Federal Accounting Standards Advisory Board

Definition and Recognition of Elements of Accrual-Basis Financial Statements

Statement of Federal Financial Accounting Concepts 5

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THE FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD

The Secretary of the Treasury, the Director of the Office of Management and Budget (OMB), and the Comptroller General established the Federal Accounting Standards Advisory Board (FASAB or "the Board") in October 1990. FASAB is responsible for promulgating accounting standards for the United States Government. These standards are recognized as generally accepted accounting principles (GAAP) for the Federal Government.

An accounting standard is typically formulated initially as a proposal after considering the financial and budgetary information needs of citizens (including the news media, state and local legislators, analysts from private firms, academe, and elsewhere), Congress, Federal executives, Federal program managers, and other users of Federal financial information. The proposed standards are published in an Exposure Draft for public comment. In some cases, a discussion memorandum, invitation for comment, or preliminary views document may be published before an exposure draft is published on a specific topic. A public hearing is sometimes held to receive oral comments in addition to written comments. The Board considers comments and decides whether to adopt the proposed standard with or without modification. After review by the three officials who sponsor FASAB, the Board publishes adopted standards in a Statement of Federal Financial Accounting Standards. The Board follows a similar process for Statements of Federal Financial Accounting Concepts, which guide the Board in developing accounting standards and formulating the framework for Federal accounting and reporting.

Additional background information is available from the FASAB or its website:

- "Memorandum of Understanding among the General Accounting Office, the Department of the Treasury, and the Office of Management and Budget, on Federal Government Accounting Standards and a Federal Accounting Standards Advisory Board"
- "Mission Statement: Federal Accounting Standards Advisory Board"

Exposure drafts, Statements of Federal Financial Accounting Standards and Concepts, FASAB newsletters, and other items of interest are posted on FASAB's website at: www.fasab.gov.

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STATEMENTS OF FEDERAL FINANCIAL ACCOUNTING CONCEPTS

This Statement of Federal Financial Accounting Concepts (SFFAC) is the fifth in a series of concepts statements intended to set forth objectives and fundamentals on which financial accounting and reporting standards will be based. The objectives identify the goals and purposes of financial reporting. The fundamentals are the underlying concepts of financial accounting—concepts that guide the selection of transactions, events, and circumstances to be accounted for; their recognition and measurement; and the means of summarizing and communicating them to interested parties.

The Federal Accounting Standards Advisory Board's (FASAB or "the Board") conceptual framework enhances the consistency of standards and serves the public interest by providing structure and direction to federal financial accounting and reporting. The most direct beneficiaries of the FASAB's concepts statements are the Board itself and preparers and auditors of federal financial reports. The statements guide the Board's development of accounting and reporting standards by providing the Board with a common foundation and basic reasoning on which to consider the merits of alternatives. The statements enhance preparers' and auditors' understanding of that common foundation and reasoning and provide valuable guidance for their analysis of new or emerging problems of federal financial accounting and reporting in the absence of applicable authoritative pronouncements.

Knowledge of the objectives and concepts the Board applies in developing standards also should help users and others who are affected by or interested in federal financial accounting and reporting standards to understand better the purposes, content, and qualitative characteristics of information provided by federal financial accounting and reporting. That knowledge should enhance the usefulness of, and confidence in, federal financial accounting and reporting.

Statements in this series describe concepts and relations that will underlie future federal financial accounting standards and practices and in due course will serve as a basis for evaluating existing standards and practices. With issuance of this statement, the series of concepts statements comprises:

- SFFAC 1, *Objectives of Federal Financial Reporting* (includes the qualitative characteristics of information in financial reports)
- SFFAC 2, *Entity and Display*
- SFFAC 3, *Management's Discussion and Analysis*
- SFFAC 4, *Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government*
- SFFAC 5, *Definition and Recognition of Elements of Accrual-Basis Financial Statements*.

Like other pronouncements of the FASAB, Statements of Federal Financial Accounting Concepts remain in effect until amended, superseded, or withdrawn by appropriate action under the Board's Rules of Procedure.

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Executive Summary

Objective of This Statement

Elements of financial statements result from an entity's transactions or other events that affect the entity. Elements are the "building blocks" of financial statements—the broad classes of items from which the statements are constructed. This Statement defines five elements of accrual-basis financial statements of the federal government. Items that meet the definitions also are elements of accrual-basis financial statements of the relevant component entity. The elements are defined as follows:

An ***asset*** is a resource that embodies economic benefits or services that the federal government is able to control.

A ***liability*** is a present obligation of the federal government to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand.

Net position or its equivalent, net assets, is the arithmetic difference between the total assets and total liabilities recognized in the federal government's or a component entity's balance sheet. Net position may be positive (assets greater than liabilities) or negative (assets less than liabilities).

