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Financial Reporting Issues Conference

Introduction

January 2023

1. This year, the Financial Reporting Issues Conference (FRIC) will focus on applying Chapter 4, *Elements of Financial Statements,* of Concepts Statement No. 8, *Conceptual Framework for Financial Reporting*, to the accounting for research and development costs and the accounting for contingencies.

History and Background

2. In 1973, the FASB's initial technical agenda included a project on accounting for research and development costs that resulted in Statement of Financial Accounting Standards (SFAS) No. 2. It also included a project called Accounting for Future Losses, which resulted in SFAS 5 Accounting for Contingencies.
3. Those two projects demonstrated to the Board that the definitions of assets and liabilities in Accounting Principles Board (APB) Statement No. 4 needed improvement.

Definitions of Elements

4. The definitions of assets and liabilities in paragraph 132 of APB 4 are:
    - *Assets—economic resources* of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. *Assets also include certain deferred charges that are not resources but that are recognized* and measured in conformity with generally accepted accounting principles. (Emphasis added)
    - *Liabilities—economic obligations* of an enterprise that are recognized and measured in conformity with generally accepted accounting principles. *Liabilities also include certain deferred credits that are not obligations but that are recognized* and measured in conformity with generally accepted accounting principles. (Emphasis added)
5. Those definitions in APB 4 are not really definitions but instead descriptions of practice at the time. Paragraph 132 of APB 4 defines assets and liabilities as economic resources (assets) and economic obligations (liabilities), but also includes deferred charges (assets) and deferred credits (liabilities) that generally accepted accounting principles treats as assets and liabilities. Because of their unrestrictive and circular nature, the definitions were not useful in resolving issues related to accounting for research and development costs and accounting for contingencies.
6. More robust asset and liability definitions were developed in Concepts Statement No. 3 and then later carried over into Concepts Statement 6. Those definitions were modified by Chapter 4 of Concepts Statement No. 8.[1] The asset and liability definitions in Chapter 4 are reproduced below. Appendix A

[1] That chapter supersedes Statement of Financial Accounting Concepts (SFAC) No. 6, *Elements of Financial Statements*.

(pg.4-11) contains both excerpts from the text of Chapter 4, including explanatory information and the Board's basis for conclusions.

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

E17. An asset has the following two essential characteristics:

a) It is a present right

b) The right is to an economic benefit.

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

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.

Conference Overview

7. The conference will focus on the conditions for recognition of an asset that results from research and development activities and application of the definition of liabilities to litigation, claims, and assessments. Conference participants are asked to focus on the identification of an asset or a liability as the first step in recognizing either as an element in financial statements. The first session will focus on issues related to identifying an asset as a result of research and development activities. The second session will focus on what SFAS 5 called litigation, claims and assessments and when those events or circumstances create a liability. The final session will focus on recognition and measurement of assets or liabilities identified in the first two sessions. Participants will also be asked to evaluate the conclusion of SFAS 5 that gain contingencies should not be recognized and whether that conclusion is consistent with the asset and liability definitions in Chapter 4 of SFAC 8.

8. As such, the materials for the conference are divided into three sections:

- Accounting for Research and Development Costs
- Accounting for Contingencies (Including Consideration of Gain Contingencies)
- Recognition and Measurement Issues (Including Consideration of Gain Contingencies).

9. Each section includes materials from existing standards and concepts statements that may be helpful to conference participants in preparing for the conference.

Appendix A: Excerpts of Ch.4, *Elements*, of SFAC 8

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 those two characteristics allows an entity to obtain the economic benefit and control others' access to the benefit. A present right of an entity to an economic benefit entitles the entity to the economic benefit and the ability to restrict others' access to the benefit to which the entity is entitled.

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.

E19. Essential to the definition of an asset is a right to an "economic benefit"—the capacity to provide services or benefits to the entities that use them. Generally, 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 entities rely significantly on contributions or donations of cash to supplement selling prices or to 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. Rights that give an entity no advantage beyond the common advantages of others because they are available to all do not qualify as assets. 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 an economic benefit, but because the entity cannot restrict access to that road by others, 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. A specific right to use a public highway from which a licensee might otherwise be excluded—for example, a license to operate a truck on the highways within a state—would create an economic benefit for the licensee, with respect to that license, even though it does not restrict access of others to the highway.

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.[2]

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 and the lessor the right to receive lease payments for a specified interval and (b) the lessor the right to receive any residual value. Each entity has an asset based on its rights to a particular economic benefit, and the rights allow the entity to restrict access to the particular 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, not a right expected to occur in the future. 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 or circumstances. Often, assets are obtained by purchasing or producing them, but other transactions, events, or circumstances may generate assets. Examples include 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 or circumstances expected to occur in the future do not 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. 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. The purchasing power of cash is the basis of its value and economic benefit.

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[2]The Uniform Trade Secrets Act defines a "trade secret" as follows:

- Information, including a formula, pattern, compilation, program, device, method, technique, or process that:
    - Derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and
    - Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

E33. 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. However, if the right can be identified and, particularly, the identified right can be separated from the entity, it gives credibility that the right exists and that it is to an economic benefit.

E35. Many 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 those activities are not assets, the activities may result in an entity creating a right to an economic benefit and, therefore, obtaining an asset or enhancing an existing asset. For those and similar activities, assessments of when a present right exists and whether the right is to a related economic benefit may be especially uncertain. An entity (a) may have rights that are not to a discernible economic benefit or (b) may have identified future economic benefits to which it has no present rights. 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. If an item is capable of being separated and exchanged for something of value, that would be evidence that a right exists and that the right is to an economic benefit. Others cannot be separated from an entity and sold or otherwise transferred, but still may represent rights to economic benefits. Generalizations about facts and circumstances that bring about internally generated intangible assets are so varied that whether an asset has been created often must be resolved at the standards level.

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.[3]

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 or to be ready to do so. Liabilities are based on a foundation of legal rights and duties.

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 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 the occurrence of specified events.

Present obligation

E41. A liability requires that an entity be obligated to perform or act in a certain manner. In most cases it is apparent that 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,

[3]This chapter continues the practice of describing liabilities as an obligation either 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.

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.

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.[4] 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 or circumstances 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 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.

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. Most liabilities are legally enforceable, including those arising from contracts, agreements, rules, and statutes. An entity also can become obligated by other means that would be expected to be upheld by a judicial process. However, the existence of a present obligation may be less clear in those circumstances.

E50. Some liabilities rest on constructive obligations, including some that arise in exchange transactions. 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 clear contractual 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 because the pattern of behavior may create an enforceable claim for performance that would be upheld in the ultimate conclusion of a judiciary process.

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[4]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 11th edition of *Black's Law Dictionary* (2019) 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.

E51. 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 that 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.

E52. Determining whether an entity is bound by an obligation to a third party in the absence of a clear determination of legal enforceability is often extremely difficult. Thus, the concept of 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.

E53. 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 a constructive obligation of an entity. A donor's restriction directs that fiduciary responsibility to 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

E54. 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.

E55. 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.

E56. 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.

E57. 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 such an 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.

E58. Examples of certain types of contractual and legal obligations with uncertain outcomes are options, guarantees, and warranties. 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.

E59. The nature of those obligations 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. Although contractual and legal situations often provide the clearest examples of those obligations, it is possible that noncontractual situations also can give rise to present obligations. For example, an entity may implicitly warrant a product, and, as a result, that entity would be presently obligated to provide services.

E60. 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.

Basis for Conclusions

Assets and Liabilities

BC4.9. 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.

BC4.10. 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.

BC4.11. Both the definitions of an asset and a liability in Concepts Statement 6 include the term *probable* and the phrases *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 a liability is met. In other words, if the probability of future economic benefit is low, the asset definition is not met under that 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 definitions of both assets and liabilities.

BC4.12. 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.

BC4.13. 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 definitions.

BC4.14. 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.

