FASAB

Federal Accounting Standards Advisory Board

August 3, 2005

TO: Members of FASAB

FROM: Penny Wardlow, Consultant

THROUGH: Wendy Comes, Executive Director

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

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 partial draft of a proposed concepts statement on *Definition and Recognition of Elements of the Financial Statements.* This memo presents a brief commentary on each section of the draft, in the same order as the sections in the draft. The headings in this memo are the section headings in the draft. Questions for the Board are included at the end of the commentary on each section and are repeated in a list at the end of the memo.

STATEMENTS OF FEDERAL FINANCIAL ACCOUNTING CONCEPTS

The Board has previously discussed the desirability of including at the front of the concepts statement a brief discussion of the purpose of concepts statements in general. Because such a discussion has not been included in previous FASAB concepts statements, the discussion in the attached draft (page 1) is an abbreviation and adaptation to the federal environment of the FASB's discussion in its Concepts Statement No. 6, *Elements of the Financial Statements*. The FASB has included a similar discussion in each of its seven concepts statements.

1. **Does the Board approve the discussion of federal financial accounting concepts (page 1 of the draft)?**

INTRODUCTION (begins on page 2)

The introductory section of the draft states the purpose of the concepts statement (par. 1) and defines the terms *elements, recognition,* and *recognize (*pars. 2 and 4). It also identifies the elements defined in the statement, namely assets, liabilities, net position, revenues, and expenses (par. 3). The draft does not include definitions of net position, revenues, and expenses, but the proposed locations are indicated on pages 16 and 17.

The Board has not yet discussed which elements should be included in the concepts statement, although the initial intent clearly is to include assets, liabilities, revenues, and expenses. As indicated in paragraph 3, staff believes it also may be necessary to define "net position." The definition is likely to be brief—e.g., "Net position is the difference between recognized assets and liabilities" and to require little discussion. However, it may be appropriate to include a discussion of the components of net position.

The Board also may wish to consider whether other elements should be defined and discussed in the proposed concepts statement—for example "net cost of operations," which presumably would entail defining "cost" as well as "expense." Staff recommends that the Board include in its consideration the broader issue of whether and, if so, to what extent the proposed concepts statement should include elements that are specific to statements required by the current financial reporting model—or by any particular model—and/or may be issues that should be discussed in standards governing display, rather than in a concepts statement.

2. **Does the Board agree with the definition of**
   (a) "elements"? (par. 2)
   (b) "recognition" and "recognize"? (par. 4)

3. **Should the proposed concepts statement include a definition of "net position"? (par. 3)**

4. **Should the proposed concepts statement include a definition of "cost" and "net operating cost"?**

5. **Are there other elements of financial statements required by the current financial reporting model that should be defined in the proposed concepts statement?**

RECOGNITION CRITERIA (begins on page 3)

The Board considered proposed recognition criteria at the June meeting and adopted those proposed in paragraph 5: (a) The item should meet the definition of an element of financial statements and (b) The item should be measurable. The Board decided that "reliably" need not be included in criterion (b). Rather, all of the qualitative characteristics, as well as the pervasive constraints of materiality and cost versus benefit are applicable to all reported financial information. Staff has included this concept in paragraph 7, as part of the discussion of the recognition criteria and process.

A majority of the Board decided in June that neither the definitions of elements nor the recognition criteria should include a specific reference to probabilities. Rather, the Board wished to consider a section that would discuss the concept of uncertainty in both the existence and measurement of elements and the view that probability assessments are part of measurement. The requested section is included in the attached draft on pages 17 through 19, after the discussion of elements, and is referred to later in this memo.

The natural order of definition and recognition (an item should meet the definition of an element before being considered for recognition) is reflected in the proposed title of the document. Staff therefore considered whether the establishment and discussion of the recognition criteria should be placed after the definitions and discussion of the elements. However, staff is proposing to place the section on recognition first.

Staff believes it important to make the distinction between definition and recognition early in the draft for several reasons. The distinction is clearer when presented as part of the discussion of recognition, and the meaning of recognition and the establishment of the recognition criteria are concepts that help the reader understand the discussion of the definitions of elements and their role and scope in financial reporting. In addition, the discussion of recognition can be quite short, compared with the definitions and discussion of the elements. Thus, reversing the order of the sections on recognition and definition would, in staff's view, leave the reader waiting too long for some important concepts.

