Federal Accounting Standards Advisory Board

September 22, 2005

TO: Members of FASAB

FROM: Penny Wardlow, Consultant

THROUGH: Wendy Comes, Executive Director

SUBJECT: **Elements: Revised Draft of a Proposed Concepts Statement — TAB B**

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

Attached to this memo is a revised partial draft of a proposed concepts statement on *Definition and Recognition of Elements of the Financial Statements.* This memo presents a brief commentary on the principal changes since the first draft, presented at the August 2005 meeting. Questions for the Board are included at various places in this memo and are repeated in a list at the end of the memo.

1. Component Entities

A significant issue ("component entity issue") that was debated at length at the August meeting without resolution was how to address the fact that items currently presented as assets of a component entity of the federal government might not meet the proposed definition of an asset contained in the August 2005 draft: ***An asset is a resource that embodies economic benefits or services that the entity can control.*** For example, an entity that is responsible for collections but is required to deposit them with the U.S. Treasury and cannot use or benefit from those funds arguably has what is commonly perceived to be an asset (accounts receivable). However, the component entity does not have or control access to the economic benefits embodied in the receivables. Therefore, the receivables do not meet the proposed definition of an asset. The Board asked the staff to find a solution to this issue.

Staff considered modifying the August definition of an asset, consistent with maintaining the essential characteristics of all assets as the foundation of the definition. However, staff found no way that would retain the appropriateness of the definition from the federal government's and the component entities' perspective and also resolve the component entity issue.

Rather than a change in the definition of an asset, in the current draft staff proposes to change the definition of the "entity" in relation to which the elements are defined. In the August draft (and all previous drafts), elements were defined in relation to EITHER the federal government as a whole OR a component entity. In other words:

(a) To be recognized in the *federal government's* financial statements, an item would need to meet the definition of an asset *from federal government's perspective* and be measurable. Based on the proposed definition, for a resource to be an asset, the federal government would need to be able to obtain the economic benefits or services embodied in the resource and deny or regulate the access of others to those benefits or services.

(b) To be recognized in a component entity's financial statements, an item would need to meet the definition of an asset *from the perspective of the component entity* and be measurable. Based on the proposed definition, for a resource to be an asset, the component entity would need to be able to obtain the economic benefits or services embodied in the resource and deny or regulate the access of others to those benefits or services.

As indicated earlier, some component entities make collections but cannot access the economic benefits or services embodied in them. Moreover, in some transactions, more than one component entity may be involved in different components or shares of the same transaction (different assets), without any of them being able to benefit from the related economic benefits or services.

The staff concluded that the source of the problem was the definition of the "entity" in relation to which elements are defined as being *either* the federal government *or* a component entity. That approach indicates that the federal government and its component entities are two types of entity that are separate and distinct from each other. Thus, in order to report an asset, each type of entity must conclude that an item meets the definition of assets from its particular perspective. As already noted, that cannot be achieved when the benefits of an asset effectively are obtained by a component entity other than the one that is charged with collecting resources.

In the current draft, the staff proposes that the document address component entities as part of the U.S. Government (federal government), which effectively they are, rather than as separate entities. Thus, in the attached draft (par. 12), a*ll elements are defined in relation to the federal government.* Further,

> . . . [A]n 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 financial statements of the federal government provided that 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. (par. 12).

Pars. 10 and 11 explain the structure of the federal government, the varying responsibilities of different component entities, and how those responsibilities are assigned to them. The essence and significance of the staff's proposed change is that, to be reported as an element of a component entity's financial statements, the item does not need to separately meet the definition of an element from the component entity's perspective. Rather:

> 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. 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. (par. 13)

The draft also addresses the situation where component entities interact with each other and the resulting elements are eliminated in consolidation and, thus, are reported by the component entities but not by the federal government (par. 14).

