Federal Accounting Standards Advisory Board

February 17, 2005

TO: Members of FASAB

FROM: Penny Wardlow, Consultant

THROUGH: Wendy Comes, Executive Director

SUBJECT: **Elements of the Financial Statements: Liabilities**

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.

INTRODUCTION

At the March 2005 meeting, the Board will continue deliberations about the essential characteristics of federal liabilities. **Attachment 1** to this memo is a draft of a section on liabilities for a concepts statement on Elements of the Financial Statements. It would follow a section on assets.

As the Board requested at the December 2004 meeting, the most recent draft of the assets section also is attached, as **Attachment 2**, in case the Board wishes to refer to it. The draft is marked up to show changes made since the Board last saw it (August 2004). Most of the changes were requested by the Board—e.g., use of the word *could* in the definition of assets—but I also have included some editorial changes, mainly to make the use of certain terms more consistent (e.g., *resources* vs. *assets*).

In concept, the assets draft is not very different from the draft the Board reviewed at the August meeting. The Board agreed at that meeting to consider the liabilities definition and essential characteristics independently of the assets definitions and not to make additional changes to the assets draft until a liabilities draft had progressed to a similar stage of development. At that time, it would be useful to consider to what extent the two definitions of elements and of the related essential characteristics of assets and liabilities should be similar, and then to revise both drafts accordingly. It is the staff's intent to address that issue at a future meeting.

Following the assets draft in Attachment 2 is a section on "Effects of Uncertainty," which addresses uncertainty for both assets and liabilities. The Board last reviewed that section at the August 2004 meeting and I have not subsequently made any changes. Again, the Board deferred further consideration until the liabilities draft was fairly advanced. Thus, the paragraphs on uncertainty are attached for ease of reference, but are not presented for discussion at the March meeting.

If the FASAB decides to issue a concepts statement on elements, then it would be useful to include at the beginning of the statement an explanation of why the FASAB needs a conceptual framework, who the beneficiaries will be, and how the Board has approached the definition of elements. I have not yet drafted that section, although I have mentioned it in "Notes to the Board" at the beginning of the assets and liabilities drafts. Pending a draft of that section for the Board to consider, I have attached to this memo, as **Attachment 3 [Note: this attachment is omitted here but may be obtained using the URLs presented in the text that follows]**, two articles by FASB senior project manager L. Todd Johnson, "Understanding the Conceptual Framework" [www.fasb.org/articles&reports/conceptual_framework_tfr_dec2004.pdf] and "The Project to Revisit the Conceptual Framework," [www.fasb.org/articles&reports/project_revisit_cf_tfr_dec2004.pdf] which appeared in the December 28, 2004 issue of the FASB's newsletter, *The FASB Report*. I think you will find these articles interesting and useful as you continue deliberations on the FASAB's conceptual framework in general and on elements of the financial statements in particular.

The first article explains the FASB's approach to its conceptual framework, why certain decisions were made, and how the definitions of elements, for example, differed from previous definitions in the accounting literature. The second article explains what a conceptual framework is, why the FASB and the IASB believe they need one, who benefits from the framework, and how it affects practice. The author then explains why the FASB and the IASB are revisiting their respective frameworks, what some of the issues are, including, the meaning of *probable* and other problems with the current definitions, and how the two boards plan to conduct the revision.

GOALS OF THE MARCH 2005 MEETING

The principal goal of the March meeting is to reach Board agreement on the substance and wording of the essential characteristics of federal liabilities. If agreement is achieved at the March meeting, staff will propose a definition of liabilities based on the agreed essential characteristics for discussion at the next meeting. Thus the principal questions are:

(1) Does the Board agree with the *substance* of the essential characteristics in paragraph L7?

(2) Does the Board agree with the *wording* of the essential characteristics in paragraph L7?

In addition, the Board's views are sought on the discussion of the legal framework (paragraphs L1 through L3) and the discussion of the characteristics that follows their identification (paragraphs L8 through L15). In particular, staff would like to know:

(3) Does the Board agree with the substance of the discussion of the major topics, including any conclusions that are presented?

(4) Should any of the topics discussed be eliminated?

(5) Should any of the topics discussed be expanded?

(6) Should any additional topics be discussed and, if so, what are they?

(7) Does the Board have any additional requests or recommendations for improving the draft?

The remainder of this memo includes staff comments on each of the sections of the draft, in order.