BC4.15. Although the majority of respondents supported the Board's efforts to improve the concepts for elements, many disagreed with the Board's decision to remove the term *probable* from the definitions of an asset and a liability in the proposed Concepts Statement. Likewise, there were some respondents with concerns about removing the term *future* and the phrase *past transactions or events.* During redeliberations, the Board decided to affirm its decision to eliminate those terms and that phrase from the definitions. One of the primary purposes of the revised asset definition was to refocus the definition of an asset away from the phrases *past transactions or events* and *future economic benefits* and to center the determination of assets on the *present right* that an entity may or may not have. Similarly, the purposes of the revised liability definition were to refocus the definition of a liability away from the phrases *past transactions or events* and *future sacrifices of economic benefits* and to center the determination of liabilities on the *present obligation* that an entity may or may not have.

Assets

BC4.16. The definition of an asset in this chapter (a) eliminates terms from the previous definition that were misunderstood, as described in paragraphs BC4.11–BC4.13, and (b) removes the term *control* while maintaining the notion of control.

BC4.17. 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.

BC4.18. 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 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.

BC4.19. 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 including 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.

BC4.20. 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.

BC4.21. The majority of respondents to the proposed Concepts Statement expressed a preference for explicitly referring to control in the definition of an asset. Those respondents stated that the term *present right* does not sufficiently capture the concept of control and, therefore, it should be explicitly included in the definition. Other respondents stated that even if control is removed from the definition, indicators of control will still be a primary factor in determining the existence of a present right.

BC4.22. The Board redeliberated the issue and decided that the term *control* should not be used in the definition of an asset for the following reasons:

a. It eliminates redundancy. If an entity has a present right, that would seem to be sufficient to establish the fact that the asset is an asset of that entity. In fact, the Board used the phrase *of the entity* in the definition of an asset to clarify that point. Indeed, if an entity has exclusive rights, it presumably can deny or regulate access to that benefit by others.
b. It eliminates misunderstanding of the term. The term *control* has two issues in the existing definition of an asset. First, many have a different definition of the term *control*. Second, many associate the term *control* with whether one has control of the economic benefit. The Board notes that what is controlled is the existing right that gives rise to economic benefits, or potential economic benefits, rather than the economic benefits themselves. The Board's reasoning for removing the term *control* is the same as removing other terms, such as *future* and *probable*, from the definition of an asset.
c. It avoids confusion with the IASB's Conceptual Framework use and meaning of the term. The IASB defines an asset as "a present economic resource controlled by the entity as a result of past events." In the basis for conclusions to the IASB's Conceptual Framework's discussion on control, footnote 19 references both IFRS 10, *Consolidated Financial Statements*, and IFRS 15, *Revenue from Contracts with Customers*. The Board is concerned about the references to IFRS 10 and IFRS 15 because those standards refer to control of an economic benefit, not control of the right. The Board notes that convergence with the IASB's asset definition on this point is not critical because it could perpetuate the misunderstanding discussed above.

BC4.23. 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.

Liabilities

BC4.24. 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 BC4.11–BC4.13, (b) clarify when an entity becomes presently

obligated, and (c) fundamentally expand the population of liabilities to include certain present obligations settled with an entity's own shares rather than exclusively with assets.

BC4.25. 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 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 BC4.11–BC4.13.

BC4.26. 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 clear legal or contractual evidence of a present obligation pose particular challenges that may make it difficult to discern whether a present obligation exists.

BC4.27. 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.

BC4.28. Determining the existence of a present obligation is particularly challenging in evaluating constructive obligations. Interpreting constructive obligations too narrowly will tend to exclude significant actual obligations of an entity, while interpreting them too broadly will effectively nullify the definition by including items that lack an essential characteristic of liabilities.

BC4.29. Given that constructive obligations and other noncontractual obligations are created by circumstance rather than explicit agreement, it can be unclear whether a present 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 and circumstances at the standards level must be assessed to determine whether an entity has created a constructive obligation.

BC4.30. Respondents to the proposed Concepts Statement suggested further clarification on constructive obligations to address current diversity in practice. The Board decided to retain the wording in the proposed Concepts Statement relating to constructive obligations. The Board reasoned that the framework is intended as a tool for the Board and should not be directly affecting practice decisions.

BC4.31. When it is determined that a present obligation exists, some obligations have uncertain outcomes, especially related to their amount and timing. Assessing the amount and timing of those obligations is a question of measurement and, thus, is not considered in this chapter. 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. In Concepts Statement 6, obligations of this type were referred to as *stand-ready obligations*.

BC4.32. The notion of moral or ethical obligations has not been included in the discussion of present obligations. Moral and ethical notions are individually varied and are not a foundation for establishing whether a present obligation exists. An entity may take voluntary actions for moral or ethical reasons, and those actions may create present obligations. It is the action taken that creates present obligations, not the rationale for the action.

BC4.33. The Board has removed the term *equitable obligation* from the discussion of liabilities. Concepts Statement 6 indicated that equitable obligations stem from moral or ethical constraints. Equitable obligations are in fact created from determinations in a judicial system and not an individual's particular moral or ethical codes and, therefore, are consequently subsumed in the phrase *obligations determined through a judiciary process*.

Session 1

SFAS 2: Accounting for Research and Development Costs

Background

1. Statement of Financial Accounting Standards No. 2 (SFAS 2), *Accounting for Research and Development Costs*, was adopted by the Board in October 1974. That Statement addressed the following topics:
    a) Activities constituting research and development,
    b) Elements of costs to be identified with research and development activities,
    c) Accounting for research and development costs, and
    d) Related disclosures.
2. The objective of this paper is to summarize the major issues the Board considered in developing SFAS 2 (codified in Topic 730, Research and Development). Participants will be asked to consider the conclusions of the Board in the context of the *asset* definition in Chapter 4, *Elements of Financial Statements,* of Concepts Statement No. 8, *Conceptual Framework for Financial Reporting.* References to research and development standards in the FASB *Accounting Standards Codification* indicate the current requirements.

Definitions

3. SFAS 2 defined the terms *Research* and *Development* as the following:

    "Research is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (hereinafter "product") or a new process or technique (hereinafter "process") or in bringing about a significant improvement to an existing product or process."

    "Development is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants. It does not include routine or periodic alterations to existing products, production lines, manufacturing processes, and other on-going operations even though those alterations may represent improvements and it does not include market research or market testing activities."

Issue—Accounting for Research and Development Costs

4. During deliberations, the Board evaluated the following accounting methods for research and development costs:

a. Expense in the period incurred,
b. Capitalize in the period incurred,
c. Capitalize in the period incurred if specified conditions are met, and
d. Accumulate costs in a special category until future benefits are identified.

5. The Board concluded that research and development costs should be expensed as incurred.[5] Tangible and intangible assets with alternative uses that are used in research and development activities are capitalized and subsequently amortized. The amortization of those tangible and intangible assets is a research and development cost.[6] SFAS 2 does not apply to research and development costs capitalized under other standards, for example, capitalized software development (Refer to Appendix B: Research and Development Costs for Computer Software, pg.20-21) costs or in-process research and development assets acquired in a business combination.
6. The fundamental issue in accounting for research and development activities is when, if ever, in the course of those activities, an asset has been created. In developing SFAS 2, the Board's analysis was focused on the potential for future economic benefit and associating research and development costs with the expected future benefit. As previously described, the absence of an operable asset definition was an impediment to resolving the accounting.

