



Federal Accounting Standards Advisory Board

December 14, 2005

TO: Members of FASAB

FROM: Penny Wardlow, Consultant

THROUGH: Wendy Comes, Executive Director

SUBJECT: **Revised Draft of a Proposed Concepts Statement on Elements and Recognition Criteria – TAB B1**

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.

The Elements package for the Board's consideration at the January 2006 meeting consists of the following:

- A. This cover memo.
- B. A memo that discusses the definitions of revenues and expenses of various standard-setting authorities and includes proposed definitions of revenues and expenses for the FASAB's concepts statement. The memo also discusses whether gains and losses, appropriations, and intragovernmental transfers are subsets of revenues and expenses or distinct elements.
- C. An attachment to the memo on revenues and expenses. The attachment lists the definitions discussed in the memo, for ease of comparison.
- D. Two copies of a revised draft of the proposed concepts statement on elements and recognition criteria – a clean copy and a marked-up copy. In the marked-up copy, there are some words missing at the end of the

lengthy “balloon” showing the content of deleted pars. 10 through 13 of the October draft. The missing words are: “the component entity most responsible for managing it.”

This memo comments on the principal changes to the draft proposed concepts statement that the Board discussed at the October 2005 meeting.

1. Ms. Comes has proposed the addition of a sentence in par. 8 and a phrase in par. 9 to clarify that failure to meet the qualitative characteristics or pervasive constraints is one possible reason for not recognizing an item that meets the definition of an element. The additional language does not change the original intent of those paragraphs. It is hoped that the clarification satisfies a concern of Mr. Dacey and Mr. Patton.

2. In October, Mr. Dacey and Mr. Zavada suggested that the issue of which component entity should report an asset or liability be addressed in the definition of an asset or in the discussion following the definition of an asset. There was some discussion also that a reference should be made to liabilities reported by component entities.

Staff has considered the issues and believes that the issue of which component entity should report an asset (or liability) was addressed appropriately in the “Entity Concept” subsection of the “Definition of Elements” section in the October draft. However, a specific reference to liabilities of component units should be added. The intent of the subsection in the October draft was to address the issues of (a) What is the entity in terms of which elements are defined? and (b) How does one know which component entity should report an item that meets the definition of an element? Also, the intent was to address those issues in one place in the draft, rather than separately for each element.

The “Entity Concept” subsection indicated that all elements are defined in terms of the federal government, and that an item that meets the definition of an element of the federal government also is an element of a component entity, with no additional definition needed. Nevertheless, staff believes that there may have been some confusion due to the inclusion in the assets section of the draft of two paragraphs (the former paragraphs 22 and 23) about which component entity may have responsibility for shared assets or when a component entity’s responsibility is narrow.

Staff does not believe that component entities should be specifically named in the definition of assets. They are already included in the definition because the Entity Concept discussion states that “The federal government is composed of component entities . . .” (par. 10 of the October draft and par. 11 of the revised

draft). Therefore, the reference to the federal government in the asset definition already includes component entities. To refer to them separately, in addition to the federal government, in the definition would confuse the issue by apparently contradicting the statement about the composition of the federal government.

Staff proposes the following revisions to clarify the issues.

- a. The discussion of "Entity Concept" should be a section of its own, rather than the first subsection of the section on "Definition of Elements." This change will reinforce the intent that the content of the Entity Concept section applies to all elements of the financial statements. Therefore, in the current draft, "Entity Concept" has been capitalized, to indicate a new section, and the section heading "Definition of Elements" has been moved to the beginning of the assets section (just above par. 16). The previous discussion under Entity Concept has been rearranged and, in places, reworded to improve clarity.
 - b. Pars. 22 and 23 of the October draft (referred to above) have been deleted. The content of these paragraphs is included in par. 13 of the revised draft. Moreover, if an additional reference to component entities' responsibilities is included in the assets subsection, it would need to be included also in the discussions of liabilities, revenues, and expenses. The result could be confusion as well as redundancy and would defeat the intent of covering the issue of component entities for all elements in one place in the draft.
 - c. References to component entities' liabilities (as well as assets) have been included in pars. 10, 11, and 12 of the new draft.
 - d. A reference to the federal government has been included in the liability definition (par. 37), equivalent to the reference in the asset definition (par. 16).
3. Following the discussion of "probability" at the October meeting, and after discussion with Mr. Patton, Ms. Comes has proposed adding a sentence to the end of par. 17 to clarify that pars. 5 through 9 on the recognition criteria "do not establish a threshold to be assumed in applying judgment."
 4. In October, Mr. Mosso suggested including a mention of the government's power to tax and why, in accounting, it is not considered an asset. Language to that effect has been added to par. 32 of the current draft.
 5. In October, some members expressed concern that the wording of the second of two example transactions that result in a present obligation could

appear to establish a standard, although that was not the intent. Staff has combined and reworded the examples (par. 41 of the current draft) and believes this should resolve the issue.

