GPF Meeting		Agenda reference	**Agenda Paper 5**
Staff Paper		Date	**25 February 2011**

Project	**Cross cutting issues**
Topic	**Measuring uncertain future cash flows**

Meeting objectives

1. Several recent exposure drafts have proposed to require entities to measure assets and liabilities by reference to future cash flows. In some but not all cases, the exposure drafts have proposed that entities should estimate the 'expected value' of the future cash flows, ie take into account all the possible outcomes weighted according to the probability of each occurring.

2. Respondents to the exposure drafts have raised concerns about the proposals for expected value measurements. Because the arguments are similar across the projects, the boards intend to consider them as a cross-cutting exercise.

3. The boards are starting the exercise at their February meeting by comparing the properties of various measures (expected value, most likely outcome etc) to identify the general circumstances in which each measure might be viewed as more suitable than the others. Paper 5A for this meeting contains a slightly updated text of the paper that the IASB and FASB are discussing. We would like to hear your views on its conclusions.

4. Paper 5A is longer than the summaries we usually send you. However, we thought you might find it useful to read the whole paper because it contains simple examples to explain the points it makes. The IASB staff will start the session with a short presentation summarising the main points in the paper.

Summary of conclusions

5. The main conclusions that the IASB staff reach in paper 5A are that:

(a) **expected value** could be the most suitable measure of future cash flows:

(i) if the most relevant measure of the asset or liability is its current value, either in the market or to the entity; or

(ii) if the transactions recur frequently enough that the long-run outcomes will tend towards the sum of the expected values. By measuring the transactions at expected value, the entity avoids a systematic long-run gain or loss on settlement; or

(iii) if investors place importance on the outliers (extreme, relatively unlikely outcomes) and changes in estimates of the outliers, eg if the outliers are large outflows; or

(iv) if other measures would be susceptible to 'cliff edges', eg if the distributions are likely to have two almost equally probable outcomes; or

(v) if the IASB would have difficulty specifying the unit of account.

(b) **'the maximum amount that is more likely than not to occur'** could be the most suitable measure of future cash flows:

(i) if the transactions do not recur frequently enough for their average outcomes to approximate to the long-run average. In most reporting periods, there will a net gain or loss on settlement. Consequently, it is more important to minimise the average gains and losses recognised on individual transactions; or

(ii) if investors do not place importance on the outliers, eg if the outliers are highly uncertain inflows, or outflows that will occur only if they benefit the entity; or

(iii) if 'the maximum amount that is more likely than not to occur' is easier to estimate or less susceptible to estimation error than expected value, eg if the outliers are subject to more estimation uncertainty than the more likely outcomes.

(c) **the individually most likely outcome** is a poor central estimate of distributions that are skewed or have more then one peak. However, it can be easier to estimate than either expected value or 'the maximum amount that is more likely than not to occur'. Consequently, it could be a reasonable proxy for either of those measures in some situations, eg when it can be assumed that the distribution of cash flows is approximately symmetrical about a single most likely outcome.

(d) in some situations, other measures might also be suitable. For example:

(i) **the minimum amount in the range of possible outcomes** might be the most useful measure available if all of the more central estimates are too uncertain to be relevant, ie if there is an extremely high degree of uncertainty about both the upper limit of the range *and* the probabilities of the various outcomes within the range.

(ii) **the midpoint of the range of possible outcomes** could be a reasonable estimate of either the expected value or 'the maximum amount that is more likely than not to occur':

- when it can be assumed that the distribution of cash flows is approximately symmetrical about the midpoint of the range; or
- in the absence of *any* evidence of the probabilities of the various outcomes within the range.

Question for forum members
What are your views on the IASB staff conclusions in paper 5A?