Basis for Conclusions

Identifying and Measuring Future Benefits

7. In SFAS 2, the Board noted that the future benefits of a research and development project typically have a high degree of uncertainty and lack a strong positive correlation with the costs of the underlying research and development activities. For example, the Board cited a study published by Booz-Allen and Hamilton, Inc. that concluded that less than 15% of product development projects are successfully commercialized.[7] Furthermore, products beyond the development phase are still susceptible to a high likelihood of failure (30% to 90%).[8]
8. Because the future benefits of a research and development project are uncertain, the Board noted that it is difficult to identify if (and when) an economic resource has been created as a result of research and development activities.
9. At the time SFAS 2 was adopted, recognition criteria had not been defined in official accounting literature; however, a measurability criterion had been suggested by stakeholders. That measurability criterion would require that a recognized asset have future economic benefits that are capable of being objectively measured. When foreseeable future benefits of research and development activities are

[5] 730-10-25-1
[6] 730-10-25-2(a)(c)
[7] Booz-Allen & Hamilton, Inc., *Management of New Products* (Chicago: Booz-Allen & Hamilton, Inc., 1968), p. 12.
[8] John T. Gerlach and Charles Anthony Wainwright, *Successful Management of New Products* (New York: Hastings House, Publishers, Inc., 1968), p. 126.

identified, thus indicating the potential creation of an economic resource, the Board noted that the future economic benefits may be difficult to measure with a reasonable degree of certainty. The Board noted that it is challenging to measure the future benefits of research and development activities with a high degree of certainty because the value of these future benefits, and the amount of research and development costs, have little, if any, correlation.[9] Therefore, the Board noted that research and development costs would not satisfy the suggested measurability criterion and, consequently, should not be recognized as an asset.[10]

10. The Board considered the following three principles for recognizing expenses as set forth in APB Statement No. 4, *Basis Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*:
    a. Associating cause and effect,
    b. Systematic and rational allocation, and
    c. Immediate recognition.
11. The Board determined that it was not appropriate to apply the *associating cause and effect* and *systematic and rational allocation* principles to research and development costs because there is (a) uncertainty that research and development activities will result in future benefits and (b) a lack of evidence that a direct relationship exists between the costs of research and development activities and those activities' future benefits. Therefore, the Board concluded that capitalizing research and development costs would not provide decision useful information to predict future earnings, and the Board decided to apply the *immediate recognition* principle to research and development costs.
12. In the Exposure Draft that preceded SFAS 2, the Board discussed the notion of *exchangeability* as a potential recognition criterion for research and development costs. Ultimately, the Board did not significantly consider the notion of *exchangeability* as it relates to the recognition of research and development costs as an asset; however, the Board noted that the notion of *exchangeability* needs to be studied further.

Selective Capitalization

13. The Board considered the possibility of specified conditions or thresholds that, if fulfilled or met, would warrant the capitalization of research and development costs. The Board considered the following conditions:
    a. Definition of a product or process,
    b. Technological feasibility,
    c. Marketability and usefulness,

[9] 730-10-05-02 through 05-03

[10] In 1984, Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, was issued. For an item to be recognized in a full set of financial statements, Concepts Statement 5 requires that item to have a relevant attribute measurable with *sufficient reliability*.

d. Economic feasibility,
e. Management action, and
f. Distortion of net income comparisons.

14. The Board concluded that capitalizing research and development costs based on meeting one of the conditions above would require significant judgment and not be comparably applied to all entities. Furthermore, the Board noted that fulfilling a condition above, such as management approval of a project for commercialization, would not guarantee that the project would result in a future economic benefit.
15. The Board noted that research and development costs that are capitalized upon fulfillment of a specified condition and subsequently amortized would not represent the total cost of the project. The Board determined that it would not be appropriate to retroactively capitalize research and development costs that were previously expensed as incurred because this practice would not align with accounting practices that prevent entities from restating financial statements based on hindsight.
16. Appendix B (pg.20-21) provides an overview of the accounting for internally developed computer software that will be sold, leased, or marketed. Upon reaching the *technological feasibility* stage of the software's development, costs incurred to develop the computer software are generally capitalized until commercialization. This overview may assist conference participants in considering when research and development costs should result in the recognition of an asset.

Accumulate Costs in a Special Category

17. The Board concluded that it would not be appropriate for research and development costs to accumulate in a *special category* on the financial statements. The Board determined this accounting approach would alter the nature of the financial statements and would not be useful in forecasting future earnings.

Aggregation of Research and Development Activities

18. Some stakeholders stated that the accounting for research and development costs should be determined after analyzing research and development activities at a program, rather than a project, level. Consequently, if future benefits of research and development activities are highly probable for a research and development program in its entirety, research and development costs would be capitalized for each project in the program.
19. The Board concluded that analyzing research and development activities at a program level was not appropriate to determine the accounting for research and development costs. Because a company's research and development program may have projects at different research and development stages, and projects with different probabilities of succeeding, it would be impractical and meaningless to estimate an amortization period at the program level.

Other Considerations

Elements of Costs to be Identified with Research and Development Activities

20. Some stakeholders stated that the costs of materials, equipment, or facilities that are acquired or constructed for a specific research and development project and have no alternative future use should be amortized over the life of the project. The Board concluded that these costs do not have a separate economic value that distinguishes them from other research and development costs like salaries; therefore, the board determined that these costs should be expensed as incurred.[11]
21. Market research and market testing activities are not research and development activities.[12] Per FASB Interpretation No. 6, *Applicability of FASB Statement No. 2 to Computer Software*, computer software costs associated with selling or administrative processes, such as a computerized customer reservation system, are not research and development costs.[13]
22. If computer software is purchased or leased and used for a particular research and development activity, the costs of this computer software are expensed as a research and development cost when incurred. However, if the purchased or leased computer software has alternative future uses, the costs of the computer software are capitalized and subsequently amortized.[14] When the capitalized software is used for research and development activities, the amortization expense is a research and development cost.[15]
23. The costs incurred to internally develop computer software used for research and development activities are expensed in the period incurred, regardless of management's intention for the future uses of the computer software.[16]

Acquired In-Process Research and Development Assets

24. This section provides supplementary information on the accounting for acquired research and development (IPR&D) assets in a business combination and asset acquisition.
25. Identifiable tangible and intangible research and development assets that are acquired in a business combination are recognized at fair value on the acquisition date. Subsequently, the acquired tangible assets used in research and development activities are accounted for based on their nature.[17] Acquired intangible assets used in research and development activities are recognized as indefinite life intangible assets and evaluated for impairment until the associated research and development project is (a)

[11] 730-10-25-2(a)
[12] 730-10-15-4(e)
[13] 730-10-15-4(c)
[14] 730-10-25-3
[15] 730-10-25-2(c)
[16] 730-10-25-4
[17] 730-10-15-4(f)

completed or (b) abandoned.[18] Intangible IPR&D assets may include historical know-how, formula protocols, designs, or procedures.[19] Additional costs to complete the IPR&D project are expensed in accordance with Topic 730.

26. FASB Statement No. 141 (revised 2007), *Business Combinations* provided the following reasoning for recognizing IPR&D assets at fair value on the acquisition date:

> B152. The Board agreed with respondents that the likelihood that an individual research and development project will result in a profitable product often is low. However, the Board also noted that the use of the word *probable* in FASB Concepts Statement 6 refers only to something that is not certain….Therefore, the Board concluded that in-process research and development acquired in a business combination generally will satisfy the definition of an asset because the observable exchange at the acquisition date provides evidence that the parties to the exchange expect future economic benefits to result from the research and development. Uncertainty about the outcome of an individual project is reflected in measuring its fair value.

27. Identifiable IPR&D assets purchased in an asset acquisition are accounted for under Topic 730. Therefore, if the IPR&D asset has no future alternative uses, the cost of the IPR&D asset is expensed.
28. The Board acknowledged in its basis for conclusions for FASB Statement No. 141(R) that the accounting for IPR&D assets is inconsistent between business combinations and other types of transactions, such as asset acquisitions, and that this inconsistency may be addressed in a separate standard-setting project. During the agenda consultation outreach in 2021, some constituents expressed a desire for the Board to address this inconsistency.

