



Federal Accounting Standards Advisory Board

July 12, 2006

TO: Members of FASAB

FROM: Penny Wardlow, Consultant

THROUGH: Wendy Comes, Executive Director

SUBJECT: Conceptual Framework: Elements. Updates – TAB B

NOTE: FASAB staff prepares memos and other materials to facilitate discussion of issues at Board meetings. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

This memo provides an update on outreach related to the exposure draft (ED) of a proposed concepts statement, *Definition and Recognition of Elements of Accrual-Basis Financial Statements*. The memo also includes updates on the elements project of the GASB and on related projects of the IASB-FASB collaboration and the IPSASB.

FASAB Exposure Draft

The ED was released on June 7, 2006, with a comment deadline of August 5, 2006. A public hearing is scheduled for September 27, 2006, during the FASAB's meeting. Staff plans to provide the Board a summary of the comments received before the September meeting. Outreach for the ED has included the following distributions.

1. A press release was emailed with a copy of the ED to representatives of 19 organizations, including AGA, AICPA, FEI, GovExec, Federal Financial Managers Council, Financial Statement Audit Network, CPA Journal, and others. The press release and ED also were emailed to 27 state-level taxpayer organizations and the Government Research Association (GRA) for dissemination to their members or member organizations. GRA has at least one member organization in most states. See **Attachment 1** for a copy of the press release and a list of recipients (total recipients 55).
2. A letter describing the ED and requesting comments was mailed with a copy of the ED to representatives of a wide range of organizations. I have classified these recipients into standard-setting authorities (13), preparers and auditors (148), and

users (45). The preparers and auditors group includes 119 federal government, 20 state and local government, and 9 independent CPAs; the users group includes 27 from the financial community, 5 professional associations (in addition to those included under preparers and auditors), 7 academicians, and 6 other users. See **Attachment 2** for a copy of the letter and a list of recipients (total recipients 206).

GASB Project on Elements

At the March meeting, the FASAB received a staff summary of differences between the FASAB and GASB draft EDs on elements. The FASAB members also received a copy of the draft of the GASB ED that was discussed the GASB's May/June 2006 meeting. At that meeting the GASB tentatively agreed¹ to modify the definitions of assets and liabilities. Assets will be defined as "resources that the entity presently controls." The explanations of the two inherent characteristics (resource and present control), which were previously bulleted in the definition paragraph, will be included as the first sentence of the applicable explanatory sections. Liabilities will be defined as "an entity's present obligations to sacrifice resources or future resources that it has little or no discretion to avoid." This change will broaden the meaning of the term *obligation* to include items that do not require an entity to sacrifice present or future resources, such as an obligation to refrain from certain actions, and would not meet the definition of a liability. As a result, the word "obligation" was changed to "liability" at appropriate places in the draft. With this change the GASB and the FASAB use of the term *obligation* in the same way.

At a previous meeting, the GASB had tentatively concluded that nonexchange transactions can give rise to legal liabilities, but not to constructive liabilities. At the May/June meeting, the GASB tentatively agreed² that there are occasions when nonexchange transactions may give rise to constructive liabilities, although constructive liabilities generally arise from exchange transactions. The GASB also tentatively agreed to add an explanation in the proposed ED that "liabilities resulting from nonexchange transactions arise when commitments to sacrifice resources reach a similar stage of maturity as exchange transactions."

At the July meeting,³ the GASB tentatively reaffirmed its conclusion that constructive liabilities may result from certain nonexchange transactions. The relevant portion of paragraph 20 was retained as follows, with the addition of "generally" (i.e., "generally arise") in the third sentence below:

. . . Liabilities resulting from exchange transactions generally arise when consideration has been exchanged. For example, goods or services have been received in exchange for a promise to compensate the vendor or service provider. Liabilities resulting from nonexchange transactions generally arise when commitments to sacrifice resources or future resources reach a similar stage of maturity. For example, when the entity

¹ Tentative minutes.

² Ibid.