6. The October draft included language to clarify that the possibility that Congressional action may *in the future* remove or change a liability does not mean that the government does not have a liability *under existing conditions*. The language was included in the "Settlement of the Obligation" discussion under liabilities. At the October meeting, Mr. Torregrosa, representing the CBO, requested that the language be moved to the previous subsection, on "Present Obligation." Staff has included the issue in new par. 43 in the "Present Obligation" subsection and has reworded the passage to accommodate the change of subsection.

7. Changes have been made in the subsection on Net Position (pars. 49 and 50) in response to members' requests at the October meeting.

8. Definitions of revenue and expenses have been added to the draft, as new pars. 51 and 52. Pars. 53 through 55 refer to both revenues and expenses (and gains and losses) in the same paragraphs, to avoid the repetition that would occur in separate discussions of revenues, expenses, gains, and losses. Par. 53 is similar to pars. 17 and 38 under, respectively, assets and liabilities. Please see the separate memo under Tab B, on revenues and expenses, for the reasons for staff's proposals in pars. 51 through 55.

9. No changes have been made to the section on "Effects of Uncertainty."

Goals for the January Meeting

- Staff recommends the Board accept the changes included in the current draft.
- Staff requests that the Board indicate whether there are additional issues that should be included in the proposed concepts statement.
- Considering both the status of the current draft and any additional issues the Board identifies, staff requests an indication of when the Board would like to issue the draft for public comment.

**STATEMENT OF FEDERAL FINANCIAL ACCOUNTING CONCEPTS NO. 5:
DEFINITION AND RECOGNITION OF ELEMENTS OF THE FINANCIAL
STATEMENTS**

STATEMENTS OF FEDERAL FINANCIAL ACCOUNTING CONCEPTS

This Statement of Federal Financial Accounting Concepts (SFFAC) is one of a series of 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 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. Like other pronouncements of the FASAB, a Statement of Federal Financial Accounting Concepts may be amended, superseded, or withdrawn by appropriate action under the Board's Rules of Procedure.

SUMMARY

{To be added.}

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INTRODUCTION

Purpose of This Statement

1. This document is a conceptual statement that establishes definitions and recognition criteria for elements of the financial statements of the federal government and its component entities. The concepts it contains are consistent with the financial reporting objectives, qualitative characteristics of reported information, and reporting entity concepts established in earlier Statements of Federal Financial Accounting Concepts (SFFAC).

Elements and Recognition

2. The term *elements* refers to broad classes of items, such as assets, liabilities, revenues, and expenses, 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 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 the financial statements defined in this Statement (paragraphs 16 through 55) 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.

RECOGNITION CRITERIA

5. Recognition criteria are the conditions an item should meet in order to be recognized in financial statements. The 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 quantifiable in monetary units. However, whether an item should be measured at its

historical cost, current cost, fair value, expected value, or some other value is beyond the scope of this Statement.¹

6. As indicated by the recognition criteria, satisfying the definition of an element is a necessary but not sufficient condition for an item to be recognized in financial statements. Accordingly, there is no need to consider whether an item is measurable and should be recognized if it does not meet the definition of an element.

7. The existence or amount (or both) of many assets, liabilities, and other elements may not be certain, but the definitions and recognition criteria in this Statement do not require certainty. Conclusions about the existence of an element require judgment as to whether, based on the available evidence, the item possesses the essential characteristics of that element. However, a formal probability assessment is not required. The measurement of an element being considered for recognition in the financial statements often will require estimates and approximations. Measurement also may require a more formal probability assessment of future inflows or outflows of resources to enhance the reliability of amounts recognized in the financial statements.²

8. Recognition decisions also are influenced by assessments of the materiality and benefit versus cost of recognizing the results of the measurement of elements and by the extent to which the information meets the qualitative characteristics of understandability, reliability, relevance, timeliness, consistency, and comparability.³ Thus, it is possible that items meeting the definition and capable of being measured would not be recognized.