Acquired and Internally Developed Intangible Assets

29. This section provides information on the accounting for acquired and internally developed intangible assets. Accounting requirements may differ depending on the type of entity (public entity, private entity, and/or not-for-profit entity).
30. The Board concluded in FASB Statement No. 141(R) that goodwill meets the definition of an asset in Concepts Statement No. 6, *Elements of Financial Statements*.[20] The Board stated in its basis for conclusions that goodwill generally provides future economic benefits that the acquirer controls by its ability to direct the policies and management of the acquiree.
31. Topic 805 requires identifiable intangibles that are acquired in a business combination to be capitalized and recognized separately from goodwill.[21] The FASB *Accounting Standards Codification* defines the term *identifiable* as the following:

> An asset is identifiable if it meets either of the following criteria:

[18] 350-30-35-17A
[19] 805-10-55-65 through 55-66
[20] FAS 141(R) B313 through B317
[21] 350-30-25-1 and 805-20-30-1

a. It is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so.

b. It arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Therefore, intangible items acquired in a business combination are identifiable if they meet the *separability* criterion *or* the *contractual-legal* criterion. Identifiable intangibles are separated from goodwill and recognized as assets.[22]

32. The implementation guidance in Topic 805 provides examples of identifiable intangible assets.[23] This implementation guidance organizes identifiable intangible assets into the following categories:
    a. Marketing-related intangible assets,
    b. Customer-related intangible assets,
    c. Artistic-related intangible assets,
    d. Contract-based intangible assets, and
    e. Technology-based intangible assets.
33. The Board did not discuss if the identifiable intangible assets listed in the implementation guidance meet the definition of an asset. Furthermore, an accounting alternative for private and not-for-profit entities allows certain identifiable intangible assets, such as noncompetition agreements or customer-related intangible assets that are not capable of being sold or licensed independently from other assets of a business, to be subsumed into goodwill.[24]

[22] 805-20-25-1
[23] 805-20-55-11 through 55-45
[24] 805-20-25-29 through 25-33

Research and Development—Discussion Questions

Conference participants are asked to be prepared to discuss the following questions on the accounting for research and development activities. These questions relate to element definitions. Recognition and measurement will be discussed in the third and final Conference session.

The fundamental question in accounting for research and development activities is whether, as a result of the activities, an asset has been created. To meet the definition of an asset the entity must have a right to an economic benefit.

1) Is there any identifiable point in the research and development process that provides evidence the asset definition has been met?
2) In considering whether research and development costs meet the definition of an asset, do you find it more difficult to resolve uncertainty about whether there is a present right, or whether the right is to an economic benefit?
3) If research and development activities result in knowledge that is exchangeable, does that provide sufficient evidence an asset has been created?
4) Are the criteria for determining when an intangible should be separately identifiable from goodwill helpful in resolving whether an asset has been created? (See paragraph 31).
5) Are either of the approaches in Appendix B (pg.20-21) to accounting for software development costs helpful in resolving whether research and development costs meet the definition of an asset? Note that the Board currently has a project on the technical agenda to examine the approaches for accounting for software development costs.
6) The IASB distinguishes between research costs and development costs. Research costs are expensed as incurred and development costs are capitalized once certain criteria have been met. Is it helpful to distinguish research costs from development costs in determining whether the asset definition has been satisfied? (Appendix C, pg.22-23, contains the requirements in IAS 38).
7) Are the definitions of research and development provided in SFAS 2 and repeated in paragraph 3 of this section sufficiently clear to distinguish between these two types of costs? If so, is the point when research shifts to development helpful in resolving when an asset has been created, if at all?
8) What is the conceptual basis, if any, to distinguish between rights created by internal research and development activities from other rights acquired by acquisition?

Appendix B: Research and Development Costs of Computer Software

A1. The objective of this appendix is to provide an overview of the accounting for research and development costs of computer software.

A2. Paragraph 985-20-25-1 states that research and development costs that are incurred to establish technological feasibility of a computer software product that will be sold, licensed, or marketed are expensed as incurred. Subsequent to the establishment of technological feasibility, costs are generally capitalized until the software is commercialized.

A3. Paragraph 985-20-25-2 defines the term *technological feasibility* as the following:

> "…the technological feasibility of a computer software product is established when the entity has completed all planning, designing, coding, and testing activities that are necessary to establish that the product can be produced to meet its design specifications including functions, features, and technical performance requirements. At a minimum, the entity shall have performed the activities in either (a) or (b) as evidence that technological feasbility has been established:
>
> a. If the process of creating the computer software product includes a detail program design, all of the following:
>
> 1. The product design and the detail program design have been completed, and the entity has established that the necessary skills, hardware, and software technology are available to the entity to produce the product.
>
> 2. The completeness of the detail program design and its consistency with the product design have been confirmed by documenting and tracing the detail program design to product specifications.
>
> 3. The detail program design has been reviewed for high-risk development issues (for example, novel, unique, unproven functions and features or technological innovations), and any uncertainties related to identified high-risk development issues have been resolved through coding and testing.
>
> b. If the process of creating the computer product does not include a detail program design with the features identified in (a), both of the following:
>
> 1. A product design and working model of the software product have been completed.

2. The completeness of the working model and its consistency with the product design have been confirmed by testing."

A4. In contrast, paragraph 350-40-25-1 states that the costs incurred to develop software for internal use are expensed as incurred during the preliminary project stage. Costs are capitalized when (a) the preliminary project stage is complete and (b) management authorizes and commits to funding the project, and it is probable that the project will be completed and the system performs as intended.[25]

A5. The *Accounting Standards Codification* defines the phrase *preliminary project stage* as the following:

> "When a computer software project is in the preliminary project stage, entities will likely do the following:
>
> a. Make strategic decisions to allocate resources between alternative projects at a given point in time. For example, should programmers develop a new payroll system or direct their efforts toward correcting existing problems in an operating payroll system?
>
> b. Determine the performance requirements (that is, what it is that they need the software to do) and systems requirements for the computer software project it has proposed to undertake.
>
> c. Invite vendors to perform demonstrations of how their software will fulfill an entity's needs.
>
> d. Explore alternative means of achieving specified performance requirements. For example, should an entity make or buy the software? Should the software run on a mainframe or a client server system?
>
> e. Determine that the technology needed to achieve performance requirements exists.
>
> f. Select a vendor if an entity chooses to obtain software.
>
> g. Select a consultant to assist in the development or installation of the software."

A6. Costs incurred during the application development stage of internal-use software are generally capitalized.

[25] 350-40-25-12

Appendix C: The IASB Approach to Accounting for Research and Development Intangible Assets (IAS 38 – paragraphs 52-57)

Internally generated intangible assets

52. To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:

(a) a research phase; and

(b) a development phase.

Although the terms 'research' and 'development' are defined, the terms 'research phase' and 'development phase' have a broader meaning for the purpose of this Standard.

53. If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase only.

Research phase

54. No intangible asset arising from research (or from the research phase of an internal project) shall be recognized. Expenditure on research (or on the research phase of an internal project) shall be recognized as an expense when it is incurred.

55. In the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is recognized as an expense when it is incurred.

56. Examples of research activities are:

(a) activities aimed at obtaining new knowledge;

(b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

(c) the search for alternatives for materials, devices, products, processes, systems or services; and

(d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Development phase

57. An intangible asset arising from development (or from the development phase of an internal project) shall be recognized if, and only if, an entity can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.

(b) its intention to complete the intangible asset and use or sell it.

(c) its ability to use or sell the intangible asset.

(d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

(f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

Session 2
SFAS 5: Accounting for Contingencies

Background and Scope

1. Statement of Financial Accounting Standards No. 5 (SFAS 5), *Accounting for Contingencies* (codified as ASC 450), was issued in 1975. SFAS 5 addressed the accounting for and disclosure of contingencies.
2. SFAS 5 paragraph 1 defines a contingency as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur."
3. Prior to the issuance of SFAS 5, there was diversity in practice in the accounting for contingencies. Some reporting entities accrued estimated losses before the occurrence of the event or events that were expected to resolve the uncertainties, while other reporting entities accrued losses only when the uncertainties were resolved. In some circumstances, reporting entities, such as property and casualty insurance companies, made a provision from each period's income to cover a portion of significant losses expected in future periods;[26] this was presumably done in an attempt to prevent "income statement distortion" and smooth income volatility. The following excerpt from *The Framework of Financial Accounting Concepts and Standards* by Reed K. Storey and Sylvia Storey provides an example of stakeholder feedback on the accounting for contingencies:

> Much of the controversy over accrual of future loss has focused on whether a company had a liability for future losses or not. However, the impact on income should be overriding. The credit that arises from a provision for self-insurance is not a liability in the true sense, but that in and of itself should not keep it out of the balance sheet. APB Opinion 11 recognized deferred tax credits in balance sheets even though all agreed that the credit balances were not liabilities. Income statement considerations were considered paramount in that case, and similar thinking should prevail in accounting for self-insurance.