A ***revenue*** is an increase in assets, a decrease in liabilities, or a combination of both from providing goods or services, levying taxes or other impositions, receiving donations, or any other activity (excluding borrowing) performed during the reporting period.

An ***expense*** is a decrease in assets, an increase in liabilities, or a combination of both from providing cash or cash equivalents, goods or services or any other activity (excluding repayments of borrowing) performed during the reporting period.

This Statement establishes two basic recognition criteria that an item must meet to be a candidate for recognition in the body of a financial statement: (1) The item must meet the definition of an element and (2) The item must be measurable, meaning a monetary amount can be determined with reasonable certainty or is reasonably estimable. An item that meets the definition of an element but is not measurable is a candidate for disclosure in the notes to financial statements or as supplementary information.

Meeting the basic recognition criteria is a necessary but not a sufficient condition for recognition. Additional components of a recognition decision are measurement of the candidate for recognition and assessments of the materiality and benefit versus cost of the amount measured. Measurement entails selection of an appropriate attribute, such as historical cost, fair value, or expected value, and application of a measurement method. Measurement may require the use of estimates or approximations and an assessment of the probability that future inflows or outflows of economic benefits or services will result from the item.

This Statement includes a discussion of the effects of uncertainty on financial reporting but does not otherwise address the assessment of probabilities or other measurement issues. The Board intends to address those components of recognition decisions in future pronouncements. In the meantime, this Statement does not change existing standards for assessing probabilities or for selecting the appropriate measurement attribute, which the Board expects will continue to be based on the reporting objectives, qualitative characteristics, and cost-benefit constraints applicable to financial information.

Reasons for This Statement

Questions have arisen about the usefulness of certain definitions of elements in current standards and their applicability to transactions outside the scope of the defining standard, as well as about the absence of definitions of other important elements, such as assets. The Board believes that a concepts statement that defines the elements of federal accrual-basis financial statements and establishes basic criteria for selecting candidates for recognition will be an important part of its conceptual framework. The Board expects this Statement to provide more consistent, useful, and enduring guidance to the Board and its constituents than establishing definitions and recognition requirements standard by standard.

The concepts, definitions, and basic recognition criteria in this Statement will provide a common foundation for distinguishing between items that meet the definitions of elements of accrual-basis financial statements and those that do not, and between items that are candidates for recognition in the body of financial statements and those that qualify only for disclosure in the notes or as supplementary information. The Board therefore anticipates that the guidance in this Statement will enhance the understandability, consistency, and comparability of financial reporting for the benefit of users, preparers, and auditors of the financial statements as well as the Board itself. As a result, the Board expects this Statement to contribute to meeting the government's overall financial reporting objectives of demonstrating accountability and providing useful information, as well as the more specific objectives of assisting users in evaluating a reporting entity's operating performance and stewardship.

Acronyms

ED	Exposure Draft
FASAB	Federal Accounting Standards Advisory Board
SFFAC	Statement of Federal Financial Accounting Concepts
SFFAS	Statement of Federal Financial Accounting Standards

Introduction

PURPOSE OF THIS STATEMENT

1. This Statement of Federal Financial Accounting Concepts (SFFAC) establishes definitions and **basic recognition criteria**[1] for **elements** of accrual-basis financial statements of the federal government and its component entities. The concepts it contains are consistent with the concepts established in earlier SFFACs,[2] which are not superseded or modified by this Statement.

ELEMENTS AND RECOGNITION

2. The term *elements* refers to broad classes of items, such as **assets** and **liabilities**, that comprise the building blocks of financial statements. Components of those broad classes, such as cash, investments, and debt instruments, may meet the definitions of elements but are not elements as the term is used in this Statement. Instead, they are called *items* or by