³ Post-meeting telephone conversation with GASB staff.

engages in exchange transactions for goods or services fulfilling the commitment or when the recipient meets eligibility requirements in cases in which direct cash payments are made.

Also at the July meeting, the GASB reviewed a preballot draft of the proposed ED on elements and discussed several issues. The Board tentatively decided that (1) construction in progress meets the definition of an asset and (2) the Board should not modify its previous decision that recognition criteria should not be addressed in the proposed ED on elements. As a result of (2), the GASB did not accept proposals that the Board should include additional information in the proposed ED about the distinction between current and deferred inflows and outflows of resources and a more specific description of the meaning of "current financial resources." No change was made to the GASB's project timetable, which calls for release of the elements ED in August, a comment deadline of November 30, 2006, and release of a final statement in June 2007.

As indicated in Attachment 2 to this memo, a copy of the FASAB ED on Elements and Recognition was mailed to the Chairman of the GASB, as well as to representatives of other standard-setting authorities.

FASB and IASB (International Accounting Standards Board)

As the FASAB is aware, the FASB and IASB are revisiting their conceptual frameworks with a view to updating them and enhancing their usefulness as well as possible convergence. The effort has eight phases:⁴

<u>Phase</u>	
A	Objectives and qualitative characteristics
B	Elements and recognition
C	Measurement
D	Reporting entity
E	Presentation and disclosure, including financial reporting boundaries
F	Framework purpose and status in GAAP hierarchy
G	Applicability to the not-for-profit sector
H	Entire framework.

The Boards issued a joint preliminary views (PV) document on *Objectives and Qualitative Characteristics* on July 6, 2006, with a comment deadline of November 3, 2006. The current plan is to issue a joint ED in 2007, after consideration of the comments received on the PV and redeliberation by the Boards. Currently, the release of joint PV documents on, respectively, the elements and recognition phase and the reporting entity phase is estimated for the second quarter of 2007. The remaining phases have not yet reached the stage of board deliberations.

⁴ FASB/IASB Project Updates: Conceptual Framework—Joint Project of the IASB and FASB, revisions as of July 7, 2006.

The most recent joint FASB/IASB meeting on the elements and recognition phase was held in April. At that meeting, the boards agreed to the following working definitions of assets and liabilities and their three essential characteristics:⁵

An asset is a present economic resource of an entity and its characteristics are:

- (a) there is an underlying economic resource;
- (b) the entity has rights or other privileged access to the economic resource; and
- (c) the rights or other privileged access exist at the financial statement date.

A liability is a present economic obligation of an entity and its characteristics are:

- (a) the entity is obligated to act or perform in a certain way (or refrain from acting or performing);
- (b) the obligation exists at the financial statement date; and
- (c) the obligation is economic – it is an obligation of the entity to provide its economic resources to others, or to stand ready to do so.

At the same meeting in April, the Boards agreed to consider all aspects of the measurement portion of the conceptual framework in one phase (Phase C), rather than considering some aspects as part of Phase B as previously intended.

At the June 20 FASB meeting and the June 22 IASB meeting, the Boards separately analyzed the applicability of the April working definition of an asset to two situations: a forward contract between a farmer and a canner for corn, and an entity's own shares. With regard to the forward contract, the Boards concluded that:⁶

1. The economic resources are the promises in the contract; the canner's economic resource is the farmer's promise to deliver corn at the agreed price, and the farmer's economic resource is the canner's promise to take delivery of the corn and to pay the agreed price. In this situation, the economic resource is not the corn.
2. The canner and the farmer are connected to their economic resource – the promises they received – by means of contractual rights that provide each with the means to control and benefit from their economic resource.
3. The economic resources and the rights to the economic resources both exist during the period the contract is outstanding.

Thus, the canner and the farmer both have assets. Subsequent parts of the conceptual framework project will assess whether assets are recognized and how they are measured and presented.

⁵ IASB *Update*, April 2006.

⁶ FASB minutes, June 27, 2006.

