Federal Accounting Standards Advisory Board

June 5, 2005

TO: Members of FASAB

FROM: Penny Wardlow, Consultant

THROUGH: Wendy Comes, Executive Director

SUBJECT: **Elements: Recognition Criteria—TAB B, Paper 1**

INTRODUCTION

At the March 2005 meeting, the Board said it would like to consider the criteria for recognizing elements in the financial statements before continuing discussions of the definitions of assets, liabilities, and other elements. The plan for the conceptual framework includes consideration of recognition criteria at a later stage than the development of definitions of elements. However, some members have suggested it might be difficult to reach conclusions about the definitions without at least some understanding of the respective roles of definitions and recognition criteria. This memo explains the respective roles according to the FASB and other standard-setting authorities and presents recognition criteria adopted by those authorities. Staff recommendations begin on page 11.

RESPECTIVE ROLES OF DEFINITION AND RECOGNITION

Early in its Elements project, the FASAB adopted an approach to defining elements of the financial statements that is similar to the FASB's approach in its

Statements Nos. 3 and 6.[1] That is, elements (assets, liabilities, revenues, expenses, and so forth) would be defined based on their essential or inherent characteristics. This approach has the merit of conferring objectivity on the process and encouraging continuity of definitions regardless of changes in Board membership and consideration of new standards.

The FASB's approach contrasts with the approaches taken by previous standard-setting bodies, which tended to identify assets and other elements based on existing board members' views formed primarily by custom and then-current practice. An example of the latter approach is found in the definitions in Accounting Principles Board Statement No. 4,[2] which tend to be circular. That is, the APB concluded that an item is an asset if it is reported as an asset in the balance sheet, and it is reported as an asset in the balance sheet if the board concludes it is an asset.

The FASB's approach distinguishes between the *definition* of elements and their *recognition* in the financial statements. In fact, the two notions are addressed in separate Concepts Statements. Definition is addressed in Concepts Statements 3 and 6 (Statement 6 supersedes Statement 3). Recognition is addressed in Concepts Statement No. 5,[3] along with certain aspects of measurement and a variety of other issues. The FASB defines recognition as follows in paragraph 6 of Concepts Statement 5.[4]

> 6. Recognition is the process of formally recording or incorporating an item into the financial statements of an entity as an asset, liability, revenue, expense, or the like. Recognition includes 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.

---

[1] FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*, issued in December 1980, was superseded by FASB Concepts Statement No. 6, *Elements of Financial Statements*, issued in December 1985. Statement 6 contains basically the same definitions of elements as Statement 3, but it includes the financial statements of nongovernmental not-for-profit entities in its scope.

[2] APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, issued in October 1970.

[3] FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, issued in December 1984.

[4] A footnote to paragraph 6 of Concepts Statement 5 states that paragraph 6 is drawn from various paragraphs of Concepts Statement 3. The FASB does not define recognition in Concepts Statement 6, although the definition is implicit from the way the term is used in the Statement and from references to Concepts Statement 5.

Recognition Criteria

In Concepts Statement 5, paragraph 63, the FASB establishes the following "fundamental criteria" which must be met in order for an item to be recognized in the financial statements.

> *Definitions*—The item meets the definition of an element of financial statements.
>
> *Measurability*—It has a relevant attribute measurable with sufficient reliability.
>
> *Relevance*—The information about it is capable of making a difference in user decisions.
>
> *Reliability*—The information is representationally faithful, verifiable, and neutral.

The FASB states that the recognition criteria are derived from the qualitative characteristics of financial information established in Concepts Statement No. 2.[5] As such, the FASB points out that the requirement to meet the recognition criteria is subject to the pervasive cost–benefit constraint and the materiality threshold. That is, "the expected benefits from recognizing a particular item should justify perceived costs of providing and using the information" and "an item and information about it need not be recognized in a set of financial statements if the item is not large enough to be material and the aggregate of individually immaterial items is not large enough to be material to those financial statements."[6]

As further evidence that the qualitative characteristics are the foundation of the recognition criteria, the FASB includes two of them—relevance and reliability—as recognition criteria in their own right, as well as referring to reliability in the measurability criterion. To many, the specific references to these qualitative characteristics as recognition criteria may seem confusing and unnecessary because Concepts Statement 2 establishes the qualitative characteristics that should underlie *all* accounting information. Why should two of them be repeated as recognition criteria for a particular kind of information—elements?