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[1] Terms defined in the Glossary are printed in **bold-face** type the first time they appear in the text.
[2] SFFAC 1, *Objectives of Federal Financial Reporting*; SFFAC 2, *Entity and Display*; SFFAC 3, *Management's Discussion and Analysis*; and SFFAC 4, *Intended Audience and Qualitative Characteristics for the Consolidated Financial Report of the United States Government*
[3] *American Heritage Dictionary of the English Language*, Fourth Edition (Houghton Mifflin Company, 2000)
[4] *The Concise Oxford Dictionary* (Oxford, U.K.: (Oxford University Press, 1964)
[5] The term *obligation* is used in this Statement with its general meaning of a duty or responsibility to act in a certain way. It does not mean that an obligation of budgetary resources is required for a liability to exist in accounting or financial reporting or that a liability in accounting or financial reporting is required to exist for budgetary resources to be obligated.
[6] As indicated in paragraph 16, for a component entity the other entity could be another component entity. When component entities transact with each other, they are external to each other. Paragraph 14 explains that activity between component entities may result in intra-governmental receivables, payables, and related items that would be reported as elements in the component entities' accrual-basis financial statements, provided they meet the definition of an element and meet all other requirements for recognition Such intra-governmental items would be eliminated in consolidation and therefore would not be reported in the consolidated financial statements of the federal government.
[7] See, for example, SFFAC 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, par. 35 (FASAB, 1996).
[8] The latter distinction is included in FASB Concepts Statement No. 6, *Elements of Financial Statements,* par. 87 (FASB, 1985).
[9] As discussed in paragraph 7, measurement issues, probability assessments, and other components of recognition decisions beyond the basic recognition criteria are not addressed in this Statement. The Board intends to address those issues in future pronouncements. In the meantime, existing standards for those issues continue to apply.
[10] SFFAC 1, par. 156.

descriptive names. This Statement focuses on the broad classes and their characteristics instead of defining particular assets, liabilities, or other items. Notes to financial statements generally are considered an integral part of financial statements, but they are not elements. They serve different functions, including amplifying or complementing information about items reported in the body of financial statements.

3. The elements of accrual-basis financial statements defined in this Statement (paragraphs 17 through 56) are assets, liabilities, **net position**, **revenues**, and **expenses**. The definitions of assets and liabilities derive from the essential characteristics of those elements. The definitions of net position, revenues, and expenses derive from the definitions of assets and liabilities.

4. The terms ***recognition*** and *recognize* refer to the process of formally recording or incorporating an element into the financial statements of an entity. Recognition comprises depiction of an element in both words and numbers, with the amount included in the totals of the financial statements. For an asset or liability, recognition involves recording not only acquisition or incurrence of the item but also later changes in it, including changes that result in removal from the financial statements.

Concepts

RECOGNITION

Basic Recognition Criteria

5. Basic recognition criteria are the conditions an item should meet in order to be a candidate for recognition. The basic recognition criteria established in this Statement are (a) The item meets the definition of an element of financial statements and (b) The item is **measurable**. As used in this Statement, the term *measurable* means a monetary amount can be determined with reasonable certainty or is reasonably estimable.

6. The existence or measurability (or both) of many assets, liabilities, and other elements may not be certain, but the definitions and basic recognition criteria in this Statement do not require certainty. Uncertainty and its effects on financial reporting are discussed further in paragraphs 57 through 60. Conclusions about the existence and measurability of an element may require judgment based on the available evidence.

Additional Components of Recognition Decisions

7. Meeting both of the basic recognition criteria established in paragraph 5 is a necessary but not a sufficient condition for recognition. Additional steps are necessary before a recognition decision can be made. For example, a candidate for recognition needs to be measured. **Measurement** of an item entails the selection of an appropriate attribute to be measured, such as historical cost, fair value, or expected value, and application of a measurement method. Measurement may require the use of estimates and approximations as well as an assessment, in a manner consistent with the attribute being measured, of the probability that future inflows or outflows of economic benefits or services will result from the item. Recognition decisions also incorporate the results of assessments of the materiality and benefit versus cost of recognizing the item measured. Thus, it is possible that an item that meets the basic recognition criteria would not be recognized due to measurement, materiality, or cost-benefit considerations.

8. This Statement establishes the basic recognition criteria for elements but does not address these additional components of recognition decisions. The Board intends to establish concepts and standards for these additional components in future pronouncements. In the meantime, this Statement does not change existing standards for measurement or for assessing probabilities. The Board expects that the selection of an appropriate

measurement attribute in specific circumstances will continue to be based on the reporting objectives, **qualitative characteristics**, and cost–benefit constraints applicable to financial information.

9. An item that meets the appropriate definition of an element is an asset, liability, revenue, or expense, even if it is not recognized in the accrual-basis financial statements because, for example, it is not measurable in monetary units or its amount is not material. Unrecognized elements are candidates for disclosure in the notes to financial statements or as supplementary information.

ENTITY CONCEPT

10. All elements defined in this Statement are defined in relation to the U.S. Government ("federal government" or "government"). That is, an item that meets the relevant definition is an asset, liability, net position, revenue, or expense of the federal government. An item that meets the basic recognition criteria established in paragraph 5 and the additional components of recognition decisions referred to in paragraph 7 is recognized in the consolidated financial statements of the federal government, except when it is eliminated in the consolidation process, as discussed in paragraphs 14 and 15.