6. **Does the Board generally agree with the presentation and discussion of the recognition criteria? (pars. 5 through 9)**

7. **Does the Board agree with the placement of the section on recognition criteria ahead of the definitions and discussion of elements?**

DEFINITIONS OF ELEMENTS (begins on page 5)

The bulk of the attached draft statement covers the definitions of assets and liabilities and discussions of their essential characteristics. The Board has previously discussed several drafts of the assets and liabilities sections. The sections in the current draft are generally similar to earlier drafts and incorporate the Board's requested changes in the wording of definitions as well as ensuing discussions. Staff also revised parts of the discussions of assets and liabilities to enhance clarity, reduce redundancy, and, where possible, make the discussions of the two elements more parallel. These changes included changing the order of some paragraphs or material within paragraphs, deleting some wording perceived to be redundant or otherwise unnecessary, and adding a paragraph here and there with a clarification or an additional example.

The resulting discussions include numerous editorial changes as well as the relatively few substantive ones, which makes an accurate marked-up version difficult to achieve and potentially confusing to read; therefore, only a clean copy is attached. Because of the numerous changes, staff believes it will be easier for the Board to identify issues and concerns if members read the assets and liabilities sections of the attached draft in sequence, including the preceding section on the recognition criteria and the succeeding one on uncertainty. The following comments may assist the Board in considering the principal changes.

Definition of an asset (par. 11): "An asset is a resource that embodies economic benefits or services that the entity can control." "Embodies" replaces "could provide" in the previous definition. The word "could," inserted at a previous meeting, was intended to indicate the existence of uncertainty. However, as the Board requested at the June meeting, uncertainty in both the existence and the measurement of an element is addressed in a separate section of the draft, beginning on page 17. Staff believes, moreover, that "could" is a vague word that has various meanings and may tend to increase rather than decrease variation in readers' interpretation of the definition.

New par. 12 describes the scope of the definition.

Essential characteristics of assets: New par. 18 adds an example of an item that is considered an asset of a federal entity even though that entity does not have access to the resulting economic benefits.

The previous section on the essential characteristics of assets was longer than the equivalent one on liabilities, primarily because it contained more explanation of why certain common characteristics of assets—such as their acquisition at a cost, their being owned or possessed by the entity, and their ability to be sold—are not essential characteristics. The assets section in the current draft has been shortened by the abbreviation of some of the previous discussion.

A sentence has been added (beginning on line 22 of page 9) to help clarify the distinction between observance of certain legal or other constraints on the use of a resource and lack of control of the economic benefits or services it embodies.

A new example of when ownership and possession do not entail control of access to economic benefits or services (and therefore are not essential characteristics of assets) has been added to paragraph 27, beginning in line 2 on page 11. It addresses the issue of federal government property that is controlled and used by a state government, with the federal government's consent.

8. **Does the Board agree with the revised definition of an asset? (par. 11)**

9. **Does the Board agree with the substance and coverage of the discussion of the essential characteristics of assets? (pars. 14 through 31)**

Liabilities. Legal Framework: At the June 2005 meeting, some Board members requested an expansion of the factors that should be considered in identifying a constructive liability (though that term is not used in the draft). At one stage, the draft contained some examples of potential constructive liabilities, but those were later removed because some Board members thought they were akin to setting standards, rather than providing explanations of concepts. The current draft includes examples of factors that may affect the conclusion that a liability has been incurred (par. 33, lines 9 through 15), but does not provide examples of constructive liabilities.

Definition of a Liability (par. 35): The definition has been shortened from the previous one but is essentially the same.

Par. 36 has been reworded and amended to parallel an equivalent change in par. 13 of the assets section. It addresses the scope of the liability definition and cross-references the recognition criteria and the discussion of uncertainty.

The discussion of "**Present Obligation**" (pars. 38 through 40) is the same in substance and coverage as the discussion in the previous draft. However, the order of some issues has been changed for clarity and to remove redundancy. For example, the issue of "intent" versus "obligation" is covered in par. 38 with the definition of present obligation, rather than in a separate paragraph, which previously may not have presented a clear contrast with the definition of present obligation. Also, staff identified some confusion in places in the previous draft between "present obligation" and "liability" and has worked to remove that confusion.