[5] FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, issued in May 1980.
[6] Concepts Statement 2, paragraphs 32–33 and 133–144.

It would seem simpler and sufficient to say that for an item to be recognized in the financial statements it must meet two criteria:

1. The item must meet the definition of an element of financial statements.

2. The item must be measurable.

The FASB's distinction between definition and recognition is carried forward in Concepts Statement 6, as illustrated in paragraph 23 of that Statement. From the FASB's perspective, meeting the definition of an element of financial statements should be viewed as:

> . . . a necessary but not a sufficient condition for formally recognizing the item in the entity's financial statements . . . [S]ome items that meet the definitions may have to be excluded from formal incorporation in financial statements because of recognition or measurement considerations . . .

An important conclusion from the FASB's approach is that *not all items that meet the definition of an element will be recognized in the financial statements.* Reasons for not recognizing an element include the inability to measure the item (reliably or at all), lack of materiality, and cost–benefit considerations. However, a conclusion that, say, an asset or liability cannot or should not be recognized in a balance sheet does *not* mean that it is not an asset or a liability. On the contrary, an entity can have assets and liabilities other than those recognized in the balance sheet. Under the FASB's approach, it would be misleading to imply that items that meet the definition of an element are not elements unless and until they are recognized in the financial statements.

Nevertheless, some FASAB members have questioned whether it is useful to conclude that certain items are assets or liabilities (i.e., they have the essential characteristics of an asset or a liability) if those items will not be displayed in the financial statements. In response, one should note that an item that meets the definition of an element but does not meet recognition criteria may be disclosed in the notes to the financial statements or as supplementary information. Disclosure that an asset or liability exists but is not recognized in the financial statements, and the reason for the failure to recognize it (often, the inability to measure the item reliably), can be useful information for financial statement users. Also, the state of the art of measurement may change, so that an item that currently is not recognized may be recognized in the future. In the meantime, some information about it can be disclosed in the notes or as supplementary information. Ultimately, an advantage of the distinction between definition and recognition is that it acknowledges that an entity should be accountable for *all* of its assets and liabilities, whether they are formally recognized or not.

VIEWS OF OTHER STANDARD-SETTING AUTHORITIES

GASB

GASB Concepts Statement No. 3[7] presents recognition criteria that are essentially the same as the FASB's first and second criteria—definition and measurability. The term *recognition* is defined in paragraph 33 using language similar to the FASB's definition. No specific mention is made of relevance and reliability as recognition criteria, although there is a reminder in paragraph 33 that "Items recognized in a financial statement are intended to provide reliable representations of the effects of transactions and other events." Relevance, reliability, and other qualitative characteristics are addressed in Concepts Statement No. 1[8] and apply to all accounting and financial reporting information. Therefore, the GASB may have concluded it was unnecessary and redundant to identify specific qualitative characteristics as recognition criteria, except for associating measurement and reliability.

The GASB establishes recognition criteria in one declarative sentence at the beginning of paragraph 34:

> Items that are elements of financial statements and are measurable with sufficient reliability are recognized in financial statements.

The Statement does not provide further discussion of the two criteria for recognition (meeting the definition of an element and being measurable with sufficient reliability). However, the GASB does distinguish clearly between recognition on the one hand and disclosure in the notes or as supplementary information on the other hand. For example, the GASB states in paragraph 34 that "[d]isclosure in the notes to financial statements or presentation as supporting information is not an adequate substitute for recognition in the financial statements." Also, according to paragraph 35c, one of the purposes of notes is to provide "[a]dditional information about financial position or inflows and outflows of resources that does not meet the criteria for recognition."

The GASB's position illustrates the staff's earlier point that it is useful to determine whether an item is (meets the definition of) an asset or liability, even when that item may not be recognized in the financial statements. In both the

---

[7] GASB Concepts Statement No. 3, *on concepts related to Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements*, issued in April 2005.
[8] GASB Concepts Statement No. 1, *Objectives of Financial Reporting*, issued in May 1987.