11. The federal government is composed of component entities that **control**, manage, or are otherwise accountable for the government's assets and may be authorized to incur liabilities. Component entities include departments, independent agencies, and government corporations, as well as their agencies, bureaus, offices, administrations, corporations, and other organizational units. An item that meets the definition of an element of the federal government is also an element of a component entity. It is recognized in the component entity's accrual-basis financial statements provided it is measurable and meets the basic recognition criteria and the additional components of recognition decisions.

12. Sometimes a question may arise as to which component entity should report a particular item. Typically, a review of the authorizing legislation establishing a government program or activity, the appropriations act funding it, and related federal laws, regulations or other executive issuances clearly identifies one component entity as having a comprehensive relationship to the program or activity. That is, the component entity is responsible and accountable for receiving, controlling, managing, and utilizing government assets or incurring liabilities on behalf of the government in performing operations related to the program or activity. When a component entity has such a comprehensive relationship, the assets and other elements involved should be reported by that component entity.

13. When no component entity has a comprehensive relationship to a government program or activity, the assets and other elements involved should be reported by the component entity most responsible for managing them. For example, if one component entity has acquired and has some control over a government asset but another component entity presently manages and utilizes the asset as part of its routine operations, the second component entity should report the asset. In other circumstances, a component entity's management responsibilities may be limited to, for example, collecting monies owed to the federal government and depositing them in the U.S. Treasury. Although the component entity has no authority or responsibility to retain or use the monies collected, it should report the assets and other elements involved in the collection activity.

14. Some items recognized in the accrual-basis financial statements of component entities are not recognized in the consolidated financial statements of the federal government because they are eliminated in the consolidation process. For example, component entities may exchange services for a fee and recognize the resulting intra-governmental receivables, payables, and related elements in their financial statements. However, intra-governmental items offset each other when the government is viewed as a whole and are eliminated in preparing the government's consolidated financial statements.

15. Appropriations are another example of items reported in the accrual-basis financial statements of component entities but not in the consolidated financial statements of the federal government. For the component entities, appropriations are inflows of **resources** against which the component entity may incur obligations in support of authorized activities. Assuming an appropriation complies with the basic recognition criteria and additional components of recognition decisions, a component entity would recognize the appropriation as an increase in assets and revenues and would recognize the use of the appropriation as an increase in expenses and a decrease in fund balance with Treasury. However, from the perspective of the government as a whole, an appropriation is not a resource flow to the federal government or from the government to a component entity. Rather, it is a budgetary amount that constitutes legal authority for a component entity to incur obligations for specified purposes during specified time periods, and for the U.S. Treasury to liquidate the resulting obligations of the component entity. The actual liquidation will be from cash and other assets of the U.S. Treasury resulting from the inflow of resources from taxes and other financing sources. Therefore, appropriations recognized by component entities are eliminated in the process of consolidation and are not reported in the consolidated financial statements of the federal government.

16. The definitions of elements may refer to *another entity* or *other entities*. For the federal government, these terms describe entities external to the

government, such as foreign, state, and local governments, business enterprises, not-for-profit organizations, and individuals. For a component entity, the terms *another entity* and *other entities* include other component entities of the government as well as entities external to the government.

DEFINITIONS OF ELEMENTS

Assets

<u>Definition of an Asset</u>

17. An asset is a resource that embodies economic benefits or services that the federal government is able to control.

18. The definition of an asset addresses only whether an asset exists. It does not address whether the asset is measurable and, if so, how it should be measured or whether or when it should be recognized in the federal government's or a component entity's balance sheet. Nor does the definition address whether or when the economic benefits or services embodied in an asset will be used. Basic recognition criteria for all elements of accrual-basis financial statements are set forth and discussed in paragraphs 5 through 9. Those paragraphs also indicate that measurement issues and other components of recognition decisions will be addressed in future pronouncements. In addition, paragraph 6 acknowledges the possibility of uncertainty about whether an item meets the definition of an element and the need for judgment based on the available evidence. However, this Statement does not establish a threshold to be assumed in applying judgment.

19. The definition of an asset derives from the nature of assets—that is, their **essential characteristics**. An essential characteristic of an asset is one that is inherent to all assets and, therefore, without it an asset would not exist. Paragraphs 20 through 34 highlight and discuss those characteristics. Also discussed are certain characteristics that are common to many assets but not to all assets. As such, those characteristics are not essential, but they may provide additional evidence that an asset exists.

<u>Essential Characteristics of Assets</u>

20. The federal government needs financial, economic, human, and other resources to help it achieve its mission. In this context, the term *resource* means "a useful or valuable possession or quality of a country, organization or person"[3] or a "means of supplying a want."[4] The government has numerous resources. However, those resources are not assets unless they have the essential characteristics of assets and, therefore, meet the definition of assets in paragraph 17.

