FASB EXPOSURE DRAFT

Proposed Statement of Financial Accounting Concepts

Issued: July 16, 2020
Comments Due: November 13, 2020

Concepts Statement No. 8, Conceptual Framework for Financial Reporting

Chapter 4: Elements of Financial Statements

This Exposure Draft of a proposed Statement of Financial Accounting Concepts is issued by the Board for public comment. Comments can be provided using the electronic feedback form available on the FASB website. Written comments should be addressed to:

Technical Director
File Reference No. 2020-500

Financial Accounting Standards Board

Notice to Recipients of This Exposure Draft of a Proposed Statement of Financial Accounting Concepts

The Board invites comments on all matters in this Exposure Draft and is requesting comments by November 13, 2020. Interested parties may submit comments in one of three ways:

- Using the electronic feedback form available on the FASB website at Exposure Documents Open for Comment
- Emailing a written letter to director@fasb.org, File Reference No. 2020-500
- Sending written comments to "Technical Director, File Reference No. 2020-500, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116."

Do not send responses by fax.

All comments received are part of the FASB's public file. The FASB will make all comments publicly available by posting them to the online public reference room portion of its website.

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Proposed Statement of Financial Accounting Concepts No. 8

Conceptual Framework for Financial Reporting

Chapter 4: Elements of Financial Statements

July 16, 2020

Comment Deadline: November 13, 2020

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Preface

Background

P1. The Financial Accounting Standards Board (FASB or Board) issued its first Concepts Statement in 1978 and issued six more by 2000. In 2004, the International Accounting Standards Board (IASB) and the FASB (the Boards) began a joint project to revise and converge their conceptual frameworks. The result of that joint project was FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 1,* The Objective of General Purpose Financial Reporting, *and Chapter 3,* Qualitative Characteristics of Useful Financial Information. In late 2010, the Boards decided to postpone further action on their respective conceptual frameworks until after the completion of a number of joint projects and ultimately agreed to discontinue the effort to work on their frameworks on a joint basis.

P2. In January 2014, the FASB reactivated its conceptual framework project. This Exposure Draft, which would become Chapter 4 of Concepts Statement 8, addresses matters relating to elements of financial statements.

Authoritative Status of the Conceptual Framework

P3. Paragraph 105-10-05-3 of the *FASB Accounting Standards Codification®* states that FASB Concepts Statements are not authoritative. Some standards are inconsistent with the Concepts Statements. This Concepts Statement or other Concepts Statements do not override authoritative standards. If accounting for a transaction or event is not specified in authoritative generally accepted accounting principles (GAAP), an entity first must consider accounting principles for similar transactions or events within authoritative GAAP and then consider nonauthoritative guidance from other sources (including Concepts Statements).

How This Chapter of the Conceptual Framework Would Be Used

P4. This chapter of Concepts Statement 8 would be similar to the rest of the framework in that it establishes concepts that the Board would use in developing standards of financial accounting and reporting. In particular, this chapter would provide the Board with a framework for developing standards by identifying elements of financial statements that could be appropriate for recognition in the financial statements and relevant to the users of those financial statements. This

chapter would provide the Board with a framework for developing standards in meeting the objective of financial reporting that enhances the understandability of information to existing and potential investors, lenders, donors, and other resource providers of a reporting entity.

Summary and Questions for Respondents

Summary

Introduction to the Conceptual Framework

S1. The Conceptual Framework establishes the concepts that underlie financial reporting. The Conceptual Framework is a coherent system of concepts that flow from the objective of financial reporting. The concepts address the selection of transactions, events, and circumstances to be represented and of items that meet the definitions of elements of financial statements; how those items should be recognized, measured, and disclosed; and how they should be summarized and presented in financial statements.

Elements of Financial Statements

S2. Elements of financial statements are the building blocks with which financial statements are constructed. *Elements* refers to broad classes, such as assets, liabilities, revenues, and expenses. This chapter focuses on the broad classes and their characteristics and does not discuss or define particular items that might meet the elements definitions. For example, economic items and events, such as cash on hand or inventory, that meet the definitions of elements are not elements as the term is used in this chapter. Rather, they are called *items* or other descriptive names. Notes to financial statements are not elements, though they serve important functions that are distinct from elements, including amplifying or complementing information about items in financial statements.

S3. Definitions of elements of financial statements are a significant determinant of the content of financial statements. Possessing the essential characteristics of one of the elements is a necessary but not sufficient condition for an item to be recognized in an entity's financial statements. To be recognized in financial statements, an item must meet the fundamental recognition criteria as well as a cost-benefit constraint.

S4. All matters of recognition, measurement, and display have purposely been separated from the definitions of the elements of financial statements in the Board's conceptual framework project. The definitions in this chapter focus on the essential characteristics of elements of financial statements. Other parts of the conceptual framework project include questions of when particular items that qualify as assets, liabilities, revenues, expenses, and so forth should be formally recognized in the financial statements, how those items should be measured, and how the information included should be displayed.

Questions for Respondents

S5. The Board invites individuals and organizations to comment on all matters in this Exposure Draft, particularly on the questions below. Comments are requested from those who agree with the proposed concepts as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed concepts are asked to describe their suggested alternatives, supported by specific reasoning.

Question 1: The Board expects that most assets that met the definition of an asset in FASB Concepts Statement No. 6, *Elements of Financial Statements*, will continue to qualify as assets under the definition of an asset in this proposed chapter. Do you agree that the definition of an asset in this proposed chapter is consistent with the Board's assertion? If not, please provide examples.

Question 2: In particular, respondents are asked to focus on internally generated intangible assets. Is the definition of an asset in this proposed chapter helpful in resolving issues of identifying intangible assets?

Question 3: The Board's definition of an asset in this proposed chapter does not include the term *control*. However, this proposed chapter explains why and how control is interrelated to the definition of an asset. Is this discussion sufficient or is the term *control* necessary to include in the definition of an asset? If the term *control* is necessary to include, please explain how its inclusion would change the population of items that would meet the definition of an asset in this proposed chapter.

Question 4: The Board decided that an obligation to transfer either assets or, in certain limited circumstances, an entity's own shares would meet the definition of a liability. Is the discussion in this proposed chapter of the limited circumstances in which the entity's own shares would meet the definition of a liability sufficiently clear?

Question 5: Other than as described in Question 4, to allow certain share-settled instruments to be liabilities, the Board expects the liabilities that met the definition of a liability in Concepts Statement 6 will continue to qualify as liabilities under the definition of a liability in this proposed chapter. Do you agree that the definition of a liability in this proposed chapter is consistent with the Board's assertion? If not, please provide examples.

Question 6: In practice, the more challenging applications of the definition of a liability in Concepts Statement 6 were related to business risks, constructive obligations, and stand-ready obligations. Is the discussion of those three areas in this proposed chapter adequate to understand and apply the definition of a liability?

Question 7: The Board suggested that integration with presentation principles would be helpful in distinguishing between the components of comprehensive

income. To facilitate this distinction, paragraph E92 of this proposed chapter references presentation principles. Is distinguishing revenues from gains and expenses from losses essential as a matter of elements, or should those distinctions be exclusively a matter for presentation concepts? Please explain.

Question 8: As described in Question 7, this proposed chapter seeks to distinguish between revenues, expenses, gains, and losses. Do the definitions of and other explanatory language related to revenues, expenses, gains, and losses make the distinction between these elements sufficiently clear?

Question 9: The Board has concluded that, other than when exceptions are specifically noted in this proposed chapter, the elements described in this proposed chapter would apply to not-for-profit organizations. Do you agree with this conclusion?

Question 10: This proposed chapter was developed on the basis of Concepts Statement 6, though several paragraphs have been removed or adapted. Are any of the paragraphs from Concepts Statement 6 that have been removed in drafting this proposed chapter necessary to keep? If so, why?

Question 11: "Appendix A: Accrual Accounting and Related Concepts," includes discussion of several concepts that are used in this proposed chapter and in other chapters of the Conceptual Framework. Is this material helpful in a chapter discussing the elements of financial statements?

Conceptual Framework for Financial Reporting

CHAPTER 4: ELEMENTS OF FINANCIAL STATEMENTS

Introduction

E1. This chapter defines 10 elements of financial statements: assets, liabilities, equity (net assets), revenues, expenses, gains, losses, investments by owners, distributions to owners, and comprehensive income. This chapter also defines or describes certain other concepts that underlie or are otherwise related to those elements. The definitions in this chapter apply to both business and not-for-profit entities.

E2. Definitions of elements of financial statements are a significant determinant of the content of financial statements. Possessing the essential characteristics of one of the elements is a necessary but not sufficient condition for an item to be recognized in an entity's financial statements.[1] To be recognized in financial statements, an item should meet the fundamental recognition criteria as well as a cost-benefit constraint.

E3. Matters of recognition, measurement, and display purposely have been separated from the definitions of the elements of financial statements in the Conceptual Framework. The definitions in this chapter focus on the essential characteristics of financial statement elements. Other parts of the Conceptual Framework focus on questions of when items that qualify as assets, liabilities, revenues, expenses, and so forth should be recognized in the financial statements and how those items should be measured and displayed.

E4. There are two different types of elements of financial statements. The first type includes assets, liabilities, and equity, which describe resources or claims to or interests in resources at a specified date. The second type of elements describes

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[1]Decisions about recognizing, measuring, and displaying elements of financial statements depend on evaluations such as what information is most relevant for investment, credit, and other resource allocation decisions and whether the information is reliable enough to be trusted. Other significant evaluations of that information involve its comparability with information about other periods or other entities, its materiality, and whether the benefits of providing it exceed the costs. Those matters are discussed in Chapter 3, *Qualitative Characteristics of Useful Financial Information*, of FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting*, and criteria and guidance for business entities that are based on them are set forth in FASB Concepts Statement No, 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.

the effects of transactions and other events and circumstances that affect an entity during specified time intervals (reporting periods). In a business entity, this includes comprehensive income and its components—revenues, expenses, gains, and losses—and investments by owners and distributions to owners.[2]

E5. Assets and liabilities have conceptual and definitional primacy because the definitions of assets and liabilities and changes in those elements are foundational to the definitions of all other elements. Equity is assets minus liabilities. Investments by and distributions to owners and comprehensive income and its components are the result of increases and decreases in assets and liabilities.