FASB's and the GASB's frameworks, the definitions of elements are important for financial *reporting*, not just for financial *statements*. An item that meets the definition of an element should be reported somewhere (assuming it is material and meets cost–benefit considerations)—on the face of the financial statements if it meets recognition criteria, or in the notes or as supplementary information if it does not meet the recognition criteria.

Australia: Public Sector Accounting Standards Board of the Accounting Research Foundation (AARF), and Accounting Standards Board (AASB)

The AARF and AASB distinguish between definition and recognition in a similar fashion to the FASB. Unlike the FASB, however, the two concepts are addressed in the same Concepts Statement (SAC4)[9], albeit in separate sections. Also unlike the FASB (Concepts Statement 5), recognition criteria are established for each element, rather than for all elements in general. The criteria for all elements are, however, similar in concept and composition.

For each element, SAC 4 first defines the element and describes the essential characteristics that are fundamental to the definition. It then presents and discusses the criteria for recognition of that element. For example, the respective recognition criteria for assets (paragraph 38) and liabilities are (paragraph 65) as follows:

> An asset should be recognised in the statement of financial position when and only when:
>
> (a) it is probable that the future economic benefits embodied in the asset will eventuate; and
>
> (b) the asset possesses a cost or other value that can be measured reliably.

> A liability should be recognised in the statement of financial position when and only when:
>
> (a) it is probable that the future sacrifice of economic benefits will be required; and
>
> (b) the amount of the liability can be measured reliably.

---

[9] Statement of Accounting Concepts 4, *Definition and Recognition of the Elements of Financial Statements*, issued in March 1995.

Unlike the FASB's recognition criteria, the Australian criteria do not expressly require that the candidate for recognition meet the definition of an element. However, naming the element in the lead-in to the recognition criteria indicates an assumption that the definition has been met. To that extent, the lead-in and the FASB's first recognition criterion ("Definitions") coincide.
Australian criterion (b) is essentially the same as the FASB's second recognition criterion ("Measurability").

The main difference in the Australian recognition criteria is the express inclusion of the probability of receiving or sacrificing economic benefits in the future. The FASAB will recall that although probability is mentioned in the FASB's definitions of assets and liabilities, the text of Statement 6 explains that probability is not considered a definitional matter but rather is an issue for recognition and measurement. It appears that the Australian boards share that view: an item can meet the definition of an element and yet not be recognized because the future receipt or sacrifice of benefits is not probable.

A final difference in the Australian recognition criteria is that they do not include "relevance" and "reliability" (the FASB's third and fourth criteria) as specific criteria, although reliability is referred to in the context of measurement (Australian criterion (b) for both assets and liabilities).

New Zealand: Institute of Chartered Accountants

The New Zealand Institute's *Statement of Concepts for General Purpose Financial Reporting* (1993, revised 2001) addresses both the definition of elements, based on their essential characteristics, and recognition criteria. Similar to the FASB and the Australian boards, definition and recognition are separate concepts—two steps that are necessary to report an item on the face of the financial statements. Both the definitions of assets and liabilities and the criteria for recognizing them are the same as those in the Australian SAC4.

Canada: The Canadian Institute of Chartered Accountants (CICA)

In its *Public Sector Accounting Handbook*, the CICA includes a section on recognition in the financial statements in the chapter on "Concepts and Principles." The definition of the term *recognition* is substantively the same as the FASB's definition. The recognition criteria adopted by CICA are as follows (paragraph 1000.53):[10]

[10] Section PS 1000, January 2003.

(a) the item has an appropriate basis of measurement, and a reasonable estimate can be made of the amount involved; and

(b) for an item that involves obtaining or giving up future economic benefits, it is expected that such benefits will be obtained or given up.

The first criterion refers to measurability and is similar to criteria presented by the FASB, the GASB, and other standard setters. The second criterion is a probability notion, similar to one of the criteria in the Australian SAC4. Although there is no specific criterion that requires the item in question to meet the definition of an element, that requirement is made clear later in paragraph 1000.53 (see below).

In the same paragraph 1000.53, the CICA echoes other standard setters' position on the usefulness of distinguishing between meeting a definition and meeting recognition criteria. The CICA also expands on the probability concept by explaining the meaning of "expected" in recognition criterion (b). The FASAB members may note the similarity between this explanation and the FASB's discussion of the notion of "uncertainty."