21. To be an asset of the federal government, a resource must possess two characteristics. First, it embodies economic benefits or services that can be used in the future. Second, the government is able to control access to

the economic benefits or services and, therefore, can obtain them and deny or regulate the access of other entities.

22. To illustrate the distinction between a resource that is an asset and one that is not, the federal government may obtain economic benefits or services from a resource but be unable to deny or regulate the access of other entities to those benefits or services. If so, the resource is not an asset of the federal government. For example, outer space is a natural resource from which the federal government is able to obtain economic benefits. However, outer space is not an asset of the federal government because the government is unable to deny or regulate the access of others. In contrast, natural resources under federal lands qualify as federal government assets because the government is able to obtain the economic benefits and regulate the access of other entities as provided under federal law. Such natural resources are assets of the federal government even if they are not measurable and therefore are not candidates for recognition in the financial statements.

23. In addition to the two essential characteristics identified in paragraph 21, many resources have other features that help identify them as assets. For example, they may be acquired at a cost and owned by the federal government. However, those features are not characteristics of all assets. Whereas access to economic benefits or services often is obtained through legal ownership of the underlying item of property, legal rights to economic benefits or services can be obtained without ownership of the property—for example, under certain lease arrangements.

24. The federal government's resources often are tangible and exchangeable, and the government often has legally enforceable rights of access to the resulting benefits. But the absence of those features is not sufficient to preclude an item from qualifying as an asset. For example, an intangible resource, such as an easement on property, is an asset if the federal government is able to benefit from it and regulate or deny the access of other entities. A resource may embody economic benefits even though the federal government cannot exchange it or sell it—for example a machine that continues to provide a needed service even though there is no market for the machine. Similarly, the fact that the government's ability to access or use a resource is not legally enforceable does not mean that the resource is not an asset, if the government nevertheless is able to obtain the economic benefits or services it embodies and deny or regulate other entities' access to or use of those economic benefits or services..

Economic Benefits or Services

25. A characteristic possessed by all assets is the ability to provide economic benefits or services. Some sources use the terms *economic benefits* and *services* (or *service potential*) interchangeably. However, as used in this Statement, economic benefits may result in inflows of cash, cash

equivalents, goods, or services to the federal government, whereas the services embodied in an asset may benefit the government in other ways. For example, assets such as public parks, museums, and art galleries often provide recreational, educational, and research opportunities to the public at no charge or for a reduced fee or voluntary contribution, thereby assisting the federal government to achieve its objectives and meet its mission to provide public services.

26. The economic benefits or services that a property is able to provide can be distinguished from the property that embodies them, whether it is tangible or intangible, such as a right. Not all properties embody economic benefits or services and the assumption that a particular type of property will always be an asset is not justified. For example, whereas equipment normally is expected to provide economic benefits or services, sometimes it has become obsolete or unusable and has no scrap value. If so, it no longer embodies economic benefits or services and does not meet the definition of an asset.

27. The economic benefits or services embodied in resources may be shared by the government and another entity through specific arrangements. For example, the government and another entity may enter into a joint venture and share an interest in the resources committed to the joint venture. If so, each party may possess assets comprising its respective share of the resources and any resulting benefits. Similarly, lease agreements unbundle the economic benefits or services embodied in leased property and may, for example, give the lessee the right to hold and use the property and the lessor the right to receive rentals and any residual value. Thus, both parties may have assets corresponding to their respective rights.

Control by the Federal Government

28. The second essential characteristic of an asset is control, which refers to the *ability* of the federal government to obtain the economic benefits or services embodied in a resource and to deny or regulate the access of others. It is possible that the government does not currently exercise control. Nevertheless, as long as the government has the ability to exercise control of the economic benefits or services and to deny or regulate the access of other entities, the item is an asset of the government. In exercising control of the economic benefits or services, the government may, depending on the nature of the resource, hold the resource; exchange it; use it to obtain cash, cash equivalents, goods, or services; exact a price for other entities' use of the economic benefits or services; or use it to settle liabilities. Many resources are subject to certain legal or other external constraints, such as public land subject to preservation requirements. Such restrictions on the use of a resource do not negate the government's ability to control the economic benefits or services embodied in the resource.

29. The ability of the federal government to control access to the economic benefits or services embodied in a resource normally stems from legal rights and may be evidenced by title deeds, contractual agreements, possession, or other devices that protect the government's interests. However, legal enforceability of a right is not a prerequisite to the establishment of control of access to economic benefits or services, because the government may be able to exercise control in some other way.