Staff appreciates the contributions from Mr. Jacobson concerning the structure of the federal government and proposed wording for the section on "Entity Concept" (pars. 10 through 15), proposed wording for pars. 22 and 23, and suggestions for carrying through the new approach in other parts of the revised draft. The Board will note that in numerous paragraphs the word "entity" (previously meaning *either* the federal government *or* a component entity) has been replaced by "federal government," and component entities are referred to specifically only where necessary for clarification. Although the Board will wish to discuss and possibly refine the new approach, staff believes that it is a practical as well as a conceptual solution to the component entity issue discussed at the August meeting.

Question 1: Does the Board agree with the "Entity Concept" presented in paragraphs 10 through 15 and its application in the remainder of the draft?

2. Treatment of Uncertainty

At the August meeting, some Board members requested that uncertainty be addressed separately in the sections of the draft on definition (i.e., the existence of an element) and measurement/recognition instead of or as well as being the topic of a separate section, "Effects of Uncertainty," at the end of the August draft. Some members preferred to eliminate that separate section or move it closer to the beginning of the draft; some suggested interweaving references to uncertainty in the sections on "Recognition Criteria" and "Definitions of Elements;" some preferred to keep the separate section on uncertainty, whether at the beginning or end of the draft, even with references to uncertainty in other places; and some thought references to uncertainty should not be included in the sections on Recognition Criteria and Definitions of Elements because it would be inconsistent with the Board's decision not to include a reference to uncertainty or probability in the wording of the definitions or underlying essential characteristics.

Staff has addressed these requests in the current draft by adding comments on uncertainty (1) in new par. 7 of the section on Recognition Criteria, (2) at the end of par. 17 under Definition of an Asset, (3) at the end of par. 40 under Definition of a Liability, and (3) retaining the separate section on Effects of Uncertainty at the end of the draft, but with some adaptation and reduction because of the introduction of the earlier references. Pars. 46 and 47 also refer to uncertainty in the timing and amount of settlement of an obligation and refer to the incorporation of uncertainty in the measurement of the obligation.

Staff does not believe the section on Effects of Uncertainty fits early in the draft (e.g., in or right after the Introduction) because it requires references to concepts, such as the existence or amount of an element, that are not introduced until later in the draft. Also, the section on Recognition Criteria follows neatly after the definition of "recognition" and "recognize" in par. 4 of the introduction. In addition, staff believes that including a section on uncertainty early in the draft could be detrimental to the reader's understanding by postponing the discussion of recognition criteria and definitions of elements, which are the main topics of the concepts statement.

Question 2: Does the Board agree with (a) the separate references to uncertainty in the sections on Recognition Criteria and Definitions of Assets and Liabilities (pars. 17 and 40) and (b) retention of a shorter version of the separate section "Effects of Uncertainty" at the end of the draft?

3. Transactions Involving Financial Assistance

At the August meeting a member requested the inclusion of references to benefit programs in the section on Liabilities. The Board indicated that it preferred not to use the terms "benefit program" or "provision of benefits" because of possible misinterpretation that the references were narrowly concerned with social insurance programs. In addition to the reference to grants and subsidies at the end of par. 36, staff has included references to financial assistance at the end of pars. 42 and 43.

Question 3: Are the references to grants, subsidies, and financial assistance appropriate and sufficient? (Pars. 36, 42, and 43) If not, what does the Board wish to add and where should it be added?

4. Reference to Congress's Ability to Change the Law

At the August meeting, staff was requested to add back a reference to Congress's ability to change the law that had been included in a previous draft but omitted from the August draft. The essence of the reference is that in accounting and financial reporting assets and liabilities result from events that already have occurred by the reporting date. Thus, assessments of whether a government has a present obligation and an agreement or understanding with another entity concerning settlement of the obligation must be based on existing conditions, including current law. The ability of Congress to change the law in the future in a manner that would affect that obligation or understanding is not relevant to the assessment of whether a liability currently exists. Staff has included this discussion in par. 45 under Settlement of the Obligation. Staff believes it fits well there and better than under Present Obligation.