E6. Elements of financial statements are the building blocks with which financial statements are constructed. *Elements* refers to broad classes, such as assets, liabilities, revenues, and expenses. This chapter focuses on the broad classes and their characteristics and does not discuss or define particular items that might meet the elements definitions. For example, economic items and events, such as cash on hand or inventory, that meet the definitions of elements are not elements as the term is used in this chapter. Rather, they are called *items* or other descriptive names. Notes to financial statements are not elements, though they serve important functions that are distinct from elements, including amplifying or complementing information about items in financial statements.[3]

E7. The items incorporated in financial statements are financial representations (depictions in words and numbers) of certain resources of an entity, claims to or interests in those resources, and the effects of transactions and other events and circumstances that result in changes in those resources and claims or interests. That is, symbols (words and numbers) in financial statements stand for cash in a bank, buildings, wages due, sales, use of labor, earthquake damage to property, and a host of other economic items and events pertaining to an entity's activities.

E8. In some instances, financial statements include separate items that increase or decrease the carrying amount of an asset or a liability. For example, an estimate of uncollectible amounts reduces a receivable to the amount expected to be collected, or a bond premium increases the face value of a bond payable to its proceeds or present value. Those "valuation accounts" are part of the related assets and liabilities but are not assets or liabilities in their own right.

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[2]In a not-for-profit entity, the combination of revenues, expenses, gains, and losses often is referred to as a change in net assets. Occasionally, those entities have investments by owners and distributions to owners (see paragraphs E14 and E75–E76).

[3]Chapter 8, *Notes to Financial Statements*, of Concepts Statement 8 includes a discussion on the role of notes and their relation to financial statements.

Objective of General Purpose Financial Reporting

E9. The focus of the Conceptual Framework is the usefulness of financial reporting information in making economic decisions—reasoned choices among alternative uses of scarce resources. Chapter 1 of Concepts Statement 8 emphasizes usefulness to present and potential investors, creditors, and others in making rational investment, credit, and similar decisions. FASB Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations,* emphasizes usefulness to present and potential resource providers and others in making rational decisions about allocating resources to not-for-profit entities.[4] Chapter 3 of Concepts Statement 8 emphasizes that the usefulness of financial reporting information for those decisions rests on the fundamental qualitative characteristics of relevance and faithful representation.

E10. The financial statement elements definitions in this chapter pertain to economic items and events that are relevant to investment, credit, and other resource allocation decisions and, thus, are relevant to financial reporting.[5] Those decisions involve committing (or continuing to commit) resources to an entity. The elements defined are an entity's resources, the claims to or interests in those resources, and the changes therein from transactions and other events and circumstances involved in the entity's use of resources to produce and distribute goods or services and engage in other activities. Relevance of information about items that meet the elements definitions stems from the significance of an entity's resources and changes in resources (including those affecting comprehensive income).

E11. Economic resources or assets and changes in them are central to the existence and operations of an entity. Both business entities and not-for-profit entities require and use assets to conduct their purpose and mission. A resource's capacity to be exchanged for cash or other resources or to be combined with other resources to produce needed or desired goods or services gives the resource utility and value (present and future economic benefit).

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[4]Those who make decisions about allocating resources to not-for-profit entities include both (a) lenders, suppliers, employees, and the like who expect repayment or other direct pecuniary compensation from an entity and essentially have the same interest in and make the same kinds of decisions about the entity, whether it is a not-for-profit entity or a business entity, and (b) members, contributors, donors, and the like who provide resources to not-for-profit entities for reasons other than expectations of direct and proportionate pecuniary compensation. (See paragraphs 15–19 and 29 of Concepts Statement 4.)

[5]Decision usefulness of information provided about those relevant economic items and events depends not only on their relevance but also on the representational faithfulness of the financial representations called assets, liabilities, revenues, expenses, and so forth in financial statements. Representational faithfulness depends not only on the way the definitions are applied but also on recognition, measurement, and disclosure decisions that are beyond the scope of this chapter.

E12. Business entities and not-for-profit entities obtain resources from various sources. Business entities and some not-for-profit entities sell the goods and services they produce or acquire for cash or claims to cash. Both buy goods and services for cash or incur obligations to transfer cash or other things of value. Business entities receive resources from investments in the entity by owners, while not-for-profit entities commonly receive at least some resources from donors that do not expect to receive either repayment or economic benefits proportionate to resources provided.[6] Those contributions are the major source of resources for some not-for-profit entities but are not significant for other not-for-profit entities or for most business entities.[7]

E13. A not-for-profit entity obtains and uses resources to provide certain types of goods or services to its members or society. The nature of those goods or services or the identity of the groups or individuals that receive them is often critical in donors' or other resource providers' decisions to contribute or otherwise provide cash or other assets to a particular entity. Many donors provide resources to support certain types of services or for the benefit of certain groups and may specify how or when (or both) an entity may use the cash or other resources they contribute to it.

E14. In contrast to business entities, not-for-profit entities generally do not have defined ownership interests that can be sold, transferred, or redeemed or that convey entitlement to a share of a residual distribution of resources in the event of liquidation of the entity. A not-for-profit entity is required to use its resources to provide goods and services to its constituents and beneficiaries as specified in its articles of incorporation (or comparable document for an unincorporated

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[6]The term *donor* is used throughout this chapter and is intended to include contributors, donors and prospective donors, grantors and prospective grantors, and federated fund-raising organizations that solicit contributions and then redistribute those contributions to nonbusiness organizations after deducting fund-raising and other costs.

[7]Paragraph 6 of Concepts Statement 4 lists the distinguishing characteristics of not-for-profit entities, including (a) contributions from resource providers who do not expect pecuniary return, (b) operating purposes other than to provide goods or services at a profit, and (c) absence of ownership interests like those of business entities. Not-for-profit entities have those characteristics in varying degrees. Paragraphs 7 and 8 of Concepts Statement 4 state:

> The line between nonbusiness organizations and business enterprises is not always sharp since the incidence and relative importance of those characteristics in any organization are different. . . . As happens with any distinction, there will be borderline cases. . . . especially for organizations that possess some of the distinguishing characteristics of nonbusiness organizations but not others.
>
> Some organizations have no ownership interests but are essentially self-sustaining from fees they charge for goods and services. . . . the objectives of Concepts Statement 1 [Chapter 1 of Concepts Statement 8] may be more appropriate for those organizations. [Footnote reference omitted.]

association) or in its bylaws and generally is prohibited from distributing assets as dividends to its members, directors, officers, or others.[8] Thus, not-for-profit entities have operating purposes other than to provide goods or services at a profit or profit equivalent, and resource providers do not focus primarily on profit as an indicator of a not-for-profit entity's performance.[9]

E15. Providers of resources to a not-for-profit entity are interested in the services that the entity provides and its ability to continue to provide those services. Because profit indicators are not the focus of their resource allocation decisions, resource providers for not-for-profit entities need other information to assess an entity's performance during a period and how its managers have discharged their stewardship responsibilities, not only for the custody and safekeeping of the entity's resources but also for their efficient and effective use. This includes information about the amounts and kinds of inflows and outflows of resources during a period and the relationship of those resources to other information about service efforts and, to the extent possible, service accomplishments.[10]

Definition of Elements

Assets

E16. An asset is a present right of an entity to an economic benefit.

Characteristics of Assets

E17. An asset has the following two essential characteristics:

a. It is a present right.
b. The right is to an economic benefit.

The combination of these two characteristics allows an entity to obtain the economic benefit and control others' access to the benefit.

E18. Assets commonly have features that help identify them—for example, assets may be contractual, tangible, exchangeable, or separable. However, those features are not essential characteristics of assets. Their absence is not sufficient to preclude an item from qualifying as an asset.

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[8]Some not-for-profit entities, for example, many membership entities, may be permitted under law to distribute assets to members upon dissolution or final liquidation. However, assets of many other not-for-profit entities are held subject to limitations (a) permitting their use only for specific purposes or (b) requiring their return to donors or their designees if the entity is dissolved. Thus, upon dissolution of a not-for-profit entity, its assets, or a significant part of them, must often be transferred to another not-for-profit entity engaged in activities substantially similar to those of the dissolving entity, to donors, or, in some cases, to other unrelated entities.

[9]Concepts Statement 4, paragraphs 6–9.

[10]Concepts Statement 4, paragraphs 9, 38, 41, and 47–53.

E19. The common characteristic of assets is "economic benefit"—the capacity to provide services or benefits to the entities that use them. In a business entity, that economic benefit eventually results in potential net cash inflows to the entity. In a not-for-profit entity, that economic benefit is used to provide desired or needed goods or services to beneficiaries or other constituents, which may or may not directly result in net cash inflows to the entity. Some not-for-profit organizations rely significantly on contributions or donations of cash to supplement selling prices or replace cash or other assets used in providing goods and services. The relationship between the economic benefit of an entity's assets and net cash inflows to that entity can be indirect in both business entities and not-for-profit entities.

E20. An asset has the capacity to be beneficial to an entity by being exchanged for something else of value to the entity, by being used to produce something of value to the entity, or by being used to settle the entity's liabilities. Things that give an entity no advantage beyond the common advantages of others because they are available to all do not qualify as assets. The ability to restrict others' access is a component of an asset of an entity because the ability to restrict creates an advantage in the form of privileged access and control of economic benefits. A right that is not restricted, such as a right to sue or a right to enjoy music, is not an asset of an entity. Access to a public road outside an entity's property might provide a right to an economic benefit, but if the entity cannot restrict access to that road, the road is not an asset of the entity. Although proximity of the road might add value to the property, there is no right that has granted privileged access or advantage to the entity.

E21. Incurring a cost to acquire an item does not in itself qualify the item to meet the definition of an asset, for example, services provided by other entities, including personal services that are received and used simultaneously. They can be assets of an entity only momentarily—as the entity receives and uses them—although their use may create or add value to other assets of the entity. Rights to receive services of other entities for specified or determinable future periods can be assets of an entity.

Present right

E22. A right entitles its holder to have or obtain something or to act in a certain manner. Rights can be obtained in various ways. Often, rights are obtained by legal ownership, for example, owning a building. Legal ownership gives the owner access to economic benefits, including the ability to possess, use, and enjoy the right; to sell, donate, or exchange the right; or to exploit the right's value by, for example, pledging it as a security for borrowing.

E23. Legally enforceable rights to economic benefits can be obtained without legal ownership of the underlying benefit itself as is the case, for example, when

property is leased or intellectual property is licensed or when an entity has the rights to specified certain cash flows, as in the case of a contract providing rights only to interest flows from a specified debt instrument. Other legally enforceable rights that give rise to assets include the right to require other parties to make payments or render services and the right to use a patent or a trademark. Legally enforceable rights include, among other rights, contractual rights (for example, rights from options held).

E24. Rights also might be enforceable by means equivalent to legal enforcement, such as those arising within a self-regulatory structure. If enforcement by other such means is sufficiently similar to legal enforcement, rights enforceable by those alternative enforcement mechanisms may be the equivalent of legally enforceable rights. An entity also can obtain economic benefits from a right in the absence of legally enforceable rights. For example, an entity might not have legally enforceable rights to secret know-how but can otherwise obtain economic benefits from it. The entity may use or sell the knowledge and restrict or otherwise prevent or limit other’s access to the benefits.