30. Possession or ownership of a resource normally entails control of access to the economic benefits or services embodied in it, but that is not always the case. Whereas control of access is an essential characteristic of an asset, possession or ownership is not. For example, the government may grant another entity, acting as an agent of the government, physical possession of goods for sale and retain the right to receive the proceeds of sale. The goods are assets of the government because it has access to the economic benefits embodied in the goods. The agent has physical possession of the goods, but they are not the agent's assets because it does not control access to the economic benefits. Also, as discussed in paragraph 27, through a lease arrangement the government may control access to the economic benefits or services embodied in a resource that it does not own.

31. Sometimes the federal government cannot control the economic benefits or services that it obtains from a resource because it cannot deny or regulate the access of other entities. In those circumstances, the resource does not meet the definition of an asset of the federal government. Public goods are an example. Public highways provide economic benefits to the entities that use them. However, they are assets only of the entity that has the capacity to control their use or regulate other entities' access to them by, for example, the use of tolls or other restrictions. Similarly, natural resources, such as air and water do not qualify as assets of the federal government when it has only general access to them along with all other entities, even if the government has incurred costs to help clean the environment.

32. The federal government obtains most of its resources from cash or credit transactions. The government may acquire resources in exchange for other resources or for an obligation to transfer resources or provide services in the future, or resources may result from the exercise of the government's powers, such as, for example, the imposition of taxes, penalties, fines, and forfeitures. Government resources also may result from events such as accretion and discovery.

33. Implicit in the definition and essential characteristics of assets is that the event giving rise to the government's ability to control access to the economic benefits or services embodied in a resource must have occurred. The government's intent or ability to acquire a resource in the future does not create an asset. For the resource to qualify as an asset, the government already must have acquired the resource or otherwise obtained

access to the economic benefits or services it embodies to the exclusion of other entities. For example, the mere existence of the government's power to tax is not an asset because, until the government has exercised that power by imposing a tax and has access to benefits by virtue of completion of a taxable event, no event has occurred to generate resources and there are no resulting economic benefits that the government can control and use in providing programs and services.

34. Once acquired, a resource that meets the definition of an asset continues to be an asset until the government transfers it to another entity or uses it up, or until some other event or circumstance destroys the economic benefits or services previously embodied in the resource or removes the government's ability to obtain them and deny or regulate the access of other entities.

Liabilities

Legal Framework

35. The federal government is governed by and operates within a framework of laws. Thus, a federal liability must have its foundation in law. Some federal liabilities result from discrete actions of the government that are authorized by law but are not explicitly required by law. Examples are liabilities that result from contractual arrangements, including amounts borrowed, amounts owed for purchased goods and services, and liabilities for providing goods or services to entities that have paid for them in advance. Other liabilities flow directly from a law and its implementing regulation that specifically require the federal government to provide assets to another entity. Examples include formula grants and subsidies, claims owed under workers' compensation, and amounts owed for environmental clean-up.

36. Although all federal liabilities have their foundation in law, some liabilities are construed from the totality of the conditions and facts of a particular situation, rather than from specific legal or regulatory requirements. In those circumstances, the government should weigh the totality of the facts of the situation against the definition and essential characteristics of liabilities (discussed in paragraphs 40 through 48) and make an informed judgment as to whether or when a liability has been incurred. Factors that may affect that conclusion include relevant aspects of the legal framework within which the government is constituted, whether the government has an agreement or understanding with another entity concerning the nature and amount of the government's obligation and the timing of settlement, and decisions or actions in previous situations that are relevant precedents.

37. Settlement of a federal liability often is legally enforceable, as is the case, for example, with contracts. However, laws that create or support federal liabilities do not always confer legally enforceable rights on recipient entities. Legal enforceability may provide additional evidence that a liability exists, but it is not a prerequisite.

Definition of a Liability

38. A liability is a present obligation[5] of the federal government to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand.

39. The definition of a liability addresses only whether a liability exists and not how it should be measured or whether or when it should be recognized in the federal government's or a component entity's balance sheet. Basic recognition criteria for all elements of accrual-basis financial statements are set forth and discussed in paragraphs 5 through 9. Those paragraphs also indicate that measurement issues and other components of recognition decisions will be addressed in future pronouncements. In addition, paragraph 6 acknowledges the possibility of uncertainty about whether an item meets the definition of an element and the need for judgment based on the available evidence. However, this Statement does not establish a threshold to be assumed in applying judgment.

Essential Characteristics of Liabilities

40. Similar to the definition of an asset, the definition of a liability is derived from the nature of liabilities—that is, the essential characteristics without which a liability would not exist. A liability of the federal government has two essential characteristics. First, it constitutes a present obligation to provide assets or services to another entity. Second, the federal government and the other entity have an agreement or understanding as to the events that would require the government to settle the obligation. Paragraphs 41 through 48 discuss those characteristics.