¹ That issue may be addressed in a future concepts statement or in individual statements of standards.

² Uncertainty and its effects on financial reporting are discussed further in paragraphs 56 through 60.

³ The qualitative characteristics of information in financial reports are discussed in SFFAC 1, *Objectives of Federal Financial Reporting*, Chapter 6.

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 financial statements because, for example, it is not measurable in monetary units, its amount is not material, or the qualitative characteristics are not met. 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. The element is recognized in the government’s financial statements provided it is measurable, as defined in paragraph 5, and is material to those financial statements. Otherwise, it may be reported in the notes or as supplementary information.

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 financial statements provided it is measurable and material to those financial statements. Otherwise, the item may be reported in the component entity’s notes or supplementary information.

12. Sometimes a question may arise as to which component entity should report a particular element. 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. If so, the element should be reported by that component entity.

13. However, a component entity's relationship to a government asset or liability occasionally is less comprehensive because the component entity shares responsibilities with another component entity. For example, 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. A component entity's relationship to a government asset also may not be comprehensive because the scope of the entity's responsibilities is narrow. For example, a component entity may be responsible for collecting moneys owed to the federal government and depositing them in the U.S. Treasury, but has no authority or responsibility to retain or use the moneys collected. If no component entity has a comprehensive relationship to the item, then it is considered an element of the component entity most responsible for managing it.

14. Sometimes component entities may recognize elements in their financial statements that are not recognized in the 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, provided they meet the appropriate definitions of elements and are measurable and material to those financial statements.

15. 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

Definition of an Asset

16. An asset is a resource that embodies economic benefits or services that the federal government can control.

17. The definition of an asset addresses only whether an asset exists. It does not address how an asset 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. Recognition criteria for all elements of financial statements are set forth and discussed in paragraphs 5 through 9. Those paragraphs also acknowledge the possibility of uncertainty about whether an item meets the definition of an asset and the need for

judgment based on the available evidence. However, those paragraphs do not establish a threshold to be assumed in applying judgment.

18. The definition of an asset derives from the nature of assets—the characteristics that are fundamental or essential to all assets. Paragraphs 19 through 35 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.

Essential Characteristics of Assets

19. 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”⁴ or a “means of supplying a want.”⁵ 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 16.

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

21. 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,

⁴ *American Heritage Dictionary of the English Language*, Fourth Edition (Houghton Mifflin Company, 2000).

⁵ *The Concise Oxford Dictionary*, (Oxford, U.K.: Oxford University Press, 1964). {Need to update reference}

the resource is not an asset of the federal government. For example, outer space is a natural resource from which the federal government can obtain economic benefits. However, outer space is not an asset of the federal government because the government cannot deny or regulate the access of others. In contrast, natural resources under federal lands qualify as federal government assets because the government can 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 do not qualify for recognition in the financial statements.

22. In addition to the two essential characteristics identified in paragraph 20, 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 kinds of lease arrangements.

23. 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 can 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 can obtain the benefits or services and deny or regulate access or use by other entities.

Economic Benefits or Services

24. 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 labor 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.

25. The economic benefits or services that a property can 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, 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.

26. The economic benefits or services that flow from 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 resulting benefits. Similarly, lease agreements unbundle the resources and resulting benefits 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

27. 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 deny or regulate the access of others. In exercising control, the government can, depending on the nature of the resource, hold it; exchange it; use it to obtain cash, cash equivalents, goods, or services; exact a price for other entities' use of the resource; 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 control of the economic benefits or services embodied in the resource.

28. 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.

29. 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 28, through a lease arrangement the government may control access to the economic benefits or services embodied in a resource that it does not own.

30. 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.

31. 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.

32. 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 resulting benefits or services to the exclusion of other entities. For example, the mere existence of the government's power to tax is not an asset. The government must exercise that power by imposing a tax, thereby establishing control of access to the resulting benefits to the exclusion of other entities.

33. 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

34. 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.

35. 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 39 through 49) 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.

36. 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

37. A liability is a present obligation⁶ of the federal government to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand.