Settlement of the Obligation (par. 41 through 44)**:** The Board's request for a separate section on uncertainty prompted some rewording of the section on settlement of the obligation because the previous section incorporated several references to the consideration of uncertainty. Some of those references have been removed and are addressed in the section on uncertainty. Other references have been retained as necessary to the discussion—for example, the references to uncertainty in the timing or amount of settlement (pars. 41 and 42).

Par. 42 is new. It addresses the issue of whether an entity has a liability when the amount required for settlement is contingent on a future event, such as a decline in market prices. The paragraph supports the view that the contingency does not affect the entity's liability to "stand ready to fulfill its conditional obligation." The paragraph also reiterates that "uncertainty regarding the amount or timing of settlement is addressed through measurement of the liability." The notion of an entity having a liability to stand ready to fulfill a conditional obligation is consistent with the position taken by the FASB in its Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (issued November 2002) and by the IASB in its *Exposure Draft of Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits* (issued June 2005). The Board has previously received a copy of FASB Interpretation 45. A copy of the IASB's ED on Amendments to IAS 37 is being forwarded to the Board.

Because of the inclusion of the example of a liability to stand ready, staff deleted a previous example (at the end of par. L7 in the previous draft) that referred to an entity's agreement to provide financial assistance provided that the potential recipient entity meets certain requirements or conditions. Staff concluded that the previous example was not essential and the inclusion of both examples might cause confusion.

Among the references to uncertainty that was removed from the section on "Settlement of the Obligation" is the former par. L11, which stated that it is important that "the possibility of avoiding settlement be based on *existing* conditions, including current law, because an essential characteristic of a liability is that the entity has a *present* obligation." The remainder of par. L11 clarified that the possibility that Congress might change the law that supports an entity's present obligation and might erase the obligation "or otherwise enable the entity to avoid settlement," or that the entity might renegotiate the obligation with the payee, are potential future changes, whereas liabilities and all other elements are based on transactions that already have occurred.

The importance of elements being based on a past transaction or other event is addressed in the current draft. However, the specific issue that the Board discussed (the possibility that Congress might change the law and, if so, what effect that might have on assessments of the possibilities for avoiding settlement) is not. Staff was unable to find an appropriate place to include the deleted paragraph in the proposed section on uncertainty. It would seem more appropriate to include it in a discussion of how probabilities of future inflows or outflows of resources can be assessed as part of measurement. That is, it would fit well in a comprehensive treatment of measurement in financial reporting, which is not within the scope of the currently proposed draft concepts statement.

Par. 44 is new. It addresses the continued existence of liabilities and transactions or other events that cause their removal from the financial statements. The paragraph is intended to parallel an equivalent paragraph (par. 31) at the end of the assets section.

10. **Does the Board agree with the examples of factors to be considered in assessing whether an entity has a constructive liability? (par. 33, lines 9 through 15)**

11. **Does the Board agree with the definition of a liability (slightly shortened but otherwise unchanged from the previous draft)? (par. 35)**

12. **Does the Board agree with the substance and coverage of the discussion of "Present Obligation"? (pars. 38 through 40)**

13. **Does the Board agree with the substance and coverage of the discussion of "Settlement of the Obligation"? (pars. 41 through 44)**

Definition and discussion of Net Position, Revenues, and Expenses: As discussed at the beginning of this memo, the subheadings on page 17 show the proposed placement and order of these issues, following the sections on assets and liabilities.

EFFECTS OF UNCERTAINTY (begins on page 17)

This section is an adaptation of the FASB's discussion of uncertainty in its Concepts Statement No. 6. That discussion was limited in its references to uncertainty in recognition or measurement because Concepts Statement 6 addressed only the definition of elements and not recognition criteria or measurement issues, such as measurement attributes or measurement methods.

The discussion that staff is proposing addresses uncertainty in financial reporting in general (pars. X1, X2, and to some extent X6, which are similar to the FASB's discussion) and also uncertainty in the existence of an element and uncertainty in measurement, as part of a recognition decision. Par. X3 emphasizes that "The definitions and recognition criteria in this Statement <u>do not require certainty</u>" that items possess the essential characteristics (and therefore qualify for recognition) or certainty in the results of measuring the elements.