Question 4: Does the Board agree with the content and location of the material on Congress's ability to change the law? (par. 45)

5. Definition of Net Position

New par. 50 is a brief explanation of the derivations of the definitions of Net Position, Revenues, and Expenses. A proposed definition and brief discussion of Net Position are included in pars. 51 through 53. Consistent with the Board's discussion at the August meeting, staff has sought to avoid implying a particular financial reporting model in the definition and explanation of net position. Thus, par. 53, for example, indicates a general composition of net position but avoids providing a specific breakdown or interpretation of the meaning of net position.

Question 5: Does the Board agree with the definition and discussion of net position? (pars. 51 through 53)

6. Definitions of Revenues and Expenses

Staff had intended to include proposed definitions of revenues and expenses in the revised draft. However, staff believes that the Board should address various issues before staff can develop appropriate proposals for the Board's consideration. Several of these issues are prompted by the content of SFFAS 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting* (issued May 10, 1996). SFFAS 7 combines concepts and standards. It provides definitions of revenues, expenses, gains, losses, and other financing sources and includes different recognition criteria for exchange versus nonexchange revenues. Staff perceives a number of inconsistencies with decisions made to date by the Board in the Elements project and other projects. Staff is proposing, therefore, to prepare a paper for a future meeting that would present issues raised primarily by the definitions and requirements of SFFAS 7 compared with Board decisions in Elements, and request the Board's views in relation to the definitions of revenues and expenses in the proposed concepts statement on Elements. Staff would then prepare proposed definitions consistent with the Board's direction.

Question 6: Does the Board agree that the Board should discuss issues raised by the content of SFFAS 7 before considering definitions of revenues and expenses in the concepts statement on Elements?

7. **Discussion of Statements of Federal Financial Accounting Concepts**

Staff has made changes to the discussion of Statements of Federal Financial Accounting Concepts on page 1 of the draft, consistent with the Board's requests and comments in August. These concern primarily a more positive statement at the beginning of the second paragraph and a more balanced treatment of the usefulness of a concepts statement to the Board and to preparers and auditors (also in the second paragraph).

Question 7: Does the Board agree with the revised discussion of "Statements of Financial Accounting Concepts" on page 1 of the draft?

In addition to the changes specifically mentioned in this memo, staff has made numerous editorial changes to the August version of the draft, generally to clarify or enhance the consistency of wording, or to simplify or improve explanations or examples.

Question 8: Are there other changes that the Board wishes to make to the current draft?

LIST OF QUESTIONS FOR THE BOARD

Question 1: Does the Board agree with the "Entity Concept" presented in paragraphs 10 through 15 and its application in the remainder of the draft?

Question 2: Does the Board agree with (a) the separate references to uncertainty in the sections on Recognition Criteria and Definitions of Assets and Liabilities (pars. 17 and 40) and (b) retention of a shorter version of the separate section "Effects of Uncertainty" at the end of the draft?

Question 3: Are the references to grants, subsidies, and financial assistance appropriate and sufficient? (Pars. 36, 42, and 43) If not, what does the Board wish to add and where should it be added?

Question 4: Does the Board agree with the content and location of the material on Congress's ability to change the law? (par. 45)

Question 5: Does the Board agree with the definition and discussion of net position? (pars. 51 through 53)

Question 6: Does the Board agree that the Board should discuss issues raised by the content of SFFAS 7 before considering definitions of revenues and expenses in the concepts statement on Elements?

Question 7: Does the Board agree with the revised discussion of "Statements of Financial Accounting Concepts" on page 1 of the draft?

Question 8: Are there other changes that the Board wishes to make to the current draft?

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.}

TABLE OF CONTENTS

Contents **Page**

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 10 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]

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[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 or its amount is not material. Unrecognized elements are candidates for disclosure in the notes to financial statements or as supplementary information.

DEFINITIONS OF ELEMENTS

Entity Concept

10. The U.S. Government ("federal government" or "government") is composed of component entities that control, manage, or are otherwise accountable for the government's resources. Component entities include departments, independent agencies, and government corporations, as well as their agencies, bureaus, offices, administrations, corporations, and other organizational units.