DEFINITIONS OF ELEMENTS

Paragraph A1 (pages 1 and 2 of the liabilities draft). The Board has previously reviewed this paragraph when it reviewed the two previous drafts of the assets section of the document. It would precede the definition of assets. I have reproduced it in this first draft of the liabilities section for ease of reference. Elements need to be defined in relation to a particular "entity" that has assets, liabilities and other elements. Thus, the definition of *federal entity* as "the federal government or a component unit of the federal government" is significant to understanding the definition and discussion of the characteristics of liabilities.

Liabilities

Legal Framework

Paragraphs L1 through L3 are intended to provide coverage of the issue of the "legal basis" for liabilities and also the issues of "constructive liabilities" and "legal enforceability."

The Board has discussed these issues at previous meetings. The conclusion of the majority of the Board has been that the activities of federal entities are "legally based" in the sense that they operate within a framework of laws. In that sense, federal liabilities are legally based, but they are not necessarily legally enforceable. Also, the majority has not wished to restrict the definition of liabilities to those that are contractual in nature or are specifically mentioned in statutes. On the other hand, the Board also does not wish to adopt as broad a concept of constructive liabilities as is included in the FASB's Concepts Statement 6, *Elements of the Financial Statements*, and the concepts statements of other standard setters who have addressed primarily private-sector entities.

Based on those discussions, I am proposing to address the legal framework at the beginning of the section on liabilities, to set the stage for the discussion of the definition of a liability and its essential characteristics. I have included in the legal framework a more restricted version of constructive liabilities than the FASB has. The version I propose would include them in the legal framework but indicate that judgment is needed to decide whether or when a liability exists, and should be based on the totality of the circumstances as well as consideration of the essential characteristics of a liability. I have not used the term *constructive obligation* in the draft in order to avoid potential confusion with the use of that term with a broader meaning by the FASB and other standard setters.

Definition of "Liability"

Paragraph L4 would present a definition of *liability*. I have not proposed a definition in this draft because I think it may be counterproductive to try to agree on the wording of the definition at the same time as the Board is seeking agreement on the substance and wording of the essential characteristics. If agreement is reached on those characteristics at the March meeting, then a definition based on those characteristics can be proposed at the next meeting.

Paragraph L5 is a reminder to the reader that definition and recognition are separate issues. The conceptual distinction between them would be addressed in the introductory section of the concepts statement. However, I think a reminder here (and also after the definition of assets) would be helpful. The Board has not yet decided whether criteria for recognition would be included in a separate section of the concepts statement on elements or in a separate statement. Therefore, the last sentence of paragraph L5 includes those alternatives, one of which would be deleted.

Essential Characteristics of Liabilities

Paragraph L6 responds to a Board member's suggestion that readers be alerted to the organization of the section—that is, the definition is derived from essential characteristics and those are identified and discussed in the referenced paragraphs. It is hoped that this will encourage readers to consider the entire discussion before reaching a conclusion on how the definition should be interpreted. (I have added an equivalent paragraph [A3] to the draft of the assets section.)

Paragraph L7 lists the essential characteristics. These are the same, in substance, as the FASB's essential characteristics.[1] However, I have endeavored to word them more appropriately for federal liabilities, and I have organized them into two, rather than three, characteristics. I think this simplifies them and removes some redundancy.

I experimented with several versions of the characteristics, combining them in different ways, before settling on the version in the draft. However, there are many ways these characteristics could be organized and the Board may prefer a different organization.

The Board has discussed several times whether to use the word *obligation*—and make it clear that the meaning is different from *obligation of budgetary resources* (which is in the FASAB Glossary) —or to use another word, such as *duty* or *responsibility*. I am not sure there was a majority decision on that issue. At first I

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[1] According to the FASB (Concepts Statement 6, paragraph 36), the essential characteristics of a liability are:

(a) It embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand.
(b) The duty or responsibility obligates a particular entity leaving it little or no discretion to avoid the future sacrifice, and
(c) The transaction or other event obligating the entity has already happened.

used *responsibility*, but I concluded that it sounded weaker than *obligation* and somewhat odd in places. The word *responsibility* also has the disadvantage of not having a clearly associated verb or adjective (as in *obligation, obligate*, and *obligated* entity). Perhaps more significantly, the word *obligation* is commonly used in accounting documents and might be a useful word for the Board to use in future standards without invoking its budgetary connotation. The use of the word in a concepts statement on elements could be a good precedent. Thus, I opted for *obligation* in the draft, with an explanation in footnote 1 of the draft.