Par. X5 points out that the distinction made in the draft between meeting the definition of a liability and qualifying for recognition, and the position that assessments of probabilities are part of measurement and not part of applying definitions, means that the second recognition criterion (measurability) is a higher hurdle than is the first criterion (meeting the definition of an element). The Board has discussed this issue of different hurdles several times and the majority of members have indicated their agreement with the position stated in the draft.

Some members indicated at the June 2005 meeting that it would be useful to place the discussion of uncertainty close to the definitions of assets and liabilities, if the Board continues to hold the position that those definitions should not contain a specific reference to uncertainty. However, staff believes that, because of the general applicability of the topic to all definitions of elements and to the second recognition criterion (measurability), as well as the various issues of uncertainty that should be discussed, the discussion is more usefully located in one section, immediately after the discussion of the last element defined.

14. **Does the Board agree with the substance and coverage of the discussion of "Uncertainty"? (pars. X1 through X6, pages 17 through 19)**

15. **Does the Board agree with the proposed placement of the discussion of uncertainty in one section following the discussion of the last element defined?**

LIST OF QUESTIONS FOR THE BOARD

1. **Does the Board approve the discussion of federal financial accounting concepts (page 1 of the draft)?**

2. **Does the Board agree with the definition of**
   (a) “elements”? (par. 2)
   (b) “recognition” and “recognize”? (par. 4)

3. **Should the proposed concepts statement include a definition of “net position”? (par. 3)**

4. **Should the proposed concepts statement include a definition of “cost” and “net operating cost”?**

5. **Are there other elements of financial statements required by the current financial reporting model that should be defined in the proposed concepts statement?**

6. **Does the Board generally agree with the presentation and discussion of the recognition criteria? (pars. 5 through 9)**

7. **Does the Board agree with the placement of the section on recognition criteria ahead of the definitions and discussion of elements?**

8. **Does the Board agree with the revised definition of an asset? (par. 11)**

9. **Does the Board agree with the substance and coverage of the discussion of the essential characteristics of assets? (pars. 14 through 31)**

10. **Does the Board agree with the examples of factors to be considered in assessing whether an entity has a constructive liability? (par. 33, lines 9 through 15)**

11. Does the Board agree with the definition of a liability (slightly shortened but otherwise unchanged from the previous draft)? (par. 35)

12. Does the Board agree with the substance and coverage of the discussion of "Present Obligation"? (pars. 38 through 40)

13. Does the Board agree with the substance and coverage of the discussion of "Settlement of the Obligation"? (pars. 41 through 44)

14. Does the Board agree with the substance and coverage of the discussion of "Uncertainty"? (pars. X1 through X6, pages 17 through 19)

15. Does the Board agree with the proposed placement of the discussion of uncertainty in one section following the discussion of the last element defined?

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 (SFFAC 1, *Objectives of Federal Financial Reporting*) 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 is expected to lead to consistent standards and to serve the public interest by providing structure and direction to federal financial accounting and reporting. The FASAB itself is likely to be the most direct beneficiary of the guidance provided by the statements in this series. They will guide the Board in developing accounting and reporting standards by providing the Board with a common foundation and basic reasoning on which to consider merits of alternatives. 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.

Knowledge of the objectives and concepts the Board uses in developing standards also should enable those 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. The concepts also may provide some guidance in analyzing new or emerging problems of federal financial accounting and reporting in the absence of applicable authoritative pronouncements.

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**

Contents	Page
Summary	2
Introduction	2
Recognition Criteria	3
Definitions of Elements	5
Effects of Uncertainty	17

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 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. Particular economic things within those broad classes, such as cash, investments, and debt instruments, which may meet the definitions of elements 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 XX) 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 item into the financial statements of an entity as an asset, liability, revenue, expense, or other element. Recognition comprises depiction of an item 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 should meet the definition of an element of financial statements and (b) The item should be measurable.

6. In the context of federal financial statements, *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. That issue may be addressed in a future concepts statement or in individual statements of standards.

7. Recognition decisions are influenced not only by the recognition criteria but also by assessments of the materiality and benefit versus cost of the information. Recognition decisions also are influenced by the extent to which a candidate for recognition meets the qualitative characteristics of reported information: understandability, reliability, relevance, timeliness, consistency, and comparability.[1]

8. 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 should be recognized if it does not meet the definition of an element.