> It is possible that an item will meet the definition of an element but still not be recognized in the financial statements because it is not expected that future economic benefits will be obtained or given up or because a reasonable estimate cannot be made of the amount involved. It may be appropriate to provide information about items that do not meet the recognition criteria in notes to the financial statements. "Expected" is used with its usual general meaning and refers to that which can reasonably be anticipated, contemplated or believed on the basis of available evidence or logic but is neither certain nor proved. The use of the word in the recognition criteria is intended to acknowledge that economic activities occur in an environment characterized by uncertainty. It is not intended to accommodate the recognition of items that do not meet the definition of one of the elements of financial statements. By implication, recognition would, therefore, not be appropriate without the occurrence of a past transaction or economic event that gives rise to an asset, liability, revenue or expense as defined in this Section. . .

United Kingdom: Accounting Standards Board (ASB)

In 2003, the UK's ASB issued a *Proposed Interpretation for Public Benefit Entities* (governments and not-for-profit entities) of its existing *Statement of Principles for Financial Reporting*, the scope of which was business entities. Similar to the FASB and other authorities already discussed, the UK's ASB treats the definition of elements and criteria for recognition of elements on the face of the financial statements as two separate issues. Assets, liabilities, and other elements are defined based on their essential characteristics, which are similar to those identified by the FASB and other bodies in their respective concepts statements.

As noted, meeting the definition of an element is only the first step towards recognition. The essential subsequent step is to meet recognition criteria. The UK ASB's Proposed Interpretation establishes the following recognition principle in Chapter 5, page 59. It is similar to the principle previously established for the transactions of business entities.

> If a transaction or other event has created a new asset or liability or added to an existing asset or liability, that effect will be recognised if:
>
> (a) sufficient evidence exists that the new asset or liability has been created or that there has been an addition to an existing asset or liability; and
>
> (b) the new asset or liability or the addition to the existing asset or liability can be measured at a monetary amount with sufficient reliability.

Note that the recognition criteria are quite similar to those of the FASB (except for the omission of criteria specifying the existence of relevance and reliability). That is, criterion (a) indicates that the item must meet the definition of an element (asset or liability in the example) and criterion (b) indicates the need for the item to be measurable with sufficient reliability.

Sweden: Public Governance and Territorial Development Directorate, Public Management Committee

The Swedish Public Management Committee prepared a document in 2003 titled *Conceptual Framework for the Preparation of Financial Statements in the Central Government of Sweden*. It addresses the definition of elements, recognition, and measurement in separate sections. (Previous sections address the objectives of financial statements; underlying assumptions, such as accrual basis accounting and going concern; and qualitative characteristics.) Though worded differently, the definitions of assets and liabilities are similar to those indicated earlier for the Australian SAC4 (which definitions are in turn similar to the FASB's definitions).

Recognition criteria also are similar to those cited earlier from SAC4:

> 82. An item that meets the definition of an asset, liability, net asset, expense or revenue should be recognised in the statement of financial position or statement of financial performance if
>
> (a) it is probable that the future economic benefits or the service potential associated with the item will be added to, or will leave, the entity in the future, and
>
> (b) the value of the item can be measured in a reliable way.

The previous paragraph (81) states that when an item meets the definition of an element, it should be recognised on the face of the financial statements and that recognition "cannot be replaced by disclosure of the accounting principles applied or by notes and supplementary schedules." This, again, is the same principle adopted by the FASB, the GASB, the Australian boards, and others. Also similar to the FASB, a subsequent paragraph (83) in the Swedish document refers to the need to consider the materiality constraint when assessing whether an item meets the recognition criteria.

COMPARATIVE SUMMARY OF RECOGNITION CRITERIA

The following table compares the recognition criteria established by the seven standard-setting authorities included in this paper.