4. The objective of this paper is to summarize the major issues the Board considered in developing SFAS 5. References to the current accounting requirements for loss contingencies in the FASB *Accounting Standards Codification* are made in this document.
5. Paragraph 4 of SFAS 5 provided the following examples of loss contingencies (some of which are currently in the scope of other Topics as noted):
    a. Collectability of receivables [ASC 326]
    b. Obligations related to product warranties and product defects [ASC 460]
    c. Risk of loss or damage of enterprise property by fire, explosion, or other hazards [ASC 450]
    d. Threat of expropriation of assets [ASC 450]
    e. Pending or threatened litigation [ASC 450]
    f. Actual or possible claims or assessments [ASC 450]

[26] Paragraph 50 of SFAS 5 Appendix B: Background Information of SFAS 5

g. Risk of loss from catastrophes assumed by property and casualty insurance companies including reinsurance companies [ASC 944-40]
h. Guarantees of indebtedness of others [ASC 460]
i. Obligations of commercial banks under "standby letters of credit" [ASC 460]
j. Agreements to repurchase receivables (or to repurchase the related property) that have been sold [ASC 860].

6. The scope of SFAS 5 applied to losses associated with assets and their remeasurements as well as the recognition and measurement of certain "contingent" liabilities that resulted in loss recognition. It is not clear why the measurement of a loss on an asset should be based on the factors considered in the application of a liability definition. Remeasurement of an asset to determine a loss requires different considerations than identifying a liability. The initial title of this project, "Accounting for Future Losses," suggests that loss recognition was of concern, not the recognition or measurement of liabilities. It is interesting that the application of SFAS 5 to receivables results not in recording future losses on receivables, but rather, only incurred losses. That conclusion may be the cause of the change to the title of SFAS 5 to "Accounting for Contingencies" when finalized.
7. Conference participants are asked to focus only on liabilities potentially incurred from pending or threatened litigation, actual or possible claims or assessments and injury or damage caused by products sold. Appendix D (pg.30-31) contains application guidance applicable to these issues.
8. Participants will be asked to evaluate the Board's recognition and measurement conclusions in SFAS 5 for loss contingencies in the context of the liability definition in Chapter 4, *Elements of Financial Statements*, of FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting*.

Issue—Accounting for Contingencies

9. Paragraph 1 of SFAS 5 defines a loss contingency as "an existing condition, situation, or set of circumstances involving uncertainty as to a possible loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur." Paragraph 3 of SFAS 5 states "The likelihood that a future event will confirm the loss ranges from remote to probable."

    Probable: The future event or events are likely to occur.

    Reasonably Possible: The chance of the future event or events occurring is more than remote but less than likely.

    Remote: The chance of the future event or events occurring is slight.

10. Paragraph 8 of SFAS 5 specifies the accounting for a loss contingent is as follows:

    An estimated loss from a loss contingency shall be accrued by a charge to income if both the following conditions are met:

    a. Information available prior to issuance of the financial statements indicates that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
    b. The amount of loss can be reasonably estimated.

11. Paragraph 8 of SFAS 5 provides guidance with respect to timing of recognition of a liability and a related loss, when there is uncertainty about the liability and the loss that will be resolved by the occurrence or nonoccurrence of a future event. As a result, the term *contingent liability* is generally interpreted to refer to an obligation whose existence depends on the occurrence or nonoccurrence of a future event, as opposed to an existing obligation with an uncertain outcome.
12. SFAS 5 addresses whether a probable loss will occur, not whether a liability has been created. In its deliberations, the Board focused on the term *economic obligations* because, as indicated in the introduction, the APB Statement 4 liability definition was not operable.
13. The term *economic obligations* is described in paragraph 58 of APB Statement 4 as "…present responsibilities to transfer economic resources or provide services to other entities in the future." Furthermore, the Board considered other liability descriptions in accounting literature, including, "A liability is the result of a transaction of the past, not of the future."[27]
14. The Board intended for the condition from SFAS 5 quoted in paragraph 10(a) above to prevent entities from recognizing a liability in financial statements that relates to a future period rather than a prior or current period. Said differently, the condition is intended to prohibit the recognition of a liability when it is not probable that one has been incurred. However, in paragraph 68 of SFAS 5, the Board noted that the condition "is not so past-oriented that accrual of a loss must await the occurrence of the confirming future event, for example, final adjudication or settlement of a lawsuit."
15. If the condition in paragraph 10(a) above is met, the Board decided that a loss contingency must be *reasonably estimable* to be recognized in financial statements.[28] The Board concluded that this condition was "intended to prevent accrual in the financial statements of amounts so uncertain as to impair the integrity of those statements." The following measurement requirements from SFAS 5 are provided in ASC 450-20:

    450-20-30-1 If some amount within a range of loss appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued. Even though the minimum amount in the range shall be accrued. Even though the minimum amount in the range is not necessarily the amount of loss that will be ultimately determined, it is not likely that the ultimate loss will be less than the minimum amount.

16. Litigation, claims and assessments are examples of a loss contingency. Paragraph 33 of SFAS 5 provides conditions to be analyzed in determining if a contingent loss should be accrued with respect to pending or threatened litigation and actual or possible claims and assessments:[29]

[27] Maurice Moonitz, "The Changing Concept of Liabilities," *The Journal of Accountancy*, May 1960, p. 44.
[28] ASC 450-20-25-2
[29] ASC 450-20-55-10

a. The period in which the underlying cause (i.e., the cause for action) of the pending or threatened litigation or of the actual or possible claim or assessment occurred.
b. The degree of probability of an unfavorable outcome.
c. The ability to make a reasonable estimate of the amount of loss.

17. If a lawsuit is filed or a formal assertion of a claim or assessment is made against a reporting entity, that reporting entity is required to evaluate the degree of probability of an unfavorable outcome as a condition for accruing a loss. The accrual of a contingent loss would be required if an unfavorable outcome resulting from the lawsuit, claim, or assessment is probable and reasonably estimable.[30]
18. In certain circumstances, a reporting entity may be required to evaluate an unasserted claim or assessment for accrual. In these circumstances, the reporting entity must first determine if it is probable that a suit will be filed, or a claim or assessment will be asserted, prior to evaluating the probability of an unfavorable outcome.[31]
19. If there is uncertainty as to whether an item meets the definition of an element, that item should not be recognized in financial statements, given it would fail the first of four recognition criteria in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.[32] SFAS 5 was issued in March 1975 and Concepts Statement 5 was issued in December 1984.
20. In some circumstances, a present obligation's outcome, but not its existence, may be uncertain; for example, either or both the amount and timing of the settlement or performance required by the obligation may be uncertain until resolution by a future event. Present obligations with uncertain outcomes may be contractual or noncontractual. Chapter 4 of Concepts Statement 8 provides an implicit or explicit warranty obligation as an example of a noncontractual present obligation with an uncertain outcome.
21. The Board concluded in Chapter 4 of Concepts Statement 8 that the effects of an uncertain outcome of a present obligation are reflected in the present obligation's measurement. Paragraph E60 in Chapter 4 of Concepts Statement 8 states:

> E60. 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.

[30] ASC 450-20-55-13
[31] ASC 450-20-55-14
[32] Paragraph 63 of Concepts Statement 5 specifies the four recognition criteria

Accounting for Contingencies—Discussion Questions

Conference participants are asked to consider and be prepared to discuss the following questions on accounting for contingencies that result from litigation claims and assessments. These questions relate to element definitions. Recognition and measurement will be discussed in the third and final conference session.

Case Study

Conference participants are asked to consider the following case study, "Fake News", which has also been used at a FRIC in prior years.

Fake News

A newspaper that publishes many articles about people in the public eye is frequently sued for libel. There are currently 10 claims against the newspaper with respect to articles published before the end of the reporting period. Having examined the evidence, the publisher expects two of the claims to be successful. The newspaper has also identified five articles published for which no claim has been asserted but it is probable a claim will be made because of the nature of the articles and known factual errors in the articles.

1) Which of these circumstances, if any, create a present obligation consistent with Chapter 4 of SFAC?