E25. To qualify as an asset of an entity, that entity need not have an *exclusive* right to an economic benefit. Rights, including the ability to restrict access to a benefit, and restrictions may be single (held or imposed solely by the entity) or shared (held or imposed in conjunction with others). Two or more entities might have different rights and share the same economic benefit at the same time or might otherwise have rights to the same economic benefits at different times. For example, lease arrangements unbundle the economic benefits of the underlying asset by giving (a) the lessee the right to hold and use the property for a specified interval and (b) the lessor the right to receive lease payments and any residual value. Also, timeshare property owners have the rights to use property during specified time periods. Each entity has an asset based on its rights to the economic benefit.

E26. Two or more entities might have an undivided interest in an economic benefit, such as a parcel of land or mineral resources. Each entity has a right to economic benefits deriving from that right that might qualify as an asset, even though the right of each entity is subject, at least to some extent, to the rights of the other entity or entities. The entity with rights to an economic benefit is the one that can exchange some or all of those rights, use the items to which it has the rights to produce goods and services or reduce other expenditures, exact a price for others’ use of the rights, or use the rights to settle liabilities or make distributions to owners.

E27. Assets may be intangible, and even if they are not separable or exchangeable, they may be useable by an entity in producing or distributing goods or services. For example, a license may be nontransferable and therefore not exchangeable; however, the license provides the right to engage in economically beneficial activities.

E28. To meet the definition of an asset, the right must be a *present* right; that is, the right exists at the financial statement date. The existence of a present right at the financial statement date means that the right and therefore the asset have arisen from past transactions or other past events. Often, assets are obtained by purchasing or producing them, but other transactions or events may generate assets. Examples include the discovery of mineral deposits, the receipt of land or buildings from a government, or contributions received by a not-for-profit entity. The means of acquiring rights does not affect whether the item meets the essential characteristics of an asset. However, an examination of the history of how potential rights may have been created might help to determine whether a present right exists at the financial statement date.

E29. Transactions or other events expected to occur in the future do not in themselves give rise to assets today. An intention to purchase inventory does not by itself meet the definition of an asset. Equipment to be acquired next year is not a present right to that equipment today. A benefit that is expected only because of an anticipation of the action or performance of either a counterparty or the entity is not a present right. In contrast, an existing contract to purchase equipment (a right to purchase equipment) might give rise to an economic benefit that is distinct from the benefit embodied in the equipment itself.

E30. Sometimes present rights with uncertain amounts and timing are referred to as contingent assets. The term *contingent asset* has been a source of confusion because it is often thought to refer to circumstances in which the existence of a right depends on the occurrence or nonoccurrence of a future event. Absent a present right, the occurrence or nonoccurrence of a future event does not by itself give rise to an asset. Some items commonly described as contingent assets satisfy the definition of an asset because the contingency does not relate to whether a present right exists but instead relates to one or more uncertain future events that affect the amount of economic benefit for which a right exists. For those rights, the fact that the outcome is unknown affects the measurement but not the existence of the asset.

Right to an economic benefit

E31. Another essential characteristic of an asset is that the right of an entity must be to an economic benefit. An asset of an entity might be represented by rights to a particular property (such as the right to possess, use, and enjoy a parcel of land) or by rights to some or all the economic benefits derived from the property.

E32. Money (cash, including deposits in banks) is valuable because of what it can buy. It can be exchanged for virtually any good or service that is available, or it can be saved and exchanged for goods and services in the future. Money's "command over resources"—its purchasing power—is the basis of its value and economic benefit.

E33. Assets other than cash benefit an entity by being exchanged for cash or other goods or services, by being used to produce goods or services, or by being used to settle liabilities or pay distributions to owners. To carry out their activities, both business entities and not-for-profit entities commonly produce goods or services. Both types of entities create utility and value in similar ways—by using goods or services to produce other goods or services. Business entities expect customers to pay for the utility and value added, and they price their outputs accordingly. Some not-for-profit entities distribute some or all of their outputs of goods or services at prices that include the utility and value they have added. Other not-for-profit entities commonly distribute the goods or services they produce to beneficiaries gratis or at nominal prices. Although that may make measuring the value of their outputs difficult, it does not deprive them of value.

E34. The ability of an entity to sell, transfer, license, or exchange a right provides evidence that the right presently exists, the entity controls access to that right, and the right is to an economic benefit. Some intangible assets arise from rights conveyed legally by contract, statute, or other means. For example, trademarks may be registered with the government. Contracts often are negotiated with customers or suppliers. The existence of contractual or other legal rights is a common characteristic of an intangible asset.

E35. Some activities are undertaken with the expectation of obtaining an economic benefit in the future. Examples include research and development, advertising, training, start-up activities, and preoperating activities. While the costs incurred in these activities are not assets, the activities may result in an entity obtaining an asset or enhancing an existing asset. For these and similar activities, assessments of when a present right exists and whether the right is to a related economic benefit may be especially uncertain. The practical problem is whether a right to a future economic benefit exists at a specified date.

E36. Some intangible items that do not arise from rights conveyed by contract or other legal means are nonetheless capable of being separated and exchanged for something of value. Others cannot be separated from an entity and sold or otherwise transferred. If the item is capable of being separated and exchanged for something of value, it would be evidence that a right exists and that the right is to an economic benefit. Moreover, a specific right to use a public highway from which the licensee might otherwise be excluded—for example, a license to operate a truck on the highways within a state—may have future economic benefits for the licensee, with respect to that license, even though it does not keep everyone else off the highway. Similarly, riparian rights and airspace rights may confer future economic benefits on their holders even though they do not keep others' boats off the river or prevent airplanes from flying overhead.

Liabilities

E37. A liability is a present obligation of an entity to transfer an economic benefit.

Characteristics of Liabilities

E38. A liability has the following two essential characteristics:

a. It is a present obligation.
b. The obligation requires an entity to transfer or otherwise provide economic benefits to others.[11]

E39. Liabilities commonly have features that help identify them. For example, many liabilities require the obligated entity to pay cash to one or more identified other entities. Liabilities may not require an entity to pay cash but may require the entity to convey other assets, provide services, or transfer other economic benefits. Most liabilities are based on a foundation of legal rights and duties, though existence of a legally enforceable claim is not a prerequisite for an obligation to qualify as a liability.

E40. Entities routinely incur liabilities in exchange transactions to acquire the funds, goods, and services they need to operate. For example, borrowing cash (acquiring funds) obligates an entity to repay the amount borrowed, acquiring assets on credit obligates an entity to pay for the assets, and selling products with a warranty or guarantee obligates an entity to stand ready to either pay cash or repair or replace any products that prove defective. Often, obligations incurred in exchange transactions are contractual based on written or oral agreements to pay cash or to provide goods or services to specified or determinable entities on demand at specified or determinable dates or on occurrence of specified events.

Present obligation

E41. A liability requires that an entity be obligated to perform or act in a certain manner. Most liabilities are legally enforceable. Legally enforceable obligations include those arising from binding contracts, agreements, rules, statutes, or other requirements that would be upheld by a judicial system or government. Judicial systems vary in type and form, and the term *judicial systems* includes any such system that would enforce laws, statutes, and regulations. In the context most relevant to financial reporting, an obligation is any condition that binds an entity to some performance or action. In a financial reporting context, something is binding on an entity if it requires performance. Performance is what the entity is required to do to satisfy the obligation.

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[11]This chapter continues the practice of describing liabilities as either an obligation to transfer or to provide economic benefits. For example, the term *transfer* has typically been used to describe obligations to pay cash or convey assets, and the term *provide* has typically been used to describe obligations to perform services or stand ready to do so.

E42. Many obligations that qualify as liabilities stem from contracts and other agreements that are enforceable by courts or from governmental actions that have the force of law.[12] Agreements, contracts, or statutory requirements often will specify or imply how an obligation was incurred and when and how the obligation is to be settled. For example, borrowing and lease agreements specify the amount of charges and the dates when the payments are due. The absence of a specified maturity date or event to require settlement may cast doubt that an obligation exists.

E43. Liabilities necessarily involve other parties, society, or law. The identity of the other party or recipient need not be known to the obligated entity before the time of settlement. An obligation of an entity to itself cannot be a liability. For example, in the absence of external requirements an entity is not obligated to repair the roof of its building or maintain its plant and equipment. Although those actions may be wise business moves, the entity may forgo or defer such activities because there is no present obligation to perform the activity.

E44. Certain obligations require nonreciprocal transfers from an entity to one or more other entities. Such obligations include taxes imposed by governments, donations pledged to charitable entities, and cash dividends declared but not yet paid.

E45. To have a liability, an entity must have a present obligation, that is, the obligation exists at the financial statement date. The settlement date of the liability may occur in the future, but the obligation must be present at the financial statement date. Transactions or other events expected to occur in the future do not in and of themselves give rise to obligations today.

E46. An intention to purchase an item, for example, an asset, does not in and of itself create a liability. However, a contractual obligation that requires an entity to pay more than the fair value of the asset at the transaction date may create a liability before the asset is received, reflecting what the entity might have to pay to undo the unfavorable contract.

E47. Business risks result from the conduct of an entity's business activities. A business risk is not a present obligation, though at some point in the future an event may occur that creates a present obligation. Some businesses have the

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[12]As used in this chapter, a legal obligation is an obligation that a party is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of promissory estoppel. *Promissory estoppel* is defined in the ninth edition of *Black's Law Dictionary* (2009) as:

> The principle that a promise made without consideration may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise and if the promisee did actually rely on the promise to his or her detriment.

potential of carrying out activities and creating present obligations as a result of those activities. However, no present obligation exists even if it is virtually certain that an obligating event will occur, though at present no such event has occurred. The essence of distinguishing business risks from liabilities is determining the point in time when an entity has a present obligation. One example of business risks would be the operation of a passenger airline. Airlines have the business risk that a plane might crash, creating liabilities for the airlines. However, those business risks do not produce a present obligation for the consequences of a plane crash that has yet to occur.

E48. Some business risks result from an entity’s transactions, for example, selling goods in overseas markets might expose an entity to the risk of future cash flow fluctuations because of changes in foreign exchange rates. Other business risks result from an entity’s operating environment, for example, operating in a highly specialized industry might expose an entity to the risk that it will be unable to attract sufficient skilled staff to sustain its operating activities. Those risks are not liabilities.

E49. To be presently obligated, an entity must be bound, either legally or in some other way, to perform or act in a certain way, as described in paragraph E50. Most liabilities are legally enforceable, including those arising from contracts, agreements, rules, statutes, or other requirements that would be upheld by a judicial system or government. An entity also can become obligated by other means. However, the existence of a present obligation may be less clear in those circumstances.