9. An item that meets the appropriate definition 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. The item would be a candidate for disclosure as an asset, liability, revenue, or expense in the notes to financial statements or as supplementary information.

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

DEFINITIONS OF ELEMENTS

10. All elements are defined in relation to a particular federal entity, which may be the federal government or a component entity. An item that qualifies under the definitions is a federal entity's asset, liability, net position, revenue, or expense. An entity may comprise two or more affiliated entities and does not necessarily correspond to what may be described as a statutory or legal entity. The definitions may also refer to "other entity," "other entities," or "entities other than the federal entity," which may include individuals, business enterprises, not-for-profit organizations, other governments, and so forth. For example, employees, suppliers, customers or beneficiaries, taxpayers and other resource providers, other governments, and other federal entities are all "other entities" to a particular federal entity. A subsidiary entity that is part of the same entity as its parent entity in consolidated financial statements is an "other entity" in the separate financial statements of its parent entity.

Assets

Definition of an Asset

11. An asset is a resource that embodies economic benefits or services that the entity can control.

12. The definition of an asset addresses only whether an asset exists. It does not address whether or when an asset should be recognized in a statement of financial position. Nor does it address whether or when the entity will consume the economic benefits or use the services embodied in an asset. Recognition criteria for all elements of financial statements are set forth and discussed in paragraphs 5 through 9. Issues of

uncertainty concerning the existence of an asset (and other elements) and its amount are discussed in paragraphs X1 through X6.

13. The definition of an asset derives from the nature of assets—the characteristics that are fundamental or essential to all assets. Paragraphs 14 through 31 highlight and discuss those characteristics. Also discussed are certain characteristics that are common to many assets but not to all assets and, therefore, are not essential characteristics.

Essential Characteristics of Assets

14. Government entities need financial, economic, human, and other resources to help them achieve their missions. In this context, the term *resource* means "a useful or valuable possession or quality of a country, organization or person"[2] or a "means of supplying a want."[3] All entities have resources. However, those resources are not assets unless they have the essential characteristics of assets and, therefore, meet the definition of assets in paragraph 11.

15. To be an asset of a particular entity, a resource must possess two characteristics. First, it embodies economic benefits or services that can be used in the future. Second, the entity can control access to the economic benefits or services and, therefore, can obtain them for itself and deny or regulate the access of others.

16. To illustrate the distinction between a resource and an asset, an entity may benefit from a resource but be unable to deny or regulate the access of other entities to that resource; if so, the resource is not the entity's asset. Examples include natural resources, such as air and water, to which the entity has no specific rights and, therefore, cannot

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

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

control the access of other entities; a major highway that is used by the entity and its constituents but which is controlled by another entity; and the intellectual capital of the entity's employees that the entity cannot control for its exclusive benefit.

17. In contrast, resources such as airspace over an airport, rights to specific water sources, highways under an entity's jurisdiction, and intellectual capital covered in an employment contract with the entity would be assets of the entity if it can obtain the benefits or services for itself and also deny or regulate other entities' access to those benefits or services. Such resources would be assets of the entity even if they are not measurable and therefore do not qualify for recognition in the financial statements, as discussed in paragraph 9.

18. In some cases, federal entities are assigned management responsibility for resources but the economic benefit is controlled by another federal entity. For example, a component entity is assigned to manage the collection of accounts receivable but is directed to deposit any collections directly with the US Treasury. While the economic benefit of the amounts collected accrues to another federal entity, entities assigned to manage collections in this manner provide services to other federal entities. Therefore, the resource claims (accounts receivable) qualify as assets of the entity assigned management responsibility.

19. Many resources have other features that help identify them as an entity's assets. For example, they may be acquired at a cost and owned by the entity. 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, when property is leased.

20. An entity's resources often are tangible and exchangeable, and the entity 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 entity's asset. For example, an intangible resource, such as an easement on property, is an asset if the entity can benefit from it and can regulate or deny the access of other entities. A resource may embody economic benefits for an entity even though the entity cannot exchange it or sell it—for example a machine that continues to provide a needed service to an entity even though there is no market for the machine. Similarly, the fact that an entity's right of access to or use of a resource is not legally enforceable does not mean that the resource is not an asset if the entity nevertheless has a right to obtain the benefits or services from the resource and to deny or regulate access or use by other entities.