Present Obligation

Paragraph L8 defines *obligation* and *present obligation* and **paragraphs L10** and **L11** further interpret characteristic (a). **Paragraph L9** explains why there need to be separate entities (external to each other) for a liability to exist. "External" does not necessarily mean "outside the federal government." It means any entity other than the one for which financial statements are being prepared.

The Board has previously discussed the importance of explaining that obligations may be liabilities, but intents and commitments are not. **Paragraphs L10** (on intent) and **L11** (on commitments) attempt to do that, based on the need established in L9 for the involvement of two separate entities for a liability to exist. There may be other reasons why expressions of intent and commitments are not liabilities and I would welcome suggestions for expanding the explanations in L10 and L11.

Requirement to Settle the Obligation

Paragraphs L12 through L15 elaborate on characteristic (b). You will notice that the characteristic is based on the entity being required, under current conditions, to make settlement, and I have not proposed including the phrase "little or no discretion to avoid" settlement.

In considering the FASB's essential characteristics, I was unsure what "little or no discretion to avoid the future sacrifice" entailed, especially in the context of a federal entity. I found no explanation of the phrase in FASB Concepts Statement 6 or in the FASB's special report on its conceptual framework.[2] In addition, it appears that "little or no discretion" is one of the issues to be addressed in the FASB and the IASB's joint review of their conceptual frameworks.[3]

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[2]Financial Accounting Series, Special Report, *The Framework of Financial Accounting Concepts and Standards*, by Reed K. Storey, Ph.D., CPA and Sylvia Storey, MBA (Norwalk, CT, FASB, January 1998).
[3] Personal communication from a senior FASB staff person involved in the conceptual framework review.

How would one assess whether an entity has "little or no discretion"? What discretion to avoid settlement would an entity have if it had incurred an obligation to another entity, and if one were considering *only* current conditions (as one should for definitional purposes) and not the possibility of future changes, such as a change in the law?

Based on existing conditions, I believe that the only current discretion the entity has is to dishonor the obligation and accept any consequences. This seems obvious and unnecessary to say. All other possibilities for avoiding settlement, including a change in the law that absolves the entity from the obligation and negotiating with the payee for relief, are things that might occur in the future, but they should not affect the fact that the entity *currently* has an obligation that it is required to settle in the future.

As the Board has previously discussed, in the context of the asset definition as well as the characteristics of liabilities, this is an issue of distinguishing between an item meeting the definition of a liability and whether it also meets the criteria for recognition. If there is a likelihood of a future change in the amount of the liability (including a change to zero), then I believe it should be taken into account through measurement and/or in the decision as to whether or not to recognize the liability. It should not affect whether an obligation *currently* meets the definition of a liability.

If the Board prefers to include the phrase "little or no discretion," then characteristic (b) could be drafted as follows:

(b) Under existing conditions, the federal entity has little or no discretion to avoid settlement of the obligation at a specified or determinable date, when a specified event occurs, or on demand.

Paragraph L12 essentially explains why the entity is required to settle the obligation. One reason could be that settlement is legally required and enforceable. If not, then the potential for other adverse consequences would lead the entity to decide that it currently has no realistic alternative to honoring the obligation. The explanation is adapted from the Australian standard-setting board's interpretation of the issue.

> Another essential characteristic of a liability is that it has adverse financial consequences for the entity in that the entity is obliged to sacrifice economic benefits to one or more entities. Thus, the existence of a liability depends on the present obligation being such that the legal, social, political or economic consequences of failing to honour the

> obligation leave the entity little, if any, discretion to avoid the future sacrifice of economic benefits to another entity. . .[4]

Paragraph L13 explains that the assessment of whether the entity must settle the obligation is made based on current conditions. The paragraph acknowledges that Congress may change the law and thereby absolve a federal entity from an obligation. It also mentions the possibility that the liability will be renegotiated in the future. However, the possibility of a *future* event does not *currently* enable an entity to avoid settlement and cannot be used to deny the existence of a liability at the present time. As previously noted, the likelihood of such a future event is an issue for measurement and recognition decisions.