E50. Some liabilities rest on equitable or constructive obligations, including some that arise in exchange transactions. Liabilities stemming from equitable or constructive obligations are commonly settled in the same way as those arising from legally binding contracts, but they lack the legal sanction that characterizes most liabilities and may be binding primarily because of social or moral sanctions or custom.

E51. A constructive obligation is created, inferred, or construed from the facts in a particular situation rather than contracted by agreement with another entity or imposed by government. An entity may become constructively obligated through customary business practice. In the normal course of business, an entity conducting certain activities may not create a present legal obligation but may nonetheless cause the entity to become presently obligated. For example, policies and practices for sales returns and those for warranties in the absence of a contract may create a present obligation.

E52. An entity’s past behavior also may give rise to a present obligation. Repeated engagement in a certain behavior may obligate the entity to perform or act in a certain way on the basis of the pattern of behavior. For example, the entity may create a constructive obligation to employees for vacation pay or year-end

bonuses by paying them every year even though it is not contractually bound to do so and has not announced a policy to do so.

E53. An equitable obligation also stems from ethical or moral constraints other than those imposed by law, contract, or similar strictures. An equitable obligation might arise from a duty to do that which an ordinary conscience and sense of justice would deem fair, just, and right in the circumstances even if there is no legal obligation to act. For example, a business entity may have an equitable obligation to complete and deliver a product to a customer that has no other source of supply even though its failure to deliver only would legally require the return of the customer's deposit.

E54. The distinction between equitable or constructive obligations and obligations that are enforceable in courts of law is not always clear, and the distinction between equitable or constructive obligations and no obligations often may be even more troublesome. Determining whether an entity is bound by an obligation to a third party in the absence of legal enforceability is often extremely difficult. Thus, the concepts of equitable obligations and constructive obligations must be applied with great care. Overly narrow interpretations tend to exclude significant actual obligations of an entity, while too-broad interpretations effectively nullify the definition of liabilities.

E55. The essence of a not-for-profit entity is to provide goods or services consistent with its stated purpose or mission. The fiduciary responsibility to use assets to provide services to beneficiaries does not itself create an equitable or constructive obligation of an entity. A donor's restriction focuses that fiduciary responsibility on a stipulated use for specified contributed assets but does not change the basic nature of the entity's fiduciary responsibility. Consequently, donor-imposed restrictions on an entity's use of contributed assets do not create obligations that qualify as liabilities.

Obligation to provide economic benefits

E56. A second essential characteristic of a liability is that the obligation requires an entity to transfer or provide economic benefits to others or to be ready to do so. The obligation establishes the responsibility of the entity to fulfill the requirements of the obligation or otherwise satisfy or settle the obligation. Some obligations require an entity to refrain from engaging in certain types of activities or to forgo an economic benefit to which the entity may otherwise be entitled.

E57. Many liabilities require an obligated entity to transfer cash or other assets to one or more identified other entities. An obligation also can be fulfilled, satisfied, or settled in a number of other ways, including by granting a right to use an asset, providing services, replacing that obligation with another obligation, converting the obligation to equity, or, in certain circumstances, transferring shares of the entity. Such obligations are often documented, including how the entity is required to fulfill the obligation and when—by a specified date or when specified events occur. For

example, a receipt of cash results in an obligation if the entity receiving it is expected to provide a good or service on a certain day or refund the cash if the good or service is not provided. Those actions represent transfers of economic benefits.

E58. A transfer of shares sufficient in number to satisfy an obligation of determinable or defined amount is a transfer of an economic benefit. If arrangements permit or require settlement of obligations by issuance of a variable number of the entity's own shares, those shares are essentially being used in lieu of assets to settle an obligation and therefore meet the definition of a liability.

E59. In some cases, the amount and timing of settlement or performance associated with a present obligation are uncertain. Many of those situations involve what commonly have been referred to as stand-ready obligations. With a stand-ready obligation, an entity's timing of settlement or performance, the amount of economic benefits that the entity will transfer, or both are not known at the financial reporting date.

E60. The nature of a stand-ready obligation is that the outcome of the present obligation, not the existence of the obligation itself, is determined by some future event. The consequences of the uncertain outcome may affect how the present obligation is measured. The issue associated with stand-ready obligations has been to identify when the present obligation is created.

E61. Certain types of contractual and legal obligations, such as warranties, guarantees, and options, are examples of stand-ready obligations. By writing an option, an entity formally documents that it will act in a certain way in the future if called upon by the holder of the option. Even though the external party (option holder) may never exercise the option, the entity that wrote the option is obligated to act as required by the option contract. Similarly, writing a guarantee creates a present obligation even if an outflow resulting from the guarantee is remote. The uncertainty of the payment affects measurement of the guarantee, not the existence of an obligation to honor the guarantee if called upon to do so. In the case of a product warranty, the warranty issuer has a present obligation to repair or replace the product (or to provide warranty coverage over the term of the warranty) if the product develops a fault. The issuer recognizes its liability arising from its obligation to provide warranty coverage. The amount that will be required to fulfill the conditions of the warranty depends on the product developing a fault during the warranty period, an uncertain future event. That uncertainty does not affect the existence of a present obligation to provide warranty coverage; rather, the uncertainty about whether the product will require repair or replacement is reflected in the measurement of the liability.

E62. Although contractual and legal situations often provide the clearest examples of stand-ready obligations, it is possible that noncontractual situations also can give rise to present stand-ready obligations. For example, an entity may implicitly

warrant a product and, as a result, that entity would stand ready to provide services.

E63. It is true that both stand-ready obligations and business risks can result in an outflow of economic benefits. However, stand-ready obligations are liabilities because they involve present obligations while a business risk does not give rise to a present obligation. Thus, the existence of a present obligation distinguishes stand-ready obligations (and more generally liabilities) from business risks.

E64. Sometimes present obligations with uncertain amounts and timing are referred to as contingent liabilities. The term *contingent liability* has been a source of confusion because it is often thought to refer to circumstances in which the existence of an obligation depends on the occurrence or nonoccurrence of a future event. Absent a present obligation, the occurrence or nonoccurrence of a future event does not by itself give rise to a liability. Some items commonly described as contingent liabilities satisfy the definition of a liability because the contingency does not relate to whether a present obligation exists but instead relates to one or more uncertain future events that affect the amount that will be required to settle the present obligation. For those obligations, the fact that the outcome is unknown affects the measurement but not the existence of the liability.

Equity or Net Assets

E65. Equity or net assets is the residual interest in the assets of an entity that remains after deducting its liabilities.[13]

E66. The equity or net assets of a business entity and a not-for-profit entity is the difference between the entity's assets and its liabilities. It is a residual that is affected by all events that increase or decrease total assets by amounts different than those events increase or decrease total liabilities. Thus, equity or net assets of both a business entity and a not-for-profit entity is increased or decreased by the entity's operations and certain other events and circumstances affecting the assets and liabilities of the entity.

E67. Common and preferred shareholders hold instruments that represent equity of an entity. A second class of instrument considered an equity interest in an entity is a contract or an arrangement that permits the holder to acquire a fixed number of equity instruments of the entity. Holders of this type of instrument participate in the results of the issuer's operations, just not in the same manner that a holder of an outstanding share does. For example, a holder of a written call option on the issuer's common shares participates in the upside potential in the same manner

[13]This chapter generally applies the term *equity* to business entities, which is common usage, and the term *net assets* to not-for-profit entities, for which the term *equity* is less commonly used. The two terms are interchangeable.

that a common shareholder does. However, it is subject to a different downside risk, that is, the loss of the premium paid for the instrument.

Characteristics of Equity of Business Entities

E68. In a business entity, equity is the ownership interest.[14] Equity stems from ownership rights (or the equivalent)[15] and involves a relationship between an entity and its owners as owners rather than as employees, suppliers, customers, lenders, or in some other nonowner role.[16] Since equity ranks after liabilities as a claim to or interest in the assets of the entity, it is a residual interest because:

a. Equity is the same as net assets, the difference between the entity's assets and its liabilities.
b. Equity is enhanced or reduced by increases and decreases in net assets from nonowner sources as well as investments by owners and distributions to owners.

E69. An entity may have several classes of equity (for example, one or more classes each of common stock or preferred stock) with different rights to participate in distributions of entity assets or different priorities of claims on entity assets in the event of liquidation. That is, some classes of owners may bear relatively more of the risks of the entity's unprofitability or may benefit relatively more from its profitability (or both) than other classes of owners. However, all classes depend at

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[14]This chapter defines equity of business entities only as a whole, although the discussion notes that different owners of an entity may have different kinds of ownership rights and that equity has various sources. In financial statements of business entities, various distinctions *within* equity, such as those between common stockholders' equity and preferred stockholders' equity, between contributed capital and earned capital, or between stated or legal capital and other equity, are primarily matters of display that are beyond the scope of this chapter.

[15]Other entities with proprietary or ownership interests in a business entity are commonly known by specialized names, such as stockholders, partners, and proprietors, and by more general names, such as investors, but all are owners. Equity of business entities is thus commonly known by several names, such as owners' equity, stockholders' equity, ownership, equity capital, partners' capital, and proprietorship. Some entities (for example, mutual entities) do not have stockholders, partners, or proprietors in the usual sense of those terms but have participants whose interests are essentially ownership interests.

[16]The same entities, or individuals, may simultaneously be both owners and employees, owners and creditors, owners and customers, creditors and customers, or some other combination. For example, an investor may hold both debt and equity securities of the same entity or an owner of an entity also may become its creditor by lending to it or by receiving rights to declared and unpaid cash dividends. Wages due, products or services due, accounts payable due, and other amounts due to owners in their roles as employees, customers, suppliers, and the like are liabilities and not part of equity. Exceptions involve situations in which relationships between the parties cast doubts that they are liabilities in substance rather than investments by owners.

least to some extent on entity profitability for distributions of entity assets, and no class of equity carries an unconditional right to receive future transfers of assets from the entity except in liquidation, and then only after liabilities have been satisfied.

E70. A major distinguishing characteristic of the equity of a business entity is that it may be increased through investments of assets by owners that also may receive distributions of assets from the entity. Owners invest in a business entity with the expectation of obtaining a return on their investment. Owners benefit if the entity is profitable and bear the risk that it may be unprofitable. The distinguishing characteristic of equity is that it inevitably is affected by the entity's operations and other events and circumstances affecting the entity (which together constitute comprehensive income; see paragraph E79).