Economic benefits or services

21. 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 entity, whereas the services embodied in an asset may benefit the entity in other ways. For example, government 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 government to achieve its objectives and meet its mission to provide public services.

22. 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.

23. The economic benefits or services that flow from resources may be shared by more than one entity through specific arrangements. For example, parties to a joint venture may share an interest in each of 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 a particular entity

24. The second essential characteristic of an asset is control, which refers to the ability of a particular entity to obtain for itself the economic benefits or services embodied in the resource and to deny or regulate the access of others. The entity controlling a resource is the one that 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 legal or other external constraints, such as public land subject to preservation

requirements. Such restrictions on the use of a resource do not otherwise negate an entity's control of the economic benefits or services embodied in the resource.

25. An asset is specific to an entity in that it cannot at the same time be an asset of another entity. An exception is when one entity controls another entity and, therefore, indirectly controls the resources of that entity.

26. The ability of an entity 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 entity'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 an entity may be able to exercise control in some other way. For example, a government department may not have legal ownership of the buildings in which it operates, such ownership vesting in another government entity. However, it nevertheless may control some of the economic benefits embodied in the buildings because of the terms of a particular government policy, directive, or administrative arrangement.

27. Possession or ownership of a resource normally entails control of access to the economic benefits or services embodied in the resource, 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, a principal may grant an agent physical possession of goods for sale and retain the right to receive the proceeds of sale. The goods are assets of the principal 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 embodied in the goods. Also, in some

circumstances, an entity may control access to the economic benefits or services embodied in a resource that it does not own. For example, the federal government may own highway equipment but grant to a state government full control and use of the economic benefits and services embodied in the equipment for the life of the equipment or for an indefinite period. In that case, the equipment would be an asset of the state, rather than of the federal government.

28. Some economic benefits or services cannot be controlled by the entity that obtains them, because the entity cannot deny or regulate the access of other entities. In those circumstances, the resource does not meet the definition of an asset of the first entity. Public goods are an example. Public highways provide economic benefits to the entities that use them. However, they cannot qualify as assets of entities other than the entity or entities that have the capacity to control their use or 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 entities that have only general access to them along with all other entities, even if the entities have incurred costs to help clean the environment.

29. Entities obtain most of their resources from cash or credit transactions. Acquisitions may occur through exchange transactions, whereby resources are acquired in exchange for other resources of the entity or for an obligation to transfer resources or provide services in the future. Alternatively, resources may result from nonexchange transactions, including, for example, levying taxes and fulfilling prerequisites for the receipt of donations, grants, and appropriations. Resources also may result from events such as accretion and discovery.

30. Implicit in the definition and essential characteristics of assets is that the event giving rise to the entity's ability to control access to the economic benefits or services embodied in a resource must have occurred. An entity'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 entity. For the resource to qualify as an asset, the entity already must have acquired the resource or otherwise obtained access to the resulting benefits or services to the exclusion of other entities.

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

Liabilities

Legal Framework

32. Federal entities are governed by and operate within a framework of laws. Thus, a federal liability must have its foundation in a law or in the action that a federal entity takes under a law. Some federal liabilities result from discrete actions of an agency 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 a federal entity to provide assets to

another entity. Examples include formula grants and subsidies, claims owed under workers' compensation, and amounts owed for environmental clean-up.

33. Although all federal liabilities have their foundation in law, some liabilities are construed or inferred to exist based on the totality of the conditions or facts of a particular situation, rather than specific legal or regulatory requirements. In those circumstances, the entity that potentially has a liability should weigh the totality of the facts of the situation against the definition and essential characteristics of federal liabilities (discussed in paragraphs 35 through 44) 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 entity is constituted; whether the entity has reached an agreement or mutual understanding with another entity concerning the nature and amount of the first entity's obligation and the timing of settlement; decisions or actions in previous situations that are relevant precedents; and current circumstances, such as the entry into force of new legislation or the adoption of new regulations that may affect the entity's activities or incurrence of obligations.

34. 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

35. A liability is a present obligation[4] to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand.

36. The definition of a liability addresses only whether a liability exists and not whether or when it should be recognized in a statement of financial position. Recognition criteria for all elements of financial statements are set forth and discussed in paragraphs 5 through 9. Issues of uncertainty concerning the existence of a liability (and other elements) and its amount are discussed in paragraphs X1 through X6.