Present Obligation

41. As the term is used in this Statement, an obligation is a duty or responsibility to act in a certain way. To have a *present* obligation means that the obligation arose as a result of a past transaction or other event and has not yet been settled. Thus, a present obligation should be distinguished from a mere expression of future intent, such as the government's announcement that it intends to acquire equipment. A present obligation is incurred when the government takes a specific action that commits or binds the government and affects another entity.

42. To meet the first essential characteristic of a liability, a present obligation must entail the provision of assets (cash, cash equivalents, or goods) or services to another entity in the future. For example, the government may have received from another entity goods or services that it has agreed to purchase but has not yet paid for, or it may have agreed to provide assets or services to another entity under certain conditions and those conditions

have been met. In these situations the government has a present obligation to fulfill its commitments, even if the actual provision of assets or services is not required until a later date.

43. As indicated in the previous paragraph, for a present obligation to qualify as a liability of the federal government, two separate entities must be involved.[6] Separate entities must be involved because the same entity cannot be both the recipient of settlement of a liability and the entity with the duty to settle. For example, when the government operates machinery, the government may have an obligation to maintain it. However, the obligation does not qualify as a liability for maintenance because the government cannot have a liability to itself. In contrast, if the government contracts for maintenance from another entity, it may have a liability to that other entity for the price of the maintenance services it has received.

44. To meet the definition of a liability, the federal government's contract or other agreement to provide assets or services to another entity must be based on *existing* conditions, including current law, because an essential characteristic of a liability is that the government has a *present* obligation, even if conditions may change before settlement is due. For example, the Congress may change a law under which the federal government has incurred a present obligation and erase the obligation or otherwise enable the government to avoid settlement. Alternatively, the government may be able in the future to renegotiate the obligation with the payee or recipient of the promised services. However, liabilities and all other elements of accrual-basis financial statements are based on transactions or events that already have occurred. The government's power to change existing conditions does not preclude what otherwise would be a present obligation and recognized as a liability.

Settlement of the Obligation

45. The second essential characteristic of a liability is that the government and the other entity involved have an agreement or understanding concerning settlement. The timing of settlement often is expressed in contracts and other agreements as a specific or determinable date. However, in some cases the parties agree that settlement will be triggered by a specific event or by the demand of the recipient of the assets or services, the timing of which may be uncertain. If the government and the other entity do not have an agreement or understanding concerning settlement and the government is free to decide whether and when to settle the obligation, the government's obligation does not meet the definition of a liability.

46. In addition to uncertainty as to the timing of settlement, many present obligations involve uncertainty regarding the amount of settlement. For example, the amount required to settle the obligation may be contingent on the occurrence or non-occurrence of a future event, such as a decline in market prices. The government nevertheless is obligated to fulfill its

obligation upon resolution of any contingencies affecting the timing and amount of settlement. Uncertainty regarding the amount or timing of settlement is addressed through measurement of the liability.

47. Frequently, the federal government knows before settlement is due which specific entities or individuals will receive settlement. However, such advance identification of specific recipients is not an essential characteristic of a liability. For example, the government may have a long-term disability agreement with federal employees without knowing the identity of each of the employees who ultimately will qualify for payment. The obligation qualifies as a liability if both of the essential characteristics of a liability are present.

48. Once incurred, a liability of the federal government continues as a liability until the government settles it or another event or circumstance discharges it or removes the government's responsibility to settle it.

Net Position, Revenues, and Expenses

49. Whereas the definitions of assets and liabilities derive from the essential characteristics of those items, the definitions of net position, revenues, and expenses derive from the definitions of assets and liabilities. Thus, in assessing whether items meet the definitions of net position, revenues, and expenses, reference should be made to the definitions of their underlying assets or liabilities.

Definition of Net Position

50. Net position or its equivalent, net assets, is the arithmetic difference between the total assets and total liabilities recognized in the federal government's or a component entity's balance sheet. Net position may be positive (assets greater than liabilities) or negative (assets less than liabilities).

51. Entities often subdivide net position in financial reports to provide information about its composition. However, the reported composition and intended interpretation of net position depend on the particular financial reporting model applied and resulting display requirements. As such, a discussion of the meaning of the government's or a component entity's reported net position is beyond the scope of this Statement.

Definitions of Revenue and Expense

52. A revenue is an increase in assets, a decrease in liabilities, or a combination of both from providing goods or services, levying taxes or other impositions, receiving donations, or any other activity (excluding borrowing) performed during the reporting period.

53. An expense is a decrease in assets, an increase in liabilities, or a combination of both from providing cash or cash equivalents, goods or services, or any other activity (excluding repayments of borrowing) performed during the reporting period.