The Boards concluded that an entity's own shares (unissued shares and treasury shares) are not assets because the essential characteristics of an asset are not met. "There are no promises with external parties – no one will require actions (or inactions) to be taken."⁷

The IASB proposes to continue discussion of an asset definition at its July 18 meeting. The staff paper for that meeting provides a working draft of a definition (and amplifying text) which appears to be similar in substance to the April definition. The asset characteristics are followed by the clarification that "All three characteristics must be met for an item to meet the definition of an asset. That is, each characteristic is a *necessary condition* and, collectively, they constitute a *sufficient condition* for an item to be an asset."⁸ The staff paper does not address when an asset should be recognized. A cover letter indicates that recognition is a separate topic and will be addressed later in 2006. Similar to the FASAB's conclusion, the IASB staff cover letter indicates that ". . . conclusions reached as to what meets the definition of an asset do not necessarily mean that all assets (as defined) will be recognized in financial statements." A footnote adds that the staff's view is that "any recognition criteria would most likely be limited to practical considerations."⁹

The same cover letter indicates that discussion of a liability definition will continue at the IASB's September meeting. However, the staff includes the following proposed definition that appears to differ from the April definition, primarily in the absence of a reference to an entity having an obligation to stand ready to provide economic resources to others.

A liability is a present economic burden for which an entity is presently obligated.

A liability of an entity has three essential characteristics:

- a. There is an economic burden
- b. The entity is obligated to meet the economic burden.
- c. The economic burden and the obligation both exist at the financial statement date.

There is no discussion of the reason for the changes from the April definition. However, the staff invites members' comments. The package of materials includes an appendix with other standard setters' current definitions of assets and liabilities, including the FASAB's proposed definitions in its ED on Elements and Recognition.

The next joint meeting of the FASB and the IASB will be in Norwalk, CT in October.

The IASB also has begun redeliberations of its ED proposing an amendment of IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, following the receipt of respondents' comments. As the FASAB is aware, IAS 37 is not a concepts statement but a standard, as will be the amendment. However, it includes concepts such as recognition criteria and uncertainties associated with assets and liabilities. The FASAB circulated a copy of the

⁷ Ibid.

⁸ IASB staff Agenda Paper 3a, Memorandum 30A, page 6, emphasis in the original.

⁹ IASB staff cover letter for Information for Observers for IASB meeting of July 18, 2006.

proposed amendment within an Invitation to Comment on *Selected Issues Relating to Assets and Liabilities with Uncertainties* issued in September 2005, indicating that comments on the proposals in the IASB's ED related to probabilities and uncertainties could enlighten the FASB's and IASB's deliberations on revising their conceptual frameworks. FASAB staff will be alert to information about the IASB's redeliberations of the proposed amendments to IAS 37 that may be relevant to the conceptual issues addressed in the FASAB's ED on Elements and Recognition. As shown in Attachment 2 to this memo, copies of the ED were mailed to the Chairmen of the FASB and the IASB, as well as to other standard setting bodies.

International Public Sector Accounting Standards Board (IPSASB)

In its Update 4 (April 2006), IPSASB indicates that it continues to monitor the IASB-FASB conceptual framework project and papers prepared by national standard setters on that project's implications for the public sector. The IPSASB also announces that it agreed at its March meeting to initiate a project to develop a conceptual framework for financial reporting by public sector entities. The Board also agreed "to explore the potential for collaboration with national standards setters and similar bodies around the world on the development of such a framework." In the same Update there is mention of a possible meeting with these organizations at the IPSASB's July meeting (Paris, July 3 through 6) "to establish the scope, content and operating criteria for the project." As of this writing, FASAB staff has no additional information about that proposal or the July meeting, except for the two papers mentioned in the next paragraph. As indicated in Attachment 2 to this memo, a copy of the FASAB's ED on Elements and Recognition was mailed to the Chairman of the IPSASB.

FASAB staff will review for relevance to the FASAB's Elements and Recognition project two papers prepared for the IPSASB's July meeting: "ED – Accounting for Social Policies of Government – Non Pensions," dated May 28, 2006, which includes the proposed ED, and a discussion and possible revisions to an ED on "Social Security Pensions," dated June 13, 2006.