Other Discussion Questions

2) If an entity is subject to or anticipates the filing of a suit or the formal assertion of a claim or assessment, what is the objective of recognizing a liability? Acknowledging that this discussion requires consideration of recognition and measurement, is the objective to (a) recognize an amount that faithfully represents settlement of the asserted amount, or (b) faithfully represent the consequences of the event by recognizing an estimated settlement amount plus the costs of defense?
    a) Do either or both of these amounts (settlement of the asserted amount and/or the consequences of the event) meet the definition of a liability?
3) In considering whether litigation, claims, and assessments meet the definition of a liability, do you find it more difficult to resolve uncertainty about whether there is a present obligation, or whether the obligation is to transfer economic benefits to others?
4) If the litigation is an attempt to restrain an entity from engaging in some activity, does the consequence of losing that suit meet the definition of a liability?

Gain Contingencies

1. SFAS 5 did not reconsider the conclusions in ARB 50 with respect to gain contingencies. The conclusions from ARB 50 are repeated in paragraph 17 of SFAS 5.

   "The Board has not reconsidered ARB No. 50 with respect to gain contingencies. Accordingly, the following provisions of paragraphs 3 and 5 of that Bulletin shall continue in effect:

   a) Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization.
   b) Adequate disclosures shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization."

2. Because SFAS 5 focused more on the recognition of a loss than it did the recognition of assets and liabilities, the retention of ARB 50 gain contingency recognition is understandable. Conference participants are asked to consider whether the general prohibition of recognizing gain contingencies is compatible with the asset definition in Chapter 4 of SFAC No. 8.

Gain Contingencies—Discussion Questions

Conference participants are asked to consider and be prepared to discuss the following questions on the gain contingencies. These questions relate to element definitions. Recognition and measurement will be discussed in the third and final conference session.

1) In the discussion of the Fake News case, consider each, if any, circumstance that was thought to create a liability of the entity. What should the accounting for the counterparty to the arrangement be?
2) Chapter 4 of Concepts Statement 8 makes clear that an unconditional present obligation for an uncertain outcome represents a liability. Given that conclusion, is an unconditional right to an uncertain outcome an asset?
3) Is there a compelling reason why the existence of an asset (recognition of which would result in a gain) should not be analyzed in terms of the definition of an asset?

Appendix D: Examples of Application of SFAS 5

Litigation, Claims, and Assessments (SFAS 5 – paragraphs 33-39)

33. The following factors, among others, must be considered in determining whether accrual and/or disclosure is required with respect to pending or threatened litigation and actual or possible claims and assessments:

a. The period in which the underlying cause (i.e., the cause for action) of the pending or threatened litigation or of the actual or possible claim or assessment occurred.
b. The degree of probability of an unfavorable outcome.
c. The ability to make a reasonable estimate of the amount of loss.

34. As a condition for accrual of a loss contingency, paragraph 8(a) requires that information available prior to the issuance of financial statements indicate that it is possible that an asset had been impaired or a liability had been incurred at the date of the financial statements. Accordingly, accrual would clearly be inappropriate for litigation, claims, or assessments whose underlying cause is an event or condition occurring after the date of financial statements but before those financial statements are issued, for example, a suit for damages alleged to have been suffered as a result of an accident that occurred after the date of the financial statements. Disclosure may be required, however, by paragraph 11.

35. On the other hand, accrual may be appropriate for litigation, claims, or assessments whose underlying cause is an event occurring on or before the date of an enterprise's financial statements even if the enterprise does not become aware of the existence or possibility of the lawsuit, claim, or assessment until after the date of the financial statements. If those financial statements have not been issued, accrual of a loss related to the litigation, claim, or assessment would be required if the possibility of loss is such that the condition in paragraph 8(a) is met and the amount of loss can be reasonably estimated.

36. If the underlying cause of the litigation, claim, or assessment is an event occurring before the date of an enterprise's financial statements, the probability of an outcome unfavorable to the enterprise must be assessed to determine whether the condition in paragraph 8(a) is met. Among the factors that should be considered are the nature of the litigation, claim, or assessment, the progress of the case (including progress after the date of the financial statements but before those statements are issued), the opinions or views of legal counsel and other advisers, the experience of the enterprise in similar cases, the experience of other enterprises, and any decision of the enterprise's management as to how the enterprise intends to respond to the lawsuit, claim, or assessment (for example, a decision to contest the case vigorously or a decision to seek an out-of-court settlement). The fact that legal counsel is unable to express an opinion that the outcome will be favorable to the enterprise should not necessarily be interpreted to mean that the condition for accrual of a loss in paragraph 8(a) is met.

37. The filing of a suit or formal assertion of a claim or assessment does not automatically indicate that accrual of a loss may be appropriate. The degree of probability of an unfavorable outcome must be assessed. The condition for accrual in paragraph 8(a) would be met if an unfavorable outcome is determined to be probable. If an unfavorable outcome is determined to be reasonably possible but not probable, or if the amount of loss cannot be reasonably estimated, accrual would be inappropriate, but disclosure would be required by paragraph 10 of this Statement.

38. With respect to unasserted claims and assessments, an enterprise must determine the degree of probability that a suit may be filed or a claim or assessment may be asserted and the possibility of an unfavorable outcome. For example, a catastrophe, accident, or other similar physical occurrence

predictably engenders claims for redress, and in such circumstances their assertion may be probable; similarly, in an investigation of an enterprise by a governmental agency, if enforcement proceedings have been or are likely to be instituted, is often followed by private claims for redress, and the probability of their assertion and the possibility of loss should be considered in each case. By way of further example, an enterprise may believe there is a possibility that it has infringed on another enterprise's patent rights, but the enterprise owning the patent rights has not indicated an intention to take any action and has not even indicated an awareness of the possible infringement. In that case, a judgement must first be made as to whether the assertion of a claim is probable. If the judgement is that assertion is not probable, no accrual or disclosure would be required. On the other hand, if the judgement is that assertion is probable, then a second judgement must be made as to the degree of probability of an unfavorable outcome. If an unfavorable outcome is probable and the amount of loss can be reasonably estimated, accrual of a loss is required by paragraph 8. If an unfavorable outcome is probable but the amount of loss cannot be reasonably estimated, accrual would not be appropriate, but disclosure would be required by paragraph 10. If an unfavorable outcome is reasonably possible but not probable, disclosure would be required by paragraph 10.

39. As a condition for accrual of a loss contingency, paragraph 8(b) requires that the amount of loss can be reasonably estimated. In some cases, it may be determined that a loss was incurred because an unfavorable outcome of the litigation, claim, or assessment is probable (thus satisfying the condition in paragraph 8(a)), but the range of possible loss is wide. For example, an enterprise may be litigating an income tax matter. In preparation for the trial, it may determine that, based on recent decisions involving one aspect of the litigation, it is possible that it will have to pay additional taxes of $2 million. Another aspect of the litigation may, however, be open to considerable interpretation, and depending on the interpretation by the court the enterprise may have to pay taxes of $8 million over and above the $2 million. In that case, paragraph 8 requires accrual of the $2 million if that is considered a reasonable estimate of the loss. Paragraph 10 requires disclosure of the additional exposure to loss if there is a reasonable possibility that additional taxes will be paid. Depending on the circumstances, paragraph 9 may require disclosure of the $2 million that was accrued.

Appendix E: Reasonable Estimation of the Amount of a Loss—FASB Interpretation No. 14

An Interpretation of FASB Statement No. 5 (FIN 14 – paragraphs 2-6)

2. As indicated in paragraph 59 of *FASB Statement No. 5*, the purpose of the two conditions in paragraph 8 of the Statement is "to require accrual of losses when they are reasonably estimable and relate to the current or a prior period." Condition (b) in paragraph 8, that "the amount of loss can be reasonably estimated," does not delay accrual of a loss until only a single amount can be reasonably estimated. To the contrary, when condition (a) in paragraph 8 is met, i.e., "it is probable that an asset had been impaired or a liability had been incurred," and information available indicates that the estimated amount of loss is within a range of amounts, it follows that some amount of loss has occurred and can be reasonably estimated.