38. 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. Recognition criteria for all elements of financial statements are set forth and discussed in paragraphs 5 through 9. Those paragraphs also acknowledge the possibility of uncertainty about whether an item meets the definition of a liability and the need for judgment based on the available evidence.⁷

Essential Characteristics of Liabilities

39. Similar to the definition of an asset, the definition of a liability is derived from the nature of liabilities—the characteristics that are fundamental or essential to all liabilities. 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 when settlement of the obligation is to occur. Paragraphs 42 through 49 discuss those characteristics.

Present Obligation

40. 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

⁶ 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.

⁷ See footnote 2.

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.

41. 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 resources 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 transfer of resources is not required until a later date.

42. 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, namely the government and an entity that is external to the government. 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.

43. 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 financial statements are based on transactions or events that already have occurred. Thus, the possibility of a future change in the conditions that gave rise to a present obligation does not mean that the government currently has no obligation and therefore no liability.

Settlement of the Obligation

44. 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.

45. 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 stand ready 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.

46. Frequently, the federal government knows which specific entities or individuals will receive settlement before settlement is due. 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.

47. 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

48. 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

49. 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).

50. 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

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

52. An expense is a decrease in the federal government's assets, an increase in its 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.

53. 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. Recognition criteria

for all elements of financial statements are set forth and discussed in paragraphs 5 through 9. Those paragraphs also acknowledge the possibility of uncertainty about whether an item meets the definition of an element and the need for judgment based on the available evidence.

54. 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 nature⁸ or their having resulted from peripheral or incidental activities of an entity.⁹

55. 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

56. 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. Whether a resource embodies economic benefits or services to which the

⁸ See, for example, Statement of Federal Financial Reporting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, par. 35 (FASAB, 1996)

⁹ The latter distinction is included in FASB Concepts Statement No. 6, *Elements of Financial Statements*, par. 87 (FASB, 1985)

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government can control access, or whether the government has a present obligation to provide assets or services in the future, often can be determined reliably only with hindsight. As a result, the government may have recognized as expenses or revenues some items that with hindsight actually met the definitions of assets or liabilities or vice versa. Alternatively, some items may not have been recognized because of uncertainty about whether they qualified as assets or liabilities or because of measurement issues stemming from uncertainty at the time of assessment.

57. Uncertainty increases the costs of financial reporting, particularly the costs of measurement and recognition. Some items that meet the definitions of assets or liabilities may be recognized as expenses or revenues or remain unrecognized because a cost-benefit analysis indicates that their recognition is not useful enough to justify the necessary time and effort. It may be possible to make the information more reliable in the face of uncertainty by exerting greater effort or spending more money, but it also may not be worth the added cost.

58. A highly significant practical consequence of the features described in the preceding two paragraphs is that the existence or amount (or both) of many assets and liabilities may not be certain. However, as discussed in paragraph 7, the definitions and recognition criteria in this Statement do not require certainty that items possess the essential characteristics of particular elements in order for the items to qualify for recognition. Moreover, their measurement often will require estimates and approximations or more formal probability assessments unless financial statements are to be restricted to reporting only cash transactions.

59. Degrees of uncertainty or probability are not part of the definitions of elements and formal assessments are not required when comparing items with the definitions. Rather, uncertainty about the existence of an element means that the application of the relevant definition often requires judgment about whether items possess the essential characteristics. Items that are judged to meet the definition of an element qualify for recognition if they are measurable in monetary units. Otherwise they may be disclosed. Assessments of the probabilities of inflows or outflows of economic benefits or services as a result of the existence of an element may be necessary for reliable measurement of the amount to be recognized and, if so, are part of a decision whether to recognize or disclose the element.

60. A practical result of the distinction between deciding whether an item meets the definition of an element and deciding whether an element should be recognized is that measurability (the second recognition criterion) is a more stringent hurdle for recognizing an item in the financial statements than is meeting the definition of an element (the first criterion). Based on the available evidence, the government may conclude that an item meets the definition of an element of the financial statements. However, application of the measurement criterion, including when appropriate an assessment of the probability of future resource flows, may result in an amount that is not material to the financial statements. If so, the asset or liability will not be recognized, but it may be disclosed, together with the reasons for not recognizing it. Measurement considerations also may result in postponing recognition of some assets or liabilities until their future outcomes become less uncertain or their measures become more reliable.