Characteristics of Net Assets of Not-for-Profit Entities

E71. In a not-for-profit entity, as in a business entity, net assets (equity) is a residual, the difference between the entity's assets and its liabilities. In contrast to equity of a business entity, net assets of a not-for-profit entity is not typically an ownership interest. Distinguishing characteristics of a not-for-profit entity include the absence of ownership interest(s) in the same sense as a business entity, operating purposes not centered on profit, and significant receipts of contributions, many involving donor-imposed restrictions.

E72. Net assets of not-for-profit entities is divided into two mutually exclusive classes—net assets with donor restrictions and net assets without donor restrictions.

E73. Restrictions impose responsibilities on management to ensure that an entity uses donated resources in a manner specified by resource providers. Sometimes, donor-imposed restrictions limit an entity's ability to sell or exchange an asset. For example, a donor may give a painting to a museum subject to the requirement that it must be publicly displayed, properly maintained, and never sold.

E74. More commonly, donors' restrictions permit an entity to pool the donated assets with other assets to sell or exchange the donated assets for other suitable assets as long as the economic benefits of the donated assets are not consumed or used for a purpose that does not comply with the restriction. For example, a donor may contribute 100 shares of Security A to an entity's endowment, thereby requiring that the amount of the gift be restricted but not requiring that the specific shares be held indefinitely. Thus, net assets with donor restrictions generally refer to amounts of net assets that are restricted by donor-imposed limits, not to specific assets.

Investments by and Distributions to Owners

E75. Investments by owners are increases in equity of an entity resulting from transfers to the entity from other entities of something valuable to obtain or increase ownership interests (or equity) in the entity. Assets are the most common form of investments by owners, but owners' investments also may take the form of providing services or satisfying or converting liabilities of the entity.

E76. Distributions to owners are decreases in equity of an entity resulting from transferring assets, rendering services, or incurring liabilities by the entity to owners. Distributions to owners decrease ownership interest (or equity) in an entity.

Characteristics of Investments by and Distributions to Owners

E77. Investments by owners and distributions to owners are transactions between an entity and its owners *as owners*. Through investments by owners, an entity obtains resources (a) to begin or expand operations, (b) to retire debt securities or other liabilities, or (c) for other business purposes. As a result of investing resources in the entity, other entities obtain ownership interests in that entity or increase ownership interests that they already have. Not all investments in the equity securities of an entity by other entities are investments by owners as that concept is defined in this chapter. In an investment by owners, the entity that issues the interests acquired by an owner always receives the proceeds or benefits; therefore, the entity's net assets increase. If the purchaser of equity interests becomes an owner or increases its ownership interest in an entity by purchasing those securities from another owner that is decreasing or terminating its ownership interest, the transfer does not affect the net assets of the entity.

E78. An entity's distributions to its owners decrease the entity's net assets and decrease or terminate ownership interests of owners that receive the distributions. An entity's reacquisition of its own equity interests by transferring assets or incurring liabilities to owners is a distribution to owners as that concept is defined in this chapter. Because owners become creditors for a dividend that is declared until it is paid, an entity's incurrence of a liability to transfer assets to owners in the future converts a part of the equity or ownership interest of the entity into creditors' claims. That is, equity is reduced by the incurrence of the liability to owners, not by the settlement of the liability.

Comprehensive Income

E79. Comprehensive income is the change in equity of a business entity during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

Characteristics of Comprehensive Income

E80. Although an entity's revenues and expenses from its business activities are generally the primary source of comprehensive income, they are not the only source. The various sources of comprehensive income may vary in stability, risk, and predictability. That is, characteristics of various sources of comprehensive income may differ significantly from one another, indicating a need for information about various components of comprehensive income. That need underlies the distinctions between revenues and gains, between expenses and losses, and between various kinds of gains and losses.

E81. A concept of maintenance of capital or recovery of cost is a prerequisite for separating return on capital from return of capital because only inflows exceeding the amount needed to maintain capital are a return on equity. Two major concepts of capital maintenance exist, both of which can be measured in units of either money or constant purchasing power—the financial capital concept and the physical capital concept (which is often expressed in terms of maintaining operating capability, that is, maintaining the capacity of an entity to provide a constant supply of goods or services). The financial capital concept is the traditional view and is generally the capital maintenance concept in present primary financial statements. Comprehensive income as defined is a return on financial capital.

Elements of Comprehensive Income[17]

E82. The definitions of revenue, expenses, gains, and losses serve a different purpose than the definition of the six elements described in the beginning of this chapter—assets, liabilities, equity, investment by owners, distributions to owners, and comprehensive income. Those six elements constitute the complete set of fundamental elements of financial statements of business entities. In contrast, the definitions of revenues, gains, expenses, and losses are not needed to determine comprehensive income. Because comprehensive income is determined by changes in assets and liabilities other than investments by and distributions to owners, it can be derived without being separated into its various components.

E83. Definitions of the components of comprehensive income are significant because satisfying the objective of financial reporting requires more information about comprehensive income than just its amount. Investors and creditors want and need to know how and why equity has changed, not just the amount that it has changed. Reflecting those changes is a matter of presentation. The sources of comprehensive income are significant to those attempting to use financial statements to help them with investment, credit, and similar decisions.

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[17]The elements of comprehensive income equally apply to comprehensive income of a business entity and changes in net assets of not-for-profit entities.

Revenues

E84. Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities.[18]

Expenses

E85. Expenses are outflows or other using up of assets of an entity or incurrences of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities.

Gains

E86. Gains are increases in equity (net assets) from transactions and other events and circumstances affecting an entity except those that result from revenues or investments by owners.

Losses

E87. Losses are decreases in equity (net assets) from transactions and other events and circumstances affecting an entity except those that result from expenses or distributions to owners.

Revenues, expenses, gains, and losses

E88. Revenues and gains are similar in that they both increase comprehensive income, and expenses and losses are similar in that they both decrease comprehensive income. Revenues and expenses result from delivering or producing goods, rendering services, or carrying out other activities. Other activities, as referenced in the definitions of revenues and expenses in this chapter, are those activities that permit others to use the entity's resources, which result in interest, rent, royalties, and fees. Other activities also include charitable contributions received and made.

E89. Gains and losses typically result from one of the following four circumstances:

a. Nonreciprocal transactions or events such as natural catastrophes
b. Adjustments to estimates of reported assets and liabilities
c. Exchange transactions
d. Holding gains and losses.

E90. The definitions of revenues, expenses, gains, and losses in this chapter do not distinguish precisely between revenues and gains and expenses and losses particularly when considering exchange transactions. Distinctions between revenues and gains and expenses and losses from exchange transactions of an

[18]The use of the term *goods* is intended to be all-inclusive and not restricted to personal property.

entity depend to a significant extent on the nature of the entity and the activity with which an item is associated. An identical item can be used by entities differently. As a result, the proceeds from the sale of an asset may be revenue for one entity and may be a factor in determining gain or loss for another. For example, the proceeds from the sale of a machine displayed as inventory would be considered revenue, and the cost of that machine would be considered an expense. However, the proceeds from the sale of a machine used by an entity in a productive capacity would not be considered revenue, and the entity would report a gain or a loss upon disposition of that machine.

E91. The difference between items recognized as a result of transactions, especially routine transactions that result in recognizing revenue or costs of generating revenue as expenses, and those recognized for other reasons is fundamental in meeting the objective of providing information to help resource providers assess the amount, timing, and uncertainty of potential future net cash flows. Gains and losses also can provide useful information about a particular activity even though gains and losses in similar amounts would not be expected to reoccur frequently or at all. For example, a loss that results from recognizing the impairment of an operating asset may indicate that future performance associated with that asset is likely to be less than in past years.

E92. Because a primary purpose of distinguishing gains and losses from revenues and expenses is to make displays of financial information about an entity's sources of comprehensive income as useful as possible, fine distinctions between revenue and gains and expenses and losses are principally matters of presentation.[19] Ultimately, those decisions will be made at a standards level with considerations for the objective of financial reporting and presentation concepts.

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[19]Matters of presentation are discussed in the proposed Chapter 7, *Presentation*, of Concepts Statement 8.

Appendix A: Accrual Accounting and Related Concepts

Introduction

A4.1. Items that qualify under the definitions of elements of financial statements and that meet criteria for recognition and measurement are accounted for and included in financial statements by using accrual accounting procedures. Accrual accounting and related concepts are therefore significant not only for defining elements of financial statements but also for understanding and considering other aspects of the Conceptual Framework. Paragraphs A4.2—A4.10 define or describe several significant financial accounting and reporting concepts that are used in this chapter and other chapters of the Conceptual Framework.

Transactions, Events, and Circumstances

A4.2. This chapter commonly uses the phrase *transactions and other events and circumstances affecting an entity* to describe the sources or causes of changes in assets, liabilities, and equity or net assets. An event is a happening of consequence to an entity. It may be an internal event that occurs within an entity, or it may be an external event that involves interaction between an entity and its environment, such as a transaction with another entity. A transaction is a particular kind of external event, namely, an external event involving transfer of something of value (future economic benefit) between two (or more) entities. The transaction may be either an exchange in which each participant both receives and sacrifices value, such as purchases or sales of goods or services, or a nonreciprocal transfer in which an entity incurs a liability or transfers an asset to another entity (or receives an asset or cancellation of a liability) without directly receiving (or giving) value in exchange. Nonreciprocal transfers contrast with exchanges (which are reciprocal transfers) and include, for example, impositions of taxes, gifts, or contributions given or received, and thefts.

A4.3. Circumstances are a condition or a set of conditions that develop from an event or a series of events that may occur almost imperceptibly and may converge in random or unexpected ways to create situations that might otherwise not have occurred and that might not have been anticipated. To see the circumstance may be fairly easy, but to discern specifically when the event or events that caused it occurred may be difficult or impossible. For example, a debtor going bankrupt or a thief stealing gasoline may be an event, but a creditor facing the situation in which its debtor is bankrupt or a warehouse facing the fact that its tank is empty may be a circumstance.

Accrual Accounting

A4.4. Accrual accounting attempts to record the financial effects on an entity of transactions and other events and circumstances in the periods in which those transactions, events, and circumstances occur rather than only in the periods in which cash is received or paid by the entity. Accrual accounting thus provides information about an entity's assets and liabilities and changes in them that cannot be obtained by accounting for only cash receipts and outlays.

A4.5. Accrual accounting includes using accrual, deferral, and allocation procedures, the goal of which is to relate revenues, expenses, gains, and losses to periods to reflect an entity's performance during a period instead of merely listing its cash receipts and outlays. Thus, the recognition of revenues, expenses, gains, and losses and the related increments or decrements in assets and liabilities—including the matching of costs and revenues, allocation, and amortization—is the essence of using accrual accounting to measure the performance of entities. The goal of accrual accounting is to account for the effects on an entity of transactions and other events and circumstances in the periods in which they occur, to the extent that those financial effects are recognizable and measurable.