3. When condition (a) in paragraph 8 is met with respect to a particular loss contingency and the reasonable estimate of the loss is a range, condition (b) in paragraph 8 is met and an amount shall be accrued for the loss. When some amount within the range appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued.[33] In addition, paragraph 9 of the Statement may require disclosure of the nature and, in some circumstances, the amount accrued, and paragraph 10 requires disclosure of the nature of the contingency and the additional exposure to loss if there is at least a reasonable possibility of loss in excess of the amount accrued.

4. As an example, assume that an enterprise is involved in litigation at the close of its fiscal year ending December 31, 1976 and information available indicates that an unfavorable outcome is probable. Subsequently, after a trial on the issues, a verdict unfavorable to the enterprise is handed down, but the amount of damages remains unresolved at the time the financial statements are issued. Although the enterprise is unable to estimate the exact amount of loss, its reasonable estimate at the time is that the judgment will be for not less than $3 million or more than $9 million. No amount in that range appears at the time to be a better estimate than any other amount. *FASB Statement No. 5* requires accrual of the $3 million at December 31, 1976, disclosure of the nature of the contingency and the exposure to an additional amount of loss of up to $6 million, and possibly disclosure of the amount of the accrual.

5. The same answer would result under the example in paragraph 4 above if it is probable that a verdict will be unfavorable even though the trial has not been completed before the financial statements are issued. In that situation, condition (a) in paragraph 8 would be met because information available to the enterprise indicates that an unfavorable verdict is probable. An assessment that the range of loss is between $3 million and $9 million would meet condition (b) in paragraph 8. If no single amount in that range is a better estimate than any other amount, FASB Statement No. 5 requires an accrual of $3 million at December 31, 1976, disclosure of the nature of the contingency and the exposure to an additional amount of loss of up to $6 million, and possibly disclosure of the amount of the accrual. Note, however, that if the enterprise had assessed the verdict differently (e.g., that an unfavorable verdict was *not* probable but was only reasonably possible), condition (a) in paragraph 8 would not have been met and no

[33]Even though the minimum amount in the range is not necessarily the amount of loss that will be ultimately determined, it is not likely that the ultimate loss will be less than the minimum amount.

amount of loss would be accrued but the nature of the contingency and any amount of loss that is reasonably possible would be disclosed.

6. Assume that in the examples given in paragraphs 4 and 5 above condition (a) in paragraph 8 has been met and a reasonable estimate of loss is a range between $3 million and $9 million but a loss of $4 million is a better estimate than any other amount in that range. In that situation, *FASB Statement No. 5* requires accrual of $4 million, disclosure of the nature of the contingency and the exposure to an additional amount of loss of up to $5 million, and possibly disclosure of the amount of the accrual.

Session 3

Recognition and Measurement

1. In the first two sessions of this conference, participants considered (1) when research and development activities create an asset and (2) when certain *contingent* liabilities meet the liability definition in Chapter 4 of SFAC 8. Meeting the definition of an asset or a liability is the first step in the process of including an item in financial statements.
2. Recognition is the process of recording or incorporating an item in the financial statements of an entity. Recognition includes depiction of an item in both words and numbers with the amount included in the totals of the financial statements. Paragraph 63 of SFAC 5 states that an item to be recognized should meet four fundamental recognition criteria and should be recognized when the criteria are met, subject to a cost-benefit constraint and a materiality threshold.

   Those criteria are:

   Definitions—The item meets the definition of an element of financial statements.

   Measurability—It has a relevant attribute measurable with sufficient reliability.

   Relevance—The information about it is capable of making a difference in user decisions.

   Reliability—The information is representationally faithful, verifiable, and neutral.

3. At the July 20, 2022 Board meeting, the Board tentatively decided on the following recognition criteria in Chapter 5, *Recognition and Derecognition*, of Concepts Statement 8 that would replace the recognition criteria for SFAS 5.

   Definitions: The item meets the definition of an element.

   Measurability: The item is measurable with a relevant measurement attribute.

   Faithful Representation: The item can be depicted with faithful representation.

   Appendix F (pg.37-40) presents the Exposure Draft that proposes these criteria.

4. For financial information to be faithfully represented, it must be complete, free from error, and neutral. Paragraph QC16 in Chapter 3, *Qualitative Characteristics of Useful Accounting Information*, of Concepts Statement 8 states that an item subject to measurement uncertainty can be faithfully represented if the reporting entity (i) describes and applies an appropriate estimation process, (ii) appropriately describes the estimate, and (iii) appropriately describes any significant uncertainties. Furthermore, “free from error” does not imply precision. Free from error implies that the estimation process used to measure an item is applied in the manner described and without error.
5. An argument may be made that items with significant measurement uncertainty provide less relevant financial information. To be relevant, financial information should provide confirmatory value, predictive

value, or both. Items subject to measurement uncertainty may provide confirmatory value or predictive value about the amount, timing, and uncertainties of future net cash inflows to the reporting entity and, therefore, provide useful financial information to resource providers in assessing returns on their investments. While recognizing items with a high degree of measurement uncertainty may result in income volatility, the Board acknowledged in paragraphs 63-65 of the Basis for Conclusions for SFAS 5 that earnings variability provides relevant information to financial statement users who wish to evaluate an investment's expected return and risk.

6. In the contemplated measurement chapter for SFAC 8 the staff has concluded that relevant measurements are based on either exit prices or entry prices and that exit prices may represent fair value (a market participant perspective) or an estimated exit price from an entity perspective.
7. For purposes of this conference discussion, assume the relevant measurement alternatives are based on an entry price or an exit price. The Master Glossary defines entry price as "the price paid to acquire an asset or received to assume a liability in an exchange transaction" and exit price as "the price that would be received to sell an asset or paid to transfer a liability".

Recognition and Measurement—Discussion Questions

Conference participants are asked to consider and be prepared to discuss the following questions on the recognition and measurement of research and development costs and contingencies.

1) When engaging in internal research and development activities it is inevitable that costs will be incurred before an asset has been identified. The IASB distinction between research and development and the phases of software development (which are recognized differently) illustrate this circumstance.
    a) Does measurement of a research and development created asset that excludes the costs incurred before an asset has been identified faithfully represent the asset recognized?
    b) Assume for this question that an item created by research and development activities meets the definition of an asset. Do participants have views on whether that asset should be measured at entry price or exit price?
2) Assume a claim has been made against an entity with an assertion of damages in the amount of $1,000,000. The entity applied a probability estimation technique and concluded there is a 60% probability the claimant will be successful. If successful, it is estimated the amount assessed would be reduced to 40% of the amount of the claim.
    a) Ignoring the timing of the payment, and consequently interest, should the liability be estimated as:
        i) $600,000
        ii) $400,000
        iii) $240,000
    b) If any costs were anticipated to be incurred to achieve the estimated settlement, do those costs represent a liability at the point of initial recognition of the claim?
3) Do the proposed recognition criteria described in paragraph 3 of this section of the document provide an appropriate basis for application to research and development costs and contingent liabilities?
4) After concluding that research and development expenses or a contingency results in an asset or liability, is there any circumstance where that asset or liability has no relevant measurement or cannot be faithfully represented?

Appendix F: Exposure Draft of Chapter 5, *Recognition and Derecognition*

Chapter 5: Recognition and Derecognition

Introduction

RD1. This chapter sets forth recognition and derecognition criteria to guide when an item should be incorporated into and removed from financial statements. This chapter builds on the foundation described in other concepts, bringing those concepts together to apply them to recognition and derecognition issues.

RD2. A full set of financial statements is the principal way a reporting entity achieves the objective of general purpose financial reporting by providing financial information about the reporting entity's (a) resources, (b) claims to those resources, and (c) changes in those resources and claims during the period. The recognition and derecognition criteria provide concepts for the Board to apply when determining whether an item should be recognized or derecognized in financial statements of business or not-for-profit entities.

Recognition

RD3. Recognition is the process of incorporating an item in financial statements of a reporting entity as an asset, liability, equity, revenue, gain, expense, loss, or investment by or distribution to owners. A recognized item is depicted in both words and numbers, with the amount included in financial statement totals. For an asset or a liability, recognition involves recording the acquisition or incurrence of the item and later changes in the item (related to measurement), including changes that result in its removal from financial statements (as addressed in paragraphs RD12 and RD13). Because recognition means the depiction of an item in both words and numbers, with the amount included in the totals of financial statements, disclosure of an amount by any other means is *not* recognition.