TABLE 1. Comparative Summary of Recognition Criteria

AUTHORITY --------------SPECIFIED RECOGNITION CRITERIA-----------------

	Item meets definition of an element	**Item can be measured reliably***	**Informa-tion about item is relevant****	**Informa-tion about item is reliable****	**There is probability of receipt or sacrifice of benefits**
FASB	Yes	Yes	Yes	Yes	
GASB	Yes	Yes			
AUSTRALIA	Yes	Yes			Yes
NZ	Yes	Yes			Yes
CICA	Yes	Yes			Yes
UK ASB	Yes	Yes			
SWEDEN	Yes	Yes			Yes

Notes:

*All of the authorities cited, except the GASB, indicated that the item should have an attribute (FASB), cost or value (Australia and New Zealand), or similar feature that is measurable. However, those terms are included in the measurability criterion and are not separate criteria.

**All of the authorities cited, including the FASB have established qualitative characteristics, including relevance and reliability, for all accounting and financial reporting information, not just that recognized in financial statements.

All of the authorities indicate that *all* recognition criteria should be met in order for recognition to occur. Also, consideration should be given to the pervasive constraints of materiality and cost–benefit as well as to the qualitative characteristics of accounting information, such as relevance and reliability.

STAFF RECOMMENDATIONS

1. All of the standard setters cited have established a distinction between an item (a) meeting the definition of an element and (b) being recognized in the financial statements. **Staff recommends that the FASAB acknowledge that distinction. Thus, meeting the definition of an element would be only the first of two essential steps to recognizing an item in the financial statements. The second step would be that the item must meet the recognition criteria that the FASAB establishes. Items that meet the definition of an element but do not meet the recognition criteria would be**

candidates for disclosure in the notes to financial statements or as supplementary information.

2. The summary of recognition criteria in Table 1 shows that most of the boards cited have followed the FASB's lead, at least for the first two criteria in the table. **Staff recommends that these two criteria should be met in order for an item to be recognized in the financial statements of the federal government.**

3. No board except the FASB thought it necessary to establish relevance and reliability, or the pervasive constraints of materiality and cost–benefit, as *specific* recognition criteria; rather, they are understood as part of considerations that apply to all reported financial information. **Staff recommends that the FASAB should not establish a specific recognition criterion for relevance or reliability (although a reference to reliability in the measurement criterion may be appropriate).**

4. Four of the standard setters—the Australian, New Zealand, Canadian, and Swedish authorities—included a "test" for probability or expectation of future receipt (assets) or sacrifice (liabilities) of benefits in their recognition criteria. FASB did not do so, possibly because probability is mentioned in the definitions of assets and liabilities, even though the FASB indicates in Concepts Statement 6 that the notion of probability (uncertainty) should be addressed at the recognition and measurement stage. The FASAB thus far has not included a notion of probability in its draft definitions of assets and liabilities of the federal government. Rather, several Board members have indicated that it would be preferable to "cast a wide net" with regard to items meeting the definition of an element and then narrow the focus through the application of recognition criteria. **Staff supports that approach and recommends that the FASAB *exclude* a notion of probability from the definitions of elements and *include* a notion of probability or expectation in the recognition criteria**. The Board may wish to discuss at a later date whether and, if so how, it should stipulate a level of probability or expectation.

5. If the Board agrees with these recommendations, the recognition criteria for federal government financial statements would be as follows (wording not intended to be final):

An item should be recognized in the financial statements when all of the following criteria are met:

a. It meets the definition of an element of financial statements.

b. *The element is measurable with sufficient reliability.*
[Staff does not believe that the use of terms such as "has an attribute" or "has a cost or value that is measurable" is necessary. It should be sufficient to state that the item must be measurable.]

c. *The inflow or outflow of benefits or services inherent in the definition of the element is reasonably expected to occur in the future.*
[The phrase "expected to occur in the future" would be suitable for assets and liabilities. For revenues and expenses, "probably has occurred" might be more appropriate.]

As noted by the FASB and other standard setters, an asset or liability should be removed from the financial statements if it ceases to meet either the definition of an asset or liability or other recognition criteria.

It may be useful to mention in a discussion of recognition criteria in a concepts document that, when applying recognition criteria, consideration should be given to all of the qualitative characteristics including the pervasive constraint of materiality and cost–benefit considerations.

6. If the Board basically agrees with these proposed recognition criteria, **staff recommends that further discussion of them, refining of wording, etc. should be deferred until the Board is ready to adopt a definition for each of the elements.** Postponing further discussion might avoid the need for redeliberations if the definitions that the Board adopts suggest a need for changes in the essence of the recognition criteria or the desirability of specific wording.