FASB Conceptual Framework

Statement of Financial Accounting Concepts No. 8
December 2021

Conceptual Framework for Financial Reporting

Chapter 4, *Elements of Financial Statements*

Financial Accounting Standards Board

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CHAPTER 4: ELEMENTS OF FINANCIAL STATEMENTS

Introduction

E1. This chapter defines the following 10 elements of financial statements:

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

The definitions in this chapter apply to both business entities and not-for-profit entities.

E2. Definitions of elements of financial statements are a significant determinant of the content of financial statements. Possessing the essential characteristics of one of the elements is a necessary but insufficient condition for an item to be recognized in an entity's financial statements.[1] To be recognized in financial statements, an item should meet the fundamental recognition criteria as well as a cost-benefit constraint.

E3. Matters of recognition, measurement, and display purposely have been separated from the definitions of the elements of financial statements in the

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

Conceptual Framework. The definitions in this chapter focus on the essential characteristics of financial statement elements. Other parts of the Conceptual Framework focus on questions of when items that qualify as assets, liabilities, revenues, expenses, and so forth, should be recognized in financial statements and how those items could be measured and displayed.

E4. There are two different types of elements of financial statements. The first type includes assets, liabilities, and equity, which describe resources or claims to or interests in resources at a specified date. The second type of elements describes the effects of transactions and other events and circumstances that affect an entity during specified time intervals (reporting periods). In a business entity, this includes comprehensive income and its components—revenues, expenses, gains, and losses—and investments by owners and distributions to owners.[2]

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

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

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

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[2]In a not-for-profit entity, the combination of revenues, expenses, gains, and losses often is referred to as a change in net assets. Occasionally, those entities have investments by owners and distributions to owners (see paragraphs E14, E71, and E72).

[3]Chapter 8, *Notes to Financial Statements*, and Chapter 7, *Presentation,* of this Concepts Statement include a discussion of the role of notes and their relation to financial statements.

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

The Objective of Financial Reporting

E9. The focus of the Conceptual Framework is the usefulness of financial reporting information in making economic decisions—reasoned choices among alternative uses of scarce resources. Chapter 1, *The Objective of General Purpose Financial Reporting*, of FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting*, emphasizes usefulness to existing and potential investors, creditors, and others in making rational investment, credit, and similar decisions. It also emphasizes usefulness to existing and potential resource providers and others in making rational decisions about allocating resources to not-for-profit entities. Chapter 3, *Qualitative Characteristics of Useful Financial Information*, of this Concepts Statement emphasizes that the usefulness of financial reporting information for those decisions rests on the fundamental qualitative characteristics of relevance and faithful representation.

E10. The financial statement elements definitions in this chapter pertain to economic items and events that are relevant to investment, credit, and other resource allocation decisions and, thus, are relevant to financial reporting.[4] Those decisions involve committing (or continuing to commit) resources to an entity. The elements defined are an entity's resources, the claims to or interests in those resources, and the changes therein from transactions and other events and circumstances involved in the entity's use of resources to produce and distribute goods or services and engage in other activities. Relevance of information about items that meet the elements definitions stems from the significance of an entity's resources and changes in resources (including those affecting comprehensive income).

E11. Economic resources or assets and changes in them are central to the existence and operations of an entity. Both business entities and not-for-profit entities require and use assets to conduct their purpose and mission. A resource's capacity to be exchanged for cash or other resources or to be