Essential Characteristics of Liabilities

37. 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 has two essential characteristics. First, it constitutes a present obligation to provide assets or services to another entity. Second, the entities have reached an agreement or understanding as to when settlement of the obligation is to occur. Paragraphs 38 through 44 discuss those characteristics.

Present Obligation

38. 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 an entity's announcement that it intends to acquire equipment. A present obligation is not

[4] 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.

incurred until an entity takes a specific action that commits or binds itself and affects another entity—for example, contracting with another entity for equipment.

39. 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, an entity that has received but not yet paid for goods or services that it has agreed to purchase from another entity has a liability to settle the purchase price in accordance with the terms of the agreement. Further, when an entity agrees to provide financial assistance to another entity or entities, the first entity incurs a liability when it extends an unconditional promise to provide resources, even if the actual transfer of resources is not required until a later date.

40. As indicated in paragraph 39, for a present obligation to qualify as a liability, two separate entities must be involved, namely the federal entity that has the obligation and another federal or nonfederal entity (or entities) that is external to the obligated entity. 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, a federal entity that operates machinery may have an obligation to maintain it. However, the entity does not have a liability for maintenance; the entity cannot have a liability to itself. In contrast, if the entity 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

41. The second essential characteristic of a liability is that the parties involved have reached an agreement or understanding concerning settlement. The timing of settlement often is expressed in contracts or other agreements as a specific or determinable date, but

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 entities have not reached an agreement and the obligated entity is free to decide whether and when to settle the obligation, the entity's obligation does not meet the definition of a liability.

42. 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 entity 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.

43. Frequently, an obligated entity will know 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, an employer may have a long-term disability agreement with its 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.

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

{To be drafted:}

Net Position

<u>Definition of Net Position</u>

[Discussion]

Revenues

<u>Definition of a Revenue</u>

[Discussion]

Expenses

<u>Definition of an Expense</u>

[Discussion]

EFFECTS OF UNCERTAINTY

X1. Uncertainty about economic activities and results is pervasive and it often clouds whether a particular item qualifies as an asset or a liability of a particular entity at the time the definitions are applied. The presence or absence of economic benefits or services to which access can be controlled by the entity, or the presence or absence of the entity's present obligation to provide assets or services in the future, often can be discerned reliably only with hindsight. As a result, the entity may have recognized as expenses or revenues some items that with hindsight actually met the definitions of assets or liabilities. Alternatively, they may not have been recognized in the financial statements because of uncertainty about whether they qualified as assets or liabilities of the entity or because of recognition and measurement considerations stemming from uncertainty at the time of assessment. Conversely, some items that with hindsight did not qualify under the definitions may have been recognized as assets or liabilities because of judgments made in the face of uncertainty at the time of assessment.

X2. An effect of uncertainty is to increase the costs of financial reporting in general and the costs of recognition and measurement in particular. Some items that qualify as assets and liabilities under the definitions may be recognized as expenses or revenues or remain unrecognized as a result of a cost–benefit analysis indicating that their recognition in financial statements is not useful enough to justify the time and effort needed to do it. It may be possible to make the information more reliable in the face of uncertainty by exerting greater effort or by spending more money, but it also may not be worth the added cost.

X3. 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. The definitions and recognition criteria in this Statement <u>do not require certainty</u> that items possess the essential characteristics of particular elements in order for the items to qualify for recognition, and their measurement often will require estimates and approximations unless financial statements are to be restricted to reporting only cash transactions.

X4. 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 means that the application of the definitions 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.

X5. A practical result of the distinction between definition and recognition and the assessment of probabilities through measurement, 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, an entity may conclude that an item meets the definition of an element of the financial statements. However, application of the measurement criterion, including an assessment of probabilities, may lead to the conclusion that the amount to be recognized 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.

X6. All practical financial accounting and reporting models have limitations. The preceding paragraphs describe one limit that may affect various models—how measurement considerations stemming from uncertainty may result in not recognizing as assets or liabilities some items that qualify as such under the definitions. Alternatively, measurement considerations may result in postponing recognition of some assets or liabilities until their future outcomes become less uncertain or their measures become more reliable.