood used in

³ Source: Figure 17 *Range of terms of likelihood by Korean and Australian accounting professionals* in Research Report *Accounting Judgments on Terms of Likelihood in IFRS: Korea and Australia* (July 2016).

⁴ A further test in the study considered whether there was any statistically significant difference between terms.

future IFRS.

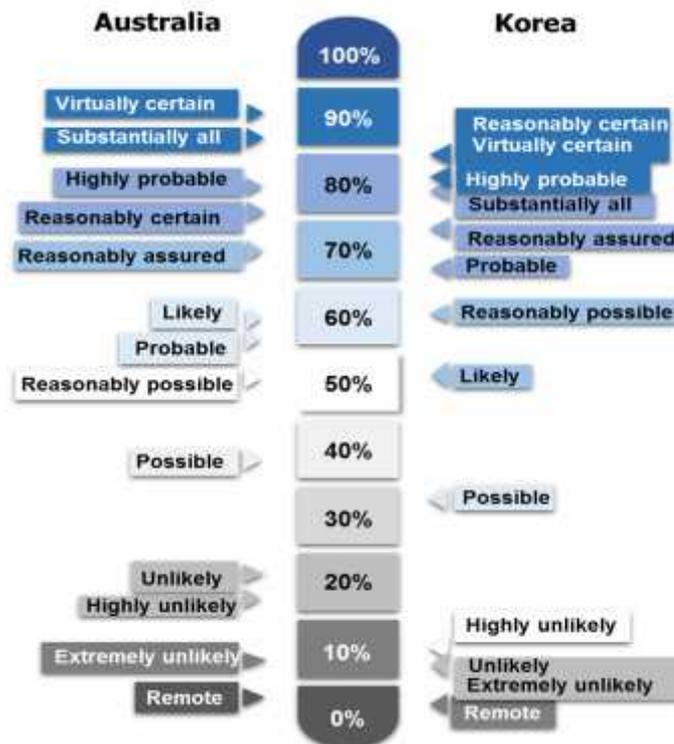
Different ranking and probability assigned to terms of likelihood

When asked to rank terms of likelihood, our research found that Australian accounting professionals rank various terms of likelihood differently to Korean peers (Figure 2). For example, 'substantially all' means something more than 'highly probable' to an Australian – while a Korean practitioner may consider them in a reverse manner.

Are the findings suggestive that Australian practitioners could be more aggressive than Korean counterparts in recognising assets and liabilities? It would be interesting to test these results in practice; for example, whether Australian entities are more likely to recognise deferred tax assets for unused tax losses compared to other jurisdictions.

Figure 2: Results for hierarchy and numerical probability of various terms of likelihood⁵

Figure 2 shows the mean probability ascribed by survey respondents to terms of likelihood when asked to evaluate the term as it is used in a specific IFRS paragraph (e.g. 'virtually certain' was provided in a given paragraph, i.e. para. 33 of IAS37).



Would you have ranked the terms differently?

⁵ Source: Table 4 Interpretation of terms of likelihood – in IFRS context in Research Report Accounting Judgments on Terms of Likelihood in IFRS: Korea and Australia (July 2016)

Our research also found that, in practice, that terms of likelihood appear to be interpreted differently in different contexts. For example, when the term 'probable' is used in the context of recognising an asset (e.g. an AASB 138 intangible asset), the study shows both Australian and Korean accounting professionals are more likely to apply a higher hurdle in comparison to when the term is used for liability recognition (e.g. a provision in accordance with AASB 137).⁶ This implies that accounting professionals – consciously or otherwise – apply conservatism when interpreting terms of likelihood, and highlights the challenge ahead for accounting professionals in applying the Conceptual Framework concept of neutrality.

Implications of the research

It is evident that accounting professionals differ in how they assess terms of likelihood, both within and across jurisdictions. This could be because of language, culture, or a host of other reasons.⁷

There are now 119 jurisdictions adopting or using IFRS for all or many of their publicly accountable entities. Consistent implementation of IFRS is imperative to achieve consistent decision-making when applying IFRS, regardless of the practitioner or jurisdiction. The IASB has been very responsive to the issues identified in the study; we are hopeful that future Standards will use a narrower suite of likelihood terms. Unfortunately, it is unlikely that there will be a quick fix on narrowing or eliminating some terms of likelihood in existing IFRS in the near future.

So, what can the Australian accounting professional do?

Communication is key to understanding differences in how terms of likelihood are interpreted. In particular, now that many of the big-ticket International Accounting Standards Board projects have been completed or are nearing completion, one of the challenges for the IASB going forward will be promoting the consistent application and interpretation of IFRS.

Awareness of the differences in interpretations of terms of likelihood is a first step in addressing the issue. It is particularly important to be clear on how terms of likelihood are interpreted when having conversations or discussions about accounting issues related to terms of likelihood (e.g. in the process of preparing financial statements). For example, when personal 'cut-off' judgments for terms of likelihood affect recognition or measurement – or even disclosure – decisions, it may be useful to communicate this with relevant parties. It may be better not to assume others would necessarily draw the same conclusion, even where the other parties may seem to have a similar background and speak the same language.

When accounting professionals from other jurisdictions are involved (for example, in multinational groups), it is important to remember that terms of likelihood in another language may not be directly translatable from English. For example, the English term 'virtually certain' and 'reasonably certain' are both translated into a single Korean term. In the absence of an official IFRS translation, active communication with relevant parties may be necessary to clarify and develop a common understanding of how application of various terms of likelihood affect an entity's general purpose financial statements.

6 See findings reported in Table 8 of the Research Report *Accounting Judgments on Terms of Likelihood in IFRS: Korea and Australia* (July 2016).

7 Drivers of the differences was not a focus of the research.

Perspective

We encourage Australian accounting professionals to keep having the conversation with each other, the regulator and, where appropriate, the AASB. We all need to work together to enhance the quality of financial information in this age of globalisation. The current theme of the IASB is, after all, *better communication*.