11. 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 that is responsible for receiving, controlling, managing, and utilizing a federal resource in performing government operations related to the program or activity. However, a component entity's relationship to a resource of the federal government occasionally is less comprehensive because the component entity shares responsibilities for the resource with another component entity. For example, one component entity has acquired and has some control over a federal government resource but another component entity presently manages and utilizes the resource as part of its routine operations. A component entity's

relationship to a federal government resource also may not be comprehensive because the scope of the component 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 general fund of the U.S. Treasury, but has no authority or responsibility to retain or use the moneys collected.

12. The elements defined in this Statement are defined in relation to the federal 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 financial statements of the federal government provided that 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.

13. 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. 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.

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.

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.

<u>Essential Characteristics of Assets</u>

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, 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

[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}

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. As discussed in paragraph 11, more than one component entity may have areas of responsibility for a resource under applicable laws, regulations, and other administrative issuance. For example, a component entity has acquired property long ago but either by law or contract makes the property available to a second component entity, which utilizes the property as part of its normal operations and controls others' access to it. In addition to being an asset of the federal government (assuming that the resource meets the definition of an asset), the property is an asset of the component entities to the extent that each manages it.

23. Also as discussed in paragraph 11, a component entity's authority and responsibility for a resource may be limited. For example, a component entity may have responsibility only for collecting receivables and depositing them to the general fund of the U.S. Treasury. Assuming that the receivables meet the definition of an asset, they are assets of the federal government. However, they also are assets of the component entity because of the management function it performs, even though the component entity may not obtain any economic benefits from them.

24. 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.

25. 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

26. 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.

27. 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.

28. 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

29. 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.

30. 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.

31. 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.

32. 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.

33. 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.

34. 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 decision to acquire a resource in the future and control access to the resulting economic benefits or services 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.

35. 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

36. 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.

37. 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.

38. 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

39. A liability is a present obligation[6] to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand.

40. 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

41. 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

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[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.

settlement of the obligation is to occur. Paragraphs 42 through 49 discuss those characteristics.

Present Obligation

42. 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—for example, contracting with another entity for equipment or reaching an agreement or understanding with another entity to provide financial assistance to that entity at a future date.

43. 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, when the government has received but not yet paid for goods or services that it has agreed to purchase from another entity the government has a present obligation to settle the purchase price in accordance with the terms of the agreement. Further, when the government has an unconditional agreement or understanding with another entity to provide it financial assistance, the government has a present obligation to do so, even if the actual transfer of resources is not required until a later date.

44. 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.

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. It is important that the agreement or understanding be based on *existing* conditions, including current law, because an essential characteristic of a liability is that the entity has a *present* obligation. 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 no agreement to settle it and therefore does not have a liability.

46. The timing of settlement often is expressed in contracts or 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.

47. 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 conditional obligation. Uncertainty regarding the amount or timing of settlement is addressed through measurement of the liability.

48. 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.

49. 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

50. 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

51. 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 indicate a surplus (assets greater than liabilities) or a deficit (assets less than liabilities).

52. The government's or component entity's recognized net position does not represent a claim against assets by taxpayers or other resource providers. Net position, therefore, is not equivalent to owners' equity or stockholders' equity in business accounting, where those recognized amounts indicate the owners' or stockholders' claim against the assets of the business after the payment of creditors.

53. In general, net position is composed of unexpended appropriations (amounts not yet obligated or expended) plus the cumulative difference, over the years, between the government's or component entity's revenues and other sources of funding and its expenses. However, the reported composition and intended interpretation of net position depend on the particular financial reporting model applied in the financial statements and the resulting display requirements. As such, a more detailed discussion of the meaning of

the government's or a component entity's net position is beyond the scope of this Statement.

Definition of a Revenue

54. [To be drafted.]

Definition of an Expense

55. [To be drafted.]

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 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.