Accrual and Deferral (Including Allocation, Amortization, and Matching)[20]

A4.6. Accrual accounting attempts to recognize noncash events and circumstances as they occur and involves not only accruals but also deferrals, including allocations and amortizations. Accrual is concerned with expected future cash receipts and payments; accrual is the accounting process of recognizing assets or liabilities and the related changes in revenues, expenses, gains, or losses for amounts expected to be received or paid, usually in cash, in the future. Deferral is concerned with past cash receipts and payments and with prepayments received or paid; deferral is the accounting process of recognizing a liability resulting from a current cash receipt (or the equivalent) or an asset resulting from a current cash payment (or the equivalent) with deferred recognition of related revenues, expenses, gains, or losses. Recognition of those elements is deferred until the obligation underlying the liability is partly or wholly satisfied or until the future economic benefit underlying the asset is partly or wholly used or lost. Common examples of accruals include purchases and sales of goods or services on account, interest, rent (not yet paid), wages and salaries, taxes, and decreases and increases in marketable securities accounted for at the lower of cost and

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[20]*Matching* is a term that unfortunately has been applied to various circumstances, although the term is not consistently described. The Accounting Principles Board concluded in footnote 43 of APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises,* that "because of the variety of its meanings, the term *matching* is not used in this Statement."

market. Common examples of deferrals include prepaid insurance and unearned subscriptions.

A4.7. Allocation is the accounting process of assigning or distributing an amount according to a plan or a formula. It is broader than and includes amortization, which is the accounting process of reducing an amount by periodic payments or write-downs. Specifically, amortization is the process of reducing a liability recorded as a result of a cash receipt by recognizing revenues or reducing an asset recorded as a result of a cash payment by recognizing expenses or costs of production. That is, amortization is an allocation process for accounting for prepayments and deferrals. Common examples of allocations include (a) assigning manufacturing costs to production departments or cost centers and to units of product to determine "product cost," (b) apportioning the cost of a "basket purchase" to the individual assets acquired on the basis of their relative market values, and (c) spreading the cost of an insurance policy or a building to two or more accounting periods. Other costs also are recognized as expenses in the period in which they are incurred because the period to which they otherwise relate is indeterminable or not worth the effort to determine.

A4.8. A major difference between accrual accounting and accounting based on cash receipts and outlays is the timing of recognition of revenues, expenses, gains, and losses. Investments by an entity in goods and services for its operations or other activities commonly do not all occur in the same period as revenues or other proceeds from selling the resulting products or providing the resulting services. Several periods may elapse between the time that cash is invested in raw materials or plant, for example, and the time that cash is returned by collecting the sales price of products from customers. A report showing cash receipts and cash outlays of an enterprise for a short period (such as a statement of cash flows) cannot indicate how much of the cash received is return *of* investment and how much is return *on* investment and, thus, cannot indicate whether or to what extent an enterprise is successful or unsuccessful. Similarly, goods or services that a not-for-profit organization provides gratis to beneficiaries commonly result from using goods or services acquired with cash received and spent in earlier periods. A report showing cash receipts and outlays of the organization for a short period cannot tell much about the relationship between the goods or services provided and the resources used to provide them and, thus, cannot indicate to what extent an organization is successful or unsuccessful in carrying out its service objectives. Cash receipts in a particular period largely may reflect the effects of the activities of a business entity or a not-for-profit entity in earlier periods, while many of the cash outlays may relate to the entity's activities and efforts expected in future periods.

A4.9. In most entities, transactions or events occur that result in simultaneous recognition of revenue and one or more expenses that result directly and jointly from the same transactions or other events. For example, a sale of a product or merchandise involves revenues from the receipt of cash or a receivable and

expense for the sacrifice of product or merchandise sold to the customer. If all assets and liabilities are recorded from the transaction, a matching of revenue and expenses in the same period is achieved by proper application of the asset and liability definitions.

A4.10. Many expenses, however, are not related directly to particular revenues but can be related to a period on the basis of transactions or events occurring in that period or by allocation. Some costs that cannot be related directly to particular revenues are incurred to obtain benefits that are exhausted in the period in which the costs are incurred. However, many assets yield their benefits to an entity over several periods, for example, prepaid insurance, buildings, and equipment. Expenses resulting from the use of assets are normally allocated to the periods of their estimated useful lives (the periods over which they are expected to provide benefits) by a "systematic and rational" allocation procedure. Usually no detectable relationship exists, and expenses are recognized by allocating costs to periods in which assets are expected to be used and are related only indirectly to the revenues that are recognized in the same period.

Appendix B: Basis for Conclusions

Introduction

BC4.1. The following summarizes the Board's considerations in reaching the conclusions in this chapter. It includes reasons for accepting some alternatives and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC4.2. Concepts Statement 6 defines the following 10 elements:

a. Assets
b. Liabilities
c. Equity
d. Revenues
e. Expenses
f. Gains
g. Losses
h. Comprehensive income
i. Investments from owners
j. Distributions to owners.

BC4.3. The Board concluded that the discussion of elements in Concepts Statement 6 could be further developed and improved with the objective of providing a foundation for future standards. Many of the decisions reflect changes in practices and standards since Concepts Statement 6 was issued and are based on the Board's experience in using those concepts in setting standards. The decisions discussed in this chapter are principally to clarify the elements definitions in Concepts Statement 6 by:

a. Clearly identifying the right or obligation that gives rise to an asset or a liability
b. Eliminating terminology that makes the definitions of assets and liabilities difficult to understand and apply
c. Clarifying the distinction between liabilities and equity and between revenues and gains and expenses and losses
d. Modifying the distinctions in equity for not-for-profit entities.

BC4.4. Beyond the decisions described in paragraph BC4.3, parts of this chapter have been carried forward from Concepts Statement 6. Accordingly, because there was no basis for conclusions in Concepts Statement 6, this chapter provides no basis for those paragraphs that were brought forward. However, in developing this chapter, the Board decided to revise the language from Concepts Statement 6 as follows:

a. Make the language internally consistent.
b. Eliminate repetition.

BC4.5. The objective of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. This chapter provides the means for carrying out that objective; it defines elements of financial statements to be applied to both business entities and not-for-profit organizations. Those elements provide a foundation for information that is relevant to the objective of financial reporting.

BC4.6. Assets and liabilities have conceptual and definitional primacy. The conceptual primacy of assets and liabilities is axiomatic such that the other elements are dependent on those two elements or changes in those elements. Given the conceptual primacy of assets and liabilities, this chapter defines those elements to support recognition in financial statements. Thus, to be recognized in financial statements an item must meet the definition of an asset or a liability. By only recognizing assets and liabilities and changes in those elements, recognition of items that are not grounded in concept is prevented and, thus, the integrity of financial reporting is maintained.

BC4.7. Assets, liabilities, equity, investment by owners, distributions to owners, and comprehensive income constitute the complete set of fundamental elements of financial statements of business entities. In contrast, the definitions of revenue, expenses, gains, and losses serve a different purpose than the definitions of the other six elements because they are not needed to determine comprehensive income but, instead, serve as presentation elements for comprehensive income.

Assets and Liabilities

BC4.8. When applied as intended, the definitions of assets and liabilities in Concepts Statement 6 were not fundamentally problematic. However, those definitions were often misunderstood. As a result, the Board concluded that improving the definitions in Concepts Statement 6 by making them clearer and more precise would enhance consistent application of the definitions in developing standards.

BC4.9. Accordingly, this chapter reflects changes decided upon by the Board, many of which are common to the definitions of both assets and liabilities. Those common changes primarily address the specific terms used in the definitions of assets and liabilities that have historically been misunderstood.

BC4.10. Both the definition of an asset and a liability in Concepts Statement 6 include the terms *probable, future economic benefit,* and *past transactions or events.* The term *probable* in the definitions in Concepts Statement 6 has been misunderstood as implying that a future economic benefit or a future sacrifice of

economic benefit must be probable to a certain threshold before the definition of an asset or liability is met. In other words, if the probability of future economic benefit is low, the asset definition is not met under this interpretation. A similar interpretation could be made for liabilities. The footnotes to the Concepts Statement 6 definition of assets and liabilities also were not helpful in clarifying the application of the term *probable* as used in the definitions of assets and liabilities. Accordingly, the Board decided to eliminate that term from the proposed definitions of both assets and liabilities.

BC4.11. The term *future* in the definitions in Concepts Statement 6 focused on identifying a future flow of economic benefits to demonstrate that an asset exists or identifying a future transfer of economic benefits to demonstrate that a liability exists. The definitions in Concepts Statement 6 were often misunderstood as meaning that the asset (liability) is the ultimate future inflow (outflow). For example, in the instance of trade receivables, the definition in Concepts Statement 6 could be misunderstood to indicate that the asset is the successful collection of the receivable in the future. When applied appropriately, however, the definition would conclude that the asset is the present right to collection. Similar misunderstandings occurred in applying the liability definition. As a result, the Board concluded that a focus on the term *present* would appropriately shift the focus from identifying a future occurrence. Therefore, the Board decided to include the term *present right* to demonstrate that an asset exists and emphasize the term *present obligation* to demonstrate that a liability exists.

BC4.12. The definitions of assets and liabilities in Concepts Statement 6 both include the phrase *past transactions or events*. The Board concluded that if an entity has a present right or a present obligation, one can reasonably assume that it was obtained from some past transaction or event. Therefore, that phrase is considered redundant and has been eliminated from the proposed definitions.

BC4.13. In addition to addressing those specific terms used in the definitions in Concepts Statement 6, this chapter addresses other considerations for the definitions of both assets and liabilities. For assets, the considerations in this chapter do not alter the population of items that were included under the previous definition of an asset in Concepts Statement 6. For liabilities, however, this chapter fundamentally expands the population of liabilities that were included under the previous definition of a liability in Concepts Statement 6 to include certain obligations to issue or potentially issue an entity's own shares.

Assets

BC4.14. The definition of an asset in this chapter (a) eliminates terms from the previous definition that were misunderstood, as described in paragraphs BC4.10–BC4.12, and (b) removes the term *control* while maintaining the notion of control.

BC4.15. The definition of an asset in Concepts Statement 6 associated assets with a particular entity by inclusion of the term *control.* Control often refers to the ability to direct, manage, or have power over something to obtain or access benefits or to increase, maintain, or protect those benefits. Control goes beyond legal rights and includes the ability to obtain and control the benefit in other ways, including restricting, or otherwise prohibiting, the access of others to the economic benefit of the asset.