Paragraph L14 adds to the explanation of the second essential characteristic by indicating that an integral part of it is the requirement to settle the obligation at a specified date, when a specific event occurs, or on demand.

Paragraph L15 explains that the specific identities of those who will receive cash, goods, or services in settlement of an obligation need not be known prior to settlement, in order for a liability to exist.

PROPOSAL FOR FUTURE MEETINGS

If the Board reaches agreement at the March meeting on the essential characteristics of federal liabilities, the staff's next step will be to propose one or more alternatives for the definition of federal liabilities. A subsequent step will be to consider whether and, if so, to what extent the definitions of assets and liabilities should be symmetrical. The staff would then present new drafts of both sections of a concepts statement.

[4] Australian Accounting Research Foundation and Australian Accounting Standards Board, *Definition and Recognition of the Elements of Financial Statements* (SAC 4, issued March 1995), paragraph 61.

PRELIMINARY DRAFT OF THE LIABILITIES SECTION OF A CONCEPTS STATEMENT ON ELEMENTS OF THE FINANCIAL STATEMENTS

> *Notes to Board:*
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> *(1) The section on liabilities would follow that on assets. A paragraph immediately before the assets section would cover the definition of "federal entity" that would apply to all the definitions of elements. That paragraph is included in this draft for ease of reference and because of its significance to evaluating the references to the federal entity in the discussion of liabilities.*
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> *(2) Introductory material would be provided in the concepts statement concerning its purpose and the approach taken to develop definitions of elements.*
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> *(3) The text is double spaced to aid the insertion of comments by Board members. Staff would welcome receiving a copy of those insertions.*

DEFINITIONS OF ELEMENTS

A1. All elements are defined in relation to a particular federal entity, which may be the federal government or a component unit of the federal government. An item that qualifies under the definitions is a federal entity's asset, liability, revenue, expense, or so forth. 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

A2. *[The definition of assets would appear here, followed by a discussion of their essential characteristics.]*

Liabilities

Legal Framework

L1. Federal entities are governed by and operate within a framework of laws. Thus, a federal liability must have its foundation in a law or 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 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.

L2. 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. For example, in some situations, certain laws and regulations may have created a framework for a federal entity to provide assets or services to other entities when a certain event occurs, without explicitly mandating that response. An example of such an event is a natural disaster; similar events in the past may or may not have resulted in a response by a federal entity. In other situations, such as certain benefit programs, laws and regulations may require the payment of benefits to other entities after a certain event occurs. Consideration of all the relevant facts and conditions may suggest that, for some of those programs, the entity's liability is incurred when the specified event occurs, whereas for other programs, the liability is incurred earlier, before payment is legally required. In the circumstances described in this paragraph, the totality of the facts of the situation, including the legal framework, specific statutory or regulatory requirements, if any, past precedents, and current conditions, should be assessed against the definition and essential characteristics of federal liabilities (discussed in paragraphs L4 through L15), so that an informed judgment can be made as to whether or when a liability has been incurred.

L3. Settlement of a federal liability may be 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 "Liability"

L4. *[The definition of liabilities would appear here.]*

L5. The definition of liabilities addresses only whether a liability exists and not whether or when it should be recognized in a statement of financial position. Criteria for the recognition of liabilities are set forth in paragraphs XX through XX [OR will be set forth in a separate Statement].

Essential Characteristics of Liabilities

L6. Similar to the definition of assets in paragraph A2, the definition of liabilities is derived from the nature of liabilities—the characteristics that are fundamental or essential to all liabilities. Paragraphs L7 through L15 identify and discuss those characteristics.

L7. A federal entity has a liability when both of these characteristics exist:

(a) The federal entity has a present obligation[5] to provide cash, goods, or services to another entity in the future.

(b) Under existing conditions, the federal entity is required to settle the obligation at a specified or determinable date, when a specified event occurs, or on demand.

Present Obligation

[5] The term *obligation* is used in this Statement with its general meaning of a duty or responsibility to act in a certain way. It is not intended to mean that an obligation of budgetary resources is required for a liability to exist in accounting or financial reporting.

L8. 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. To qualify as a liability, a present obligation must entail the provision of assets (cash 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 present obligation to settle the agreed amount. Further, when an entity establishes the conditions under which other entities will qualify to receive future payments and those conditions have been met, the entity has a present obligation to settle the agreed amount in the future.

L9. 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 (duty or responsibility) 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.