54. The definitions of revenue and expense address only whether those elements exist. The definitions do not address how a revenue or expense should be measured or whether or when it should be recognized in the federal government's or a component entity's financial statements. Basic recognition criteria for all elements of accrual-basis financial statements are set forth and discussed in paragraphs 5 through 9. Those paragraphs also indicate that measurement issues and other components of recognition decisions will be addressed in future pronouncements. In addition, paragraph 6 acknowledges the possibility of uncertainty about whether an item meets the definition of an element and the need for judgment based on the available evidence. However, this Statement does not establish a threshold to be assumed in applying judgment.

55. Existing standards or established practice may indicate that certain inflows and outflows of resources should be reported as gains and losses, rather than revenues and expenses. Use of the terms *gains* and *losses* generally serves to highlight particular features of certain revenues and expenses, such as their unusual or non-recurring nature[7] or their having resulted from peripheral or incidental activities of an entity.[8]

56. The definitions of revenue and expense in this Statement include items that might be reported as gains and losses. Gains and losses are considered subsets of revenues and expenses, rather than distinct elements, just as capital assets and financial assets are considered subsets of assets. Whether certain kinds of revenues and expenses should be reported as gains and losses and, if so, under what circumstances, is beyond the scope of this Statement.

EFFECTS OF UNCERTAINTY

57. Uncertainty about economic activities and results is pervasive and often clouds whether a particular item qualifies as an asset or a liability at the time the definitions are applied. Consequently, some items may not be recognized (although they may be disclosed) because of uncertainty about whether they meet the definition of an element, their measurability, the results of measurement (including the probability of future flows of economic benefits or services to or from the items), the materiality of the measured amounts, or the benefit versus the cost of recognizing them.

58. Uncertainty increases the costs of financial reporting, particularly the costs of recognition and measurement. It may be possible to reduce uncertainty by exerting greater effort or spending more money, but it also may not be worth the added cost. Moreover, as discussed in paragraph 6, this Statement does not require certainty that an item satisfies the basic recognition criteria in order to be considered a candidate for recognition.

59. Uncertainty about whether a transaction or other event gives rise to the existence of an element means that judgment often is required as to whether the item possesses the essential characteristics of an element and therefore meets the relevant definition. Items that are judged to meet the definition of an element are candidates for recognition provided they are measurable—that is a monetary amount can be determined with reasonable certainty or is reasonably estimable. Items that meet the definition of an element but, because of uncertainty, are judged not to be measurable are not candidates for recognition. Conversely, items that, because of uncertainty, are judged not to meet the definition of an element are not candidates for recognition even if they are measurable.

60. As discussed in paragraph 7, decisions whether to recognize or disclose an item include components in addition to satisfying the basic recognition criteria and these components also may include uncertainties. The additional components are measurement of an appropriate attribute, which includes an assessment of the probability of future flows of economic benefits or services, and assessments of the materiality of the item and the benefit versus the cost of recognizing it.[9]

Appendix A: Glossary

Asset: A resource that embodies economic benefits or services that the federal government is able to control.

Basic recognition criteria: The conditions an item should meet in order to be recognized in financial statements.

Control: The ability of the federal government to obtain the economic benefits or services embodied in a resource and to deny or regulate the access of others.

Elements: The broad classes of items, such as assets, liabilities, revenues, and expenses, which comprise the building blocks of financial statements.

Essential characteristic of an asset (or a liability): A characteristic that is inherent to all assets (or liabilities) and, therefore, without it an asset (or liability) would not exist.

Expense: A decrease in assets, an increase in liabilities, or a combination of both from providing cash or cash equivalents, goods or services, or any other activity (excluding repayments of borrowing) performed during the reporting period.

Liability: A present obligation of the federal government to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand.

Net position: Net position or its equivalent, net assets, is the arithmetic difference between the total assets and total liabilities recognized in the federal government's or a component entity's balance sheet. Net position may be positive (assets greater than liabilities) or negative (assets less than liabilities).

Measurable: A monetary amount can be determined with reasonable certainty or is reasonably estimable.

Measurement: The act or process of measuring; a figure, extent, or amount obtained by measuring.

Qualitative characteristics: The basic characteristics that information in financial reports must have in order to communicate effectively with users. These characteristics are understandability, reliability, relevance, timeliness, consistency, and comparability.[10]

Recognition: The process of formally recording or incorporating an element into the financial statements of an entity. Recognition comprises depiction of an item in both words and numbers with the amount included in the totals of the financial statements.

Resource: A useful or valuable possession or quality of a country, organization or person; a means of supplying a want.

Revenue: An increase in assets, a decrease in liabilities, or a combination of both from providing goods or services, levying taxes or other impositions, receiving donations, or any other activity (excluding borrowing) performed during the reporting period.

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