BC4.16. In applying the definition of an asset in Concepts Statement 6, however, many constituents misunderstood the notion of control. Some improperly viewed control of a probable future economic benefit in the same manner as described in business combinations or consolidation accounting. Additionally, in applying the term *control*, some often failed to properly identify that which was controlled under the asset definition. For example, in the instance of trade receivables, the definition could be misunderstood to indicate that what is controlled is the successful collection of the receivable in the future. When applied appropriately, however, the definition in Concepts Statement 6 would conclude that the present right to collection is what is controlled. Similarly, if an entity has an option to acquire an asset, the present right of that entity is to the option itself, not the underlying asset that the option provides the right to acquire. Thus, control references the existing right that has the ability to generate economic benefits, or potential economic benefits, and to restrict others access to those benefits.

BC4.17. While the Board concluded that the notion of control was an important aspect of the asset definition, it was not clear to the Board whether the explicit term *control* added anything significant to the definition of an asset. Those considerations are addressed by inclusion of the term *present right* in the definition in this chapter. If an entity has a present right to an economic benefit, that would seem to be sufficient to establish the fact that the asset is an asset of that entity. Indeed, if an entity has exclusive rights, it presumably can deny or regulate access to that benefit by others, thereby implying control.

BC4.18. An asset must give an entity rights to an economic benefit. The Board concluded that it is not the economic benefit that represents an asset. Rather, it is the existing rights that have the ability to generate economic benefits. Accordingly, the Board concluded that what is controlled is the existing right that gives rise to the economic benefits, or potential economic benefits, rather than the economic benefits themselves.

BC4.19. The Board considered whether to use the term *economic resource* or *economic benefit* in the definition of an asset. Although either term may have been appropriate if properly applied, the Board discussed that some view *economic benefit* more broadly than *economic resource* because the latter seems to some to be limited to physical resources. Because of those views, the Board determined that the term *economic benefit* should be used in the definition to yield a more consistent application.

BC4.20. In addition to considering which term to use, the Board also addressed whether all economic benefits are accounting assets. The 1976 FASB Discussion Memorandum, *Elements of Financial Statements and Their Measurement*, takes a very broad view of benefits. However, Concepts Statement 6 more narrowly discusses common characteristics of benefits such that benefits are scarce and useful for carrying out economic activities such as consumption, production, and exchange. Application of those characteristics excludes benefits that are not scarce, such as air or water, as well as benefits that are not useful to an entity's activities, such as a memento or a keepsake of purely sentimental value. Thus, accounting assets are defined in a manner that restricts them to those for which the benefits meet the characteristics described in this paragraph.

Liabilities

BC4.21. The definition of a liability in this chapter has been changed to (a) eliminate terms from the previous definition that were misunderstood, as described in paragraphs BC4.10–BC4.12, (b) clarify when an entity becomes presently obligated, and (c) fundamentally expand the population of liabilities to include present obligations settled with an entity's own shares rather than exclusively with assets.

BC4.22. The term *present obligation* is included in the definition of a liability, both in this chapter and in Concepts Statement 6. Because the application of the liability definition under Concepts Statement 6 frequently did not give sufficient emphasis to the term *present obligation*, the definition in this chapter more appropriately emphasizes that term. Assessing whether a present obligation exists is the primary criterion in the definition of a liability in this chapter. The primacy of the term *present obligation* is made more evident through the removal of many of the problematic terms in the definition of a liability in Concepts Statement 6, as discussed in paragraphs BC4.10–BC4.12.

BC4.23. Almost always, the existence of a present obligation will be apparent. Most present obligations are legally enforceable, including obligations arising from binding contracts, agreements, statutes, or other legal or contractual means. However, situations lacking legal or contractual evidence of a present obligation pose particular challenges that may make it difficult to discern whether a present obligation exists.

BC4.24. Determining when a present obligation exists has caused confusion with the existence of business risks. Business risks result from the nature of the business and where, when, and how an entity conducts its business. While certain businesses pose risks of future events occurring that will cause a transfer of economic benefits, the Board decided that the risks themselves are not present obligations because exposure to a potential negative consequence does not constitute a present obligation. Rather than viewing all business risks as liabilities, the Board decided that an entity has a present obligation only after an event occurs

that demonstrates that the inherent business risk has created a present obligation. Thus, distinguishing when a business risk makes an entity presently obligated requires analysis of the facts and circumstances at the standards level.

BC4.25. Determining the existence of a present obligation is particularly challenging in evaluating constructive obligations. Those obligations lack legal sanctions that characterize most liabilities. Instead, constructive obligations are binding because of equitable, social, or moral customs. The Board decided that language that existed in paragraph 40 of Concepts Statement 6 would be appropriate to include in this chapter to guide standard setting. Specifically, the following excerpt is helpful:

> A constructive obligation is created, inferred, or construed from the facts in a particular situation rather than contracted by agreement with another entity or imposed by government. . . . Thus, the concepts of equitable and constructive obligations must be applied with great care. To interpret equitable and constructive obligations too narrowly will tend to exclude significant actual obligations of an entity, while to interpret them too broadly will effectively nullify the definition by including items that lack an essential characteristic of liabilities.

BC4.26. Given that constructive obligations are created by circumstance rather than explicit agreement, it can be unclear whether a present obligation exists. While present obligation is the primary distinguishing characteristic of a liability, a liability is often accompanied by the notion of having "little or no discretion to avoid the future sacrifice," as described in paragraph 36 of Concepts Statement 6. This criterion of "little or no discretion to avoid the future sacrifice" is not alone sufficient to create an obligation, but it can be a helpful notion to consider in evaluating whether a constructive obligation exists. In the absence of an explicit agreement, sufficient information to distinguish a present obligation is likely only available at the specific standards level. Thus, the Board decided that specific facts or circumstances at the standards level must be assessed to determine whether an entity has created a constructive obligation.

BC4.27. When an entity determines that a present obligation exists, constructive obligations have uncertain outcomes, especially related to their amount and timing. Those types of obligations were commonly referred to as *stand-ready obligations*. Assessing the amount and timing of *stand-ready obligations* is a question of measurement and, thus, is not considered in this chapter. However, the term *stand-ready obligation* warrants discussion because it has previously created challenges in the application of the definition of a liability. The Board decided that determining when and why a present obligation exists is critical to identifying a liability. However, if an entity is presently obligated, it may be an obligation with an uncertain outcome.

BC4.28. A liability in Concepts Statement 6 is a present obligation that requires the transfer of assets of an entity or the provision of services to other entities. Under that definition, obligations that require future transfers of equity instruments of the entity are not liabilities. Current GAAP and practices are inconsistent with that definition. The inconsistency in the application of the Conceptual Framework definition has led to ad hoc standard-setting decisions, which in turn has resulted in a complex accounting model for financial instruments that have characteristics of both liabilities and equity. The Board recognizes that resolving the distinction between liabilities and equity at the standards level begins with a conceptually sound definition of a liability in the Conceptual Framework that the Board can apply in standard setting.

BC4.29. Distinguishing a liability from equity has been a difficult issue that the Board has considered several times in the past, both at a conceptual level and at the standards level. For many, distinguishing between liabilities and equity is more about the effect on net income than it is about the balance sheet classification. That is because of very different views about how particular financial instruments should be subsequently measured and how changes in values are reflected in the statement of comprehensive income. However, this discussion is a question of measurement and presentation, rather than one of elements and their definitions. A particular financial instrument meeting the definition of a liability does not imply that it must be subsequently measured using a particular measurement method. Similarly, when an instrument does not meet the definition of a liability (that is, it is an equity instrument), that does not imply that the instrument should not be remeasured or that a gain or a loss should not be recognized upon settlement of the arrangement.

BC4.30. Common and preferred shares represent the equity interest in an entity. Those outstanding instruments do not create an obligation to transfer or provide economic benefits. The debate has focused on the classification of obligations that require or may require the issuance of the entity’s own shares.

BC4.31. Some argue that all obligations should meet the definition of a liability regardless of whether the obligation is settled with assets or an entity’s own shares. The Board concluded that an obligation to transfer either assets or a variable number of shares of the entity’s own shares meets the definition of a liability. Under the Board’s proposed definition, there are instruments that create obligations and that are considered equity interests of the entity. Those are instruments in which the value of the instrument varies with the value of the outstanding stock (indexed to the entity’s shares) and that are settled with the entity’s fixed number of shares. The Board notes that the holder of that instrument, although not currently a shareholder of the entity, is on the path to potentially becoming a shareholder of the entity. Holders of that type of instrument participate in the risks and rewards of the issuer’s operations, just not the same way in which a counterparty of an outstanding share does. For example, a holder of a written call option participates in the upside potential in the same way a common

shareholder does. That holder also participates in a downside risk, that is, the loss of the premium paid for the instrument. The Board notes that an obligation that requires the issuance of a sufficient number of shares to equal a specific value when issued is a liability. The value to the recipient is fixed; as such, the obligation conveys nothing like the returns and rewards of an equity shareholder.

Net Assets of Not-for-Profit Organizations

BC4.32. Net assets of not-for-profit organizations is divided into two mutually exclusive classes dependent upon the existence or absence of donor-imposed restrictions. That requirement modifies Concepts Statement 6, which divided net assets into three classes:

a. Unrestricted
b. Temporarily restricted
c. Permanently restricted.

BC4.33. The Board concluded that the two-class distinction was preferable because the prior distinction between permanently restricted classes and temporarily restricted classes had been blurred because of changes in laws. Additionally, the term *unrestricted* implies to some that the unrestricted portion of net assets is without contractual, legal, or other restriction. For those reasons, the Board decided to combine temporarily and permanently restricted net assets into net assets with donor restrictions and to rename unrestricted net assets to net assets without donor restrictions, thereby dividing net assets for not-for-profits into two classes rather than three.

Investments by and Distributions to Owners

BC4.34. The fundamental criticism of the existing definitions of investments by and distributions to owners in Concepts Statement 6 is that the elements use the term *owners*, which was not defined. This chapter clarifies those elements by defining the term *owners*. The definition of owners is derived from the Board's decisions made to distinguish between liabilities and equity in this chapter. That is, obligations to issue a fixed number of shares (common or preferred) would be classified as equity. Holders of those instruments and holders of outstanding common and preferred shares are considered owners.

Comprehensive Income

BC4.35. The Board decided to retain the definition of comprehensive income in Concepts Statement 6. The Board notes that the term *comprehensive income* should continue to be a function of the accounting equation represented by the changes in the recorded assets and liabilities other than from investments by and distributions to owners. As a result, the Board has concluded that all revenues, expenses, gains, and losses should be included in comprehensive income. The

Board also notes that describing what is meant by the term *owner*, and consequently transactions with owners, helps to clarify the definition of comprehensive income.