L10. It is important to distinguish between a present obligation, which may be a liability, and a future intent or commitment, which is not. For example, an entity may announce its intent to purchase assets in the future, or to provide financial assistance in the future to individuals that meet certain conditions. The announcement does not, of itself, create a present obligation. For a present obligation to be incurred requires the occurrence of an event that involves another entity, namely, in the examples, delivery of the purchased assets by the vendor or satisfaction of certain conditions by the potential recipients of financial assistance.

L11. Similarly, **a** federal entity may make general commitments by announcing future programs or the expansion of existing ones. Neither these commitments nor the subsequent establishment of the program or program expansion, by themselves, create present obligations, even if accompanied by proposed budgets. For a present obligation to exist, additional events must have occurred that involve the program beneficiaries, such as the qualification of specific program beneficiaries.

Requirement to Settle the Obligation

L12. For a present obligation to another entity to qualify as a liability, the entity must, as conditions currently stand, be required to settle the obligation. For some obligations, such as contractual obligations, the entity may not be able to avoid settlement because it is legally enforceable. However, as discussed in paragraph L3, legal enforceability is not a characteristic of all liabilities. Instead of or in addition to legal consequences, the failure to honor a present obligation may result in such adverse social, political, or economic consequences for the entity that it may have no realistic alternative but to honor the obligation.

L13. It is important that the assessment of whether an entity is required to make settlement in the future be based on *existing* conditions**,** including current law, because an essential characteristic of a liability is that the entity has a *present* obligation. It is possible that conditions will change before settlement is due. For example, the Congress might change a law under which a federal entity has incurred a present obligation and erase the obligation or otherwise enable the entity to avoid settlement. Alternatively, the entity 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 an entity currently can avoid settlement and therefore does not have a liability.

L14. An integral part of the second essential characteristic of a liability is that the entity currently be required to settle the obligation on a specified or determinable date, on the occurrence of a specified event, or on demand. If the entity can unilaterally specify the settlement date or event, it has no liability because it can avoid the future provision of assets or services by, for example, indefinitely postponing the settlement date.

L15. Knowing, before settlement occurs, which specific entities will receive settlement is not an essential characteristic of a liability. For example, an employer may have a present obligation for future long-term disability payments to employees without knowing the identity of each of the employees who ultimately will qualify for payment. The obligation would qualify as a liability if the other essential characteristics of a liability were present.

PRELIMINARY DRAFT OF THE ASSETS SECTION OF A CONCEPTS STATEMENT ON ELEMENTS, AND A DISCUSSION OF UNCERTAINTY

Revised January 2005

> *Notes to Board:*
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> *(1) The text is double-spaced to aid the insertion of comments by Board members. Staff would welcome receiving a copy of those insertions.*
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> *(2) Staff envisions that a previous section of the document would explain the purpose and need for a concepts statement on elements of the financial statements. That section also would explain the Board's approach to defining elements, including the conceptual separation between (a) an item meeting the definition of an element and (b) whether the item does or does not meet criteria for recognition or disclosure in the financial statements. To help readers' understanding of the separation between definition and recognition, it may be useful to state in that same section where information about recognition criteria may be obtained. In any event, the Board should assume that references to recognition in the following paragraphs follow a previous section that would distinguish between the purpose and functions of definitions and recognition criteria.*

DEFINITIONS OF ELEMENTS

A1. All elements are defined in relation to a particular federal entity, which may be the federal government or a component unit of the federal government. An item that qualifies under the definitions is a federal entity's asset, liability, revenue, expense, or so forth. 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

A2. An entity's assets are resources that could provide economic benefits or services in the future and that the entity controls..

Essential Characteristics of Assets

A3. The definition of assets in paragraph 2 is derived from the nature of assets—the characteristics that are fundamental or essential to all assets. Paragraphs 4 through XX highlight and discuss those characteristics. Also discussed are characteristics that are common to many assets, but are not essential characteristics of all assets. The definition of assets addresses only whether an asset does or does not exist. The definition does not specify the conditions that would need to be met before an asset qualifies for recognition in the statement of financial position. Criteria for the recognition of assets are set forth in paragraph XX and discussed in paragraphs XX to XX.