Recognition Criteria

RD4. The recognition criteria are intended to provide direction for resolving issues that involve accounting recognition. The reporting entity's assets, liabilities, equity, and changes in those elements are candidates for recognition in financial statements.

RD5. An item and its financial information should meet three recognition criteria to be recognized in financial statements, subject to the pervasive cost constraint and materiality considerations. Those criteria are:

a. *Definitions*—The item meets the definition of an element of financial statements.
b. *Measurability*—The item is measurable and has a relevant measurement attribute.
c. *Faithful Representation*—The item can be depicted and measured with faithful representation.

RD6. All three criteria are subject to the cost constraint: the benefits from recognizing a particular item should justify the costs of providing and using the financial information. Recognition also is subject to materiality considerations. The cost constraint and materiality are discussed in Chapter 3 of this Concepts Statement.

Element Definitions

RD7. An item must meet the definition of an element in Chapter 4 of this Concepts Statement to be recognized in financial statements. Recognizing an item that does not meet the definition of an element would be inconsistent with the fundamental qualitative characteristic of faithful representation by misrepresenting a reporting entity's (a) resources, (b) claims to those resources, or (c) changes in those resources and claims during the period.

Measurability

RD8. The asset or liability must be measurable with a relevant measurement attribute to be recognized in financial statements. Measurability must be considered together with both relevance and faithful representation.

RD9. Relevance, as discussed in Chapter 3 of this Concepts Statement, is a fundamental qualitative characteristic. Relevant financial information is capable of making a difference in the decisions made by users. To be relevant, financial information about an item must have predictive value, confirmatory value, or both.

RD10. A relevant measurement attribute for an item being considered for recognition cannot be determined in isolation. Relevance should be evaluated in the context of the objective of general purpose financial reporting: providing financial information about a reporting entity that is useful to existing and potential investors, lenders, and other resource providers in making decisions about providing resources to the entity.

Faithful Representation

RD11. Faithful representation, as discussed in Chapter 3 of this Concepts Statement, is a fundamental qualitative characteristic. To be useful, financial information not only must represent relevant phenomena, but it also must faithfully represent the phenomena that it purports to represent. Financial information that is faithfully represented must be complete, neutral, and free from error. To achieve the objective of general purpose financial reporting, an item recognized in financial statements must be depicted and measured with faithful representation.

Derecognition

RD12. Derecognition is the process of removing an item from financial statements of a reporting entity as an asset, liability, or equity. Derecognition should occur when an item no longer meets any one of the recognition criteria in paragraph RD5. For example, an item should not continue to be recognized if it does not meet the definition of an element because continued recognition of that item would violate the definitions recognition criterion.

RD13. In certain arrangements, an entity may have continuing involvement in the asset, liability, or equity item that is being evaluated for derecognition. The nature and extent of the continuing involvement may influence the derecognition consideration at the standards level. However, that involvement also may create rights and obligations that meet the recognition requirements of paragraph RD5 and should be recognized to faithfully represent the results of the arrangement.

This proposed Concepts Statement was approved for publication by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Richard R. Jones, *Chair*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Gary R. Buesser
Frederick L. Cannon
Susan M. Cosper
Marsha L. Hunt

Basis for Conclusions

Introduction

BC1. 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 others.

BC2. Recognition concepts are currently set forth in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. The Board concluded that the discussion of the recognition concepts in Concepts Statement 5 could be further developed and improved with the objective of providing a foundation for future standards for business and not-for-profit entities. The decisions reflect changes to the fundamental qualitative characteristics of useful financial information since Concepts Statement 5 was originally issued in 1984.

BC3. Concepts Statement 5 did not explicitly address the issue of derecognition. The Board decided to develop conceptual guidance to address that issue to provide a more comprehensive framework on which to evaluate future standard-setting decisions.

Recognition Criteria and the Qualitative Characteristics

BC4. Some of the recognition criteria in this chapter are derived from the qualitative characteristics of useful financial information in Chapter 3 of this Concepts Statement. To be consistent with the fundamental qualitative characteristics described in Chapter 3, the following changes were made to the recognition criteria in Concepts Statement 5:

a. The phrase *sufficient reliability* was removed from the measurability criterion.
b. The reliability criterion was replaced with the faithful representation criterion.
c. The relevance criterion was not retained; however, the fundamental qualitative characteristic of relevance remains in the measurability criterion.

The Board concluded that an item recognized in financial statements must meet the definition of an element. Recognizing an item that does not meet the definition of an element would be inconsistent with the objective of general purpose financial reporting. As such, the Board decided to retain the elements criterion described in Concept Statement 5.

Measurability Criterion

BC5. The measurability criterion in Concepts Statement 5 contains ambiguous language that is susceptible to alternative interpretations. For example, it is not clear if the phrase *sufficient reliability* refers to the fundamental qualitative characteristic of reliability as was defined in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information* (superseded), or to a notion of precision.

BC6. As discussed in paragraph 76 of Concepts Statement 5 (as issued), the term *sufficient* refers to the level of uncertainty involving the measurement of an item. Certain items, such as contingencies, are susceptible to measurement uncertainty. While the passage of time in many cases reduces or resolves measurement uncertainty, waiting until the measurement of an item is *sufficiently reliable* could result in the delayed recognition of an item that meets the definition of an element. Consequently, that delayed recognition may reduce the usefulness of the financial information that is presented in financial statements. Therefore, the Board concluded that the phrase *sufficient reliability* may refer to the act of only recognizing items that can be measured with an unspecified degree of certainty when a reporting entity identifies an item that meets the definition of an element.

BC7. The Board decided that attempting to define a level of measurement uncertainty that, if met, would prevent an item from being recognized in financial statements would require significant judgment and be complex to apply while the result would still be ambiguous. An item that has measurement uncertainty may still provide decision-useful financial information to resource providers through confirmatory value or predictive value. Furthermore, the measurement of that item can be faithfully represented if the measurement process is (a) complete, (b) neutral, and (c) free from error. Disclosures may be necessary to compensate for concerns about measurement uncertainty.

BC8. In addition, if the Board is faced with a circumstance in which an item cannot be measured because of uncertainty, that uncertainty may relate to the existence of that item rather than its measurement. If the existence of an item is

uncertain, that item would presumably fail to meet the definition of an element (the first criterion; see paragraph RD5(a)) and, therefore, would not be recognized in financial statements.

BC9. The Board concluded that to reduce ambiguity in the measurability criterion, the phrase *sufficient reliability* should be removed. However, an item that meets the definition of an element should be recognized in financial statements when it can be (a) measured with a relevant measurement attribute and (b) faithfully represented through depiction and measurement.

Faithful Representation and Relevance Criteria

BC10. When Concepts Statement 5 was issued, relevance and reliability were fundamental qualitative characteristics in Concepts Statement 2. Concepts Statement 2 has since been superseded by Chapter 3 of this Concepts Statement. Chapter 3 of this Concepts Statement identifies relevance and faithful representation as fundamental qualitative characteristics. In the basis for conclusions of Chapter 3, the Board concluded that the term *faithful representation* "encompasses the main characteristics that the previous frameworks included as aspects of reliability." Therefore, the Board concluded that the reliability criterion, along with its explanatory paragraphs, should be updated to refer to faithful representation and its aspects of (a) completeness, (b) neutrality, and (c) freedom from error.

BC11. The Board also concluded that the relevance of an item, subject to materiality considerations, is inherently met in that item meeting the definition of an element. As such, the Board decided to remove the *relevance* criterion as a standalone recognition criterion. The Board, however, decided that the fundamental qualitative characteristic of relevance would remain in the measurability criterion as discussed in paragraph BC9.

Derecognition

BC12. Concepts Statement 5 does not explicitly address the issue of derecognition. The Board decided that, conceptually, derecognition should occur when an asset, liability, or equity element no longer meets one of the recognition criteria.