Revenues, Expenses, Gains, and Losses

BC4.36. In discussing revenues, expenses, gains, and losses, some Board members questioned whether defining those elements was necessary given that they are often perceived to be matters of presentation. However, the Board decided to retain all four elements of comprehensive income—revenues, expenses, gains, and losses. The Board also concluded that retaining the elements gains and losses as distinct from the elements revenues and expenses was informative in understanding the composition of comprehensive income.

BC4.37. Concepts Statement 6 uses the terms *other activities* and *ongoing major or central operations* to distinguish revenues from gains and expenses from losses. It is not clear whether the term *ongoing major or central operations* is intended to refer to all revenues and expenses or only those that relate to revenues and expenses from other activities. As a result, the Board decided to remove the term *ongoing major or central operations* from the proposed definitions of revenue and expense in this chapter. The Board concluded that delivering or producing goods and rendering services are primary factors in distinguishing revenue from gains and expenses from losses, regardless of whether they are considered major or central to an entity. There are certain circumstances in which distinguishing between revenues and gains and expenses and losses can be difficult. In those circumstances, the Board decided that presentation concepts are helpful when distinguishing between those elements to meet the objective of financial reporting.

BC4.38. The Board decided to retain the term *other activities* in the definitions in this chapter. The inclusion of this term allows sources such as investment income to be considered revenue and charitable contributions made to be considered an expense. It is not the Board's intent to suggest that the term *other activities* is an all-encompassing notion that captures every inflow and outflow. The Board's description of the term *other activities* is derived from a description of revenues and general activities in APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*. In APB Statement 4, the term *general activities* is described as those activities that permit others to use economic resources, which result in interest, rent, royalties, fees, and the like.

Alternative View

BC4.39. The Conceptual Framework is designed to be a robust judgment and decision-making framework that supports the setting of high-quality accounting and financial reporting standards. For reasons discussed below, Ms. Botosan

believes that certain aspects of this proposed chapter would fail to enhance, and could potentially reduce, the usefulness of the Conceptual Framework.

BC4.40. Specifically, Ms. Botosan disagrees with the following aspects of this proposed chapter in the Conceptual Framework:

a. The proposed decision to remove the term *control* from the definition of an asset
b. The proposed decision to retain the existing prescriptive definitions of equity and comprehensive income
c. The proposed definitions of revenue, gain, expense, and loss.

Removal of Control

BC4.41. Paragraph 25 of Concepts Statement 6 defines assets as "probable future economic benefits obtained or *controlled* by a particular entity as a result of past transactions or events" (emphasis added; footnote reference omitted). Concepts Statement 6 describes an entity's ability to obtain an economic benefit and control others' access to it as an essential characteristic of an asset.[21] In addition, Concepts Statement 6 notes that including the term *control* in the definition serves to exclude economic resources such as public highways, air, or water from the set of economic resources that might otherwise meet the definition of an asset.[22]

BC4.42. This proposed chapter acknowledges the existence of uncontrolled rights that do not give rise to an asset in the explanatory paragraphs following the definition of an asset. Specifically, paragraph E20 states that "access to a public road outside an entity's property *might provide a right to an economic benefit*, but if the entity cannot restrict access to that road, the road is *not an asset of the entity*" (emphasis added). Ms. Botosan agrees with this statement but believes that *control* is sufficiently important that it should be elevated from the explanatory paragraphs to the definition itself. She believes that explicit inclusion of *control* in the definition helps establish the link between an economic resource and a particular entity, which is necessary for an item to be considered an asset of the entity. Ms. Botosan believes that including *control* in the definition would mitigate potential misapplication of the definition to economic resources to which an entity has a right but no ability to control.

BC4.43. The International Accounting Standards Board's (IASB) definition of an asset is "a present economic resource *controlled* by the entity as a result of past events" (emphasis added).[23] The IASB concluded that including *control* in the definition is important to link an economic resource to a specific entity.[24] The IASB

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[21]Concepts Statement 6, *Elements of Financial Statements*, paragraph 26.

[22]Concepts Statement 6, paragraph 188.

[23]IASB's *Conceptual Framework for Financial Reporting*, paragraph 4.3.

[24]IASB's Conceptual Framework, paragraph 4.19.

considered, but rejected, a proposal to remove *control* from the definition of an asset. The IASB acknowledged that *control* may be implied by having a right to an economic resource but concluded that *control* is sufficiently important to warrant explicit inclusion in the definition.

BC4.44. Ms. Botosan believes that differences between U.S. GAAP and IFRS Standards should be limited to situations in which significant cost and/or benefit differences arise because of different legal, regulatory, or social norms. Given the foundational role that the Conceptual Framework plays in standard setting, Ms. Botosan believes that it is particularly important to limit differences in the conceptual frameworks to situations for which there is a compelling justification. Ms. Botosan believes that both the IASB and the FASB intend to restrict assets to rights *controlled* by the entity. Ms. Botosan is concerned, however, that the Boards' different decisions about the need to explicitly reference *control* in the definition raise the risk of different application outcomes. Ms. Botosan also believes that the definition of an asset in this proposed chapter would be more robust and would more closely converge with the IASB definition of an asset if *control* were included.

BC4.45. *Control* also plays an essential role in principles guiding the derecognition of an asset. For example, paragraph 5.26 of the IASB's *Conceptual Framework for Financial Reporting* states that:

> Derecognition normally occurs when that item no longer meets the definition of an asset . . .:
> (a) for an asset, derecognition normally occurs when the entity *loses control* of all or part of the recognised asset. [Emphasis added.]

BC4.46. This proposed chapter does not address principles of derecognition; however, the Conceptual Framework is intended to be a coherent system of interrelated objectives and fundamental concepts. Ms. Botosan is concerned that the proposed decision to remove the term *control* from the definition of an asset risks complicating subsequent development of principles guiding the derecognition of an asset.

Prescriptive Definitions of Equity and Comprehensive Income

BC4.47. The definition of equity in this proposed chapter is unchanged from the definition in Concepts Statement 6. Equity is defined as "the residual interest in the assets of an entity that remains after deducting its liabilities." Ms. Botosan believes that "assets minus liabilities," a mathematical statement derived from the basic accounting equation, falls far short of a conceptual definition of equity. She notes that the definitions of assets and liabilities draw on the underlying economic concepts of economic resources and economic obligations, respectively. Ms. Botosan believes that a definition of equity that similarly draws on the underlying economic concept of a residual claim would offer a more powerful tool in standard setting. Ms. Botosan finds the existing definition of equity to be of little use in

standard setting because equity, by definition, is simply a mechanical outcome of the recognition and measurement decisions afforded to assets and liabilities.

BC4.48. The definition of comprehensive income in this proposed chapter is unchanged from the definition in Concepts Statement 6. Comprehensive income is defined in terms of the change in equity from nonowner sources; a mathematical statement derived from the basic accounting equation. Ms. Botosan believes that this definition falls far short of a conceptual definition of comprehensive income. Ms. Botosan believes that a definition of comprehensive income that draws on the underlying economic concept of economic income would offer a more powerful tool in standard setting.

BC4.49. Specifically, Ms. Botosan believes that the existing prescriptive definition of comprehensive income fails to provide an adequate framework for the Board to debate whether certain changes in net assets appropriately belong in comprehensive income because under the existing definition, comprehensive income is simply a mechanical outcome of the recognition and measurement decisions afforded to assets and liabilities. Consequently, the existing definition provides no comprehensive income "off-ramp" for changes in net assets that resource providers do not view as informative of income accruing to equity holders.

BC4.50. For example, in paragraph BC62 of Accounting Standards Update No. 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, the FASB acknowledges that:

> Preparers often have to disclose the amount of fair value change related to instrument-specific credit risk in separate investor packages, in response to the fact that users often remove those amounts from net income because, to them, the amounts do not provide decision-useful information.

The amendments in Update 2016-01 addressed this issue by requiring that those changes in fair value be reported in other comprehensive income. However, in paragraph 4.53 of the 2016 Invitation to Comment, *Agenda Consultation*, the Board acknowledged that there is no conceptual basis for classifying items in other comprehensive income. Ms. Botosan believes that having to resort to a mechanism for which there is no conceptual basis is the direct result of the prescriptive definition of comprehensive income.

BC4.51. The elements definitions in the Conceptual Framework are intended to help the FASB objectively and consistently identify and classify items included in financial reports. For example, the definition of an asset has proven useful in standard setting because it provides a framework for considering what items should be reported in financial statements as assets. Ms. Botosan believes that the existing prescriptive definitions of equity and comprehensive income have not

served the Board well in past standard-setting efforts. She believes that the proposal to retain those definitions, which emphasize the practical balancing function of the equity section in a statement of financial position to the detriment of conceptual definitions of equity and comprehensive income represents a missed opportunity to improve the available tools to support the setting of high-quality accounting and financial reporting standards.

Proposed Definitions of Revenue and Gain (Expense and Loss)

BC4.52. The definitions in Concepts Statement 6 and in this proposed chapter link revenue to the provision of goods or services or conduct of other activities and gain to activities that are not revenue producing. To further distinguish revenue from gain, however, the Concepts Statement 6 definition of revenue includes a reference to an entity's ongoing major or central operations, and the existing definition of gain includes a reference to peripheral or incidental activities. The proposed definitions eliminate this language. Ms. Botosan acknowledges that the Concepts Statement 6 definitions of revenue and gain are not perfect, but she believes that the proposed removal of that language will make the definitions less helpful when deciding between revenue or gain classification in standard setting.

BC4.53. Ms. Botosan questions the benefit of separately defining revenue and gain if those definitions offer limited help in distinguishing between them. Ms. Botosan believes that the distinction between revenue and gain is more appropriately addressed as a gross versus net presentation issue. Specifically, revenue (that is, gross) presentation is preferred when margin information is relevant, whereas gain (that is, net) presentation is preferred when margin information is not relevant. Ms. Botosan notes that addressing the distinction between revenue and gain as a presentation issue instead of as a definitional issue would be more consistent with the IASB's Conceptual Framework. In Ms. Botosan's opinion, there is no compelling advantage to the proposed separate definitions of revenue and gain, and she believes that differences between the FASB's and the IASB's conceptual frameworks should be limited to situations with a compelling justification.

BC4.54. Finally, Ms. Botosan notes that the definition of revenue in Topic 606, Revenue from Contracts with Customers, is consistent with the definition in Concepts Statement 6. Ms. Botosan acknowledges that amendments to the Conceptual Framework do not affect existing authoritative guidance. Nevertheless, she believes that having a different definition of revenue in Topic 606 versus the Conceptual Framework is less than ideal. She finds this difference difficult to justify given her belief that the proposed definitions do not enhance the usefulness of the Conceptual Framework.

BC4.55. Ms. Botosan has similar concerns with the proposed definitions of expense and loss. For brevity, those concerns are not reiterated in that context.