A4. 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"[6] or a "means of supplying a want."[7] Although all entities have resources,those resources are not assets

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

[7] *The Concise Oxford Dictionary*, (Oxford, U.K.: Oxford University Press, 1964). **[Note to Board: If we keep this reference, I will find a more up-to-date edition of the source.]**

unless they have the essential characteristics of assets discussed in paragraphs A5 through A20 and, therefore, meet the definition of assets in paragraph A2.

A5. To be an asset of a particular entity and, therefore, eligible for recognition as an asset in the entity's financial statements, a resource must possess two characteristics. First, it must be able to provide economic benefits or services in the future. Second, the entity must be able at the present time, to control access to the resource such that the entity can obtain the resulting economic benefits or services for itself and deny or regulate the access of others.

A6. To illustrate the distinction between a resource and an asset, an entity may benefit from a resource but be unable to control the access of other entities to that resource; if so, the resource is not an asset. Examples include natural resources, such as air and water, to which the entity has no specific rights and, therefore, cannot control the access of other entities; a major highway that is used by the entity and its constituents but which is owned or controlled by another entity; and the intellectual capital of the entity's employees. On the other hand, 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 would meet the definition of an asset if the entity is able not only to obtain the benefits for itself but also to deny or regulate the access of other entities to those benefits. Such resources would be assets even though they might not meet the criteria for recognition in the financial statements, including measurement criteria.

A7. Many assets have other features that help identify them. For example, they may be acquired at a cost and they may be tangible, exchangeable, or legally enforceable.

However, those features are not essential characteristics of an asset and their absence is not sufficient in itself to preclude an item from qualifying as an asset. *[To be expanded, for example with the addition of some examples.]*

Economic benefits or services

A8. The common characteristic possessed by all assets is *the ability to provide economic benefits or services in the future*—that is, beyond the date at which the existence of the asset is assessed. Some publications use the terms *economic benefits* and *services* (or *service potential*) *interchangeably*. However, as used in this Statement, economic benefits are assumed to result in inflows of cash, goods, or services to the entity, whereas services may benefit the entity in other ways. Examples include the benefits obtained from public parks, museums, and art galleries that provide recreational, educational, and research opportunities at little or no charge, thereby assisting the government to meet its mission to provide public services. All assets provide a means for entities to achieve their objectives.

A9. The economic benefits or services that a resource can provide can be distinguished from the item of property that embodies them, which may be an object or a right. This means that the assumption that a particular type of resource will always be an asset is not justified. For example, whereas equipment would normally be expected to provide economic benefits in the future. However, there may be circumstances when equipment would not qualify as an asset because it has become obsolete or unusable and has no scrap value.

A10. Further, the economic benefits or services that can flow from resources may, by virtue of specific arrangements, be shared by more than one entity. For example, each party to a joint venture may have 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. Also, 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.

A11.. Access to the economic benefits or services derived from a resource can be obtained in various ways. Often it is obtained by legal ownership of the underlying item of property. However legal rights to economic benefits derived from an item of property can be obtained without having legal ownership of the property itself—for example, when property is leased.

Control by a particular entity

A12. The second essential characteristic of an asset is control, which refers to the ability of a particular entity to obtain the economic benefits or services embodied in the resource and to deny or regulate the access of others. The entity controlling an asset is the one that can, depending on the nature of the asset, hold it, exchange it, use it to provide cash, goods or services, exact a price for others' use of it, or use it to settle liabilities.

A13.-. 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.

A14. The capacity of an entity to control access to the economic benefits or services that may flow from 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 over economic benefits or services, because an entity may be able to control them 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, but 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.

A15. Possession or ownership of a resource would normally entail control of access to the economic benefits or services embodied in the resource. However, whereas control of access is an essential characteristic of an asset, possession or ownership is not. An entity may possess a resource but not expect to enjoy the benefits embodied in it or, conversely, may expect to enjoy the benefits of a resource that it does not possess. For example, an agent may hold goods for sale on behalf of a principal. The principal expects to receive the benefits from the sale of an asset that it does not physically possess, whereas the holder of the asset (the agent) can anticipate only a commission on the sale. Also, an entity may control a resource but not own it or, conversely, may own a resource but not control it. For example, under a lease agreement, control over the leased property owned by the lessor is transferred to the lessee (although the extent and duration of control will vary according to the terms of the agreement).

A16. Some economic benefits or services will not be controlled by the entity that obtains them, because the entity cannot deny or regulate the access of other entities. Public goods are an example. Public highways provide economic benefits to the entities that use them, but they cannot qualify as assets of entities other than the entity or entities that have the capacity to control their use. This is because the entities that use public highways are unable to control access to them by other entities. 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.

A17. The concept of control permits weight to be given to economic and social sanctions when they are effective in inducing entities to fulfill promises or to comply with widely accepted business practices or customs. Legal enforceability may be difficult to assess until a court has rendered its decision. Thus, inclusion in the definition of assets of a control test rather than a legal enforceability test means that the definition is broader and may be more reliable in assessing the capacity of an entity to secure the economic benefits or services embodied in a resource.

Creation and dissolution of assets

A18. Entities obtain most of their assets from cash or credit transactions. The transactions may be exchange transactions whereby assets are acquired in exchange for existing assets of the entity, or by undertaking an obligation to transfer assets in the future. Alternatively, the transactions may be nonexchange transactions—for example, taxes, donations, grants, and appropriations. Assets also may result from events such as accretion and discovery.

A19. Implicit in the essential asset characteristics is that the event giving rise to the entity's control of access must have occurred. Thus, a distinction is made between the economic benefits or services embodied in present resources and those of anticipated future resources. When an entity does not presently control access to a resource, the resource does not qualify as an asset of that entity. Thus, for the entity to decide prior to a certain date to acquire a new facility does not of itself create an asset for the entity at that date, even though it may be highly likely that the entity will acquire the facility and obtain the resulting benefits.

A20. 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.

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Effects of Uncertainty

> ***Note to Board****: This section is based on paragraphs 44 through 48 of FASB Concepts Statement 6 and includes only minor changes from that text. In that statement, the discussion of uncertainty is placed after the definitions and discussions of assets and liabilities, and it refers to both elements. A similar placement and coverage may or may not be appropriate for the FASAB's document. I am including the discussion in this paper so that the Board can consider the issue of uncertainty as part of its discussion of asset characteristics. There is no intent to prejudge the discussion of or decisions about liability characteristics or definitions or to assume that the Board's treatment of uncertainty would necessarily be the same for liabilities as for assets.*

A. 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 future economic benefits or services to which access can be controlled by the entity, or the presence or absence of the entity's legal, equitable, or constructive obligation to sacrifice assets in the future, can often be discerned reliably only with hindsight. As a result, some items that with hindsight actually qualified as assets or liabilities of the entity under the definitions may, as a practical matter, have been recognized as expenses, losses, revenues, or gains. Alternatively, they may have remained unrecognized 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 included as assets or liabilities because of judgments made in the face of uncertainty at the time of assessment.

B. 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 therefore be recognized as expenses, losses, revenues, or gains or remain unrecognized as a result of cost and benefit analysis indicating that their formal incorporation in financial statements is not useful enough to justify the time and effort needed to do it. It may be possible, for example, 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.

C. A highly significant practical consequence of the features described in the preceding two paragraphs is that the existence or amount (or both) of most assets and many liabilities can be probable but not certain.* The definitions in this Statement are not intended to require that the existence and amounts of items be certain for them to qualify as assets, liabilities, revenues, expenses, and so forth, and estimates and approximations will often be required unless financial statements are to be restricted to reporting only cash transactions.

> *Footnote: *Probable* is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in FASB Statement No. 5, *Accounting for Contingencies*, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved (*Webster's New World Dictionary of the American Language*, 2d college ed. [New York: Simon and Schuster, 1982], p. 1132).

D. To apply the definitions of assets and liabilities (and other elements of financial statements) thus commonly requires assessments of probabilities, but degrees of probability are not part of the definitions. That is, the degree of probability of future economic benefits or services (or of future cash outlays or other sacrifices of future economic benefits or services) and the degree to which its amount can be estimated with reasonable reliability that are required to recognize an item as an asset (or a liability) are matters of recognition and measurement, and not of definition. The distinction needs to be maintained between the definitions themselves and steps that may be needed to apply them. Matters involving measurement problems, effects of uncertainty, reliability, and numerous other factors may be significant in applying a definition, but they are not part of the definition. Particular items that qualify as assets or liabilities under the definitions may need to be excluded from formal incorporation in financial statements for reasons relating to measurement, uncertainty, or unreliability, but they are not excluded by the definitions. Definition, recognition, measurement, and display are separate in the Board's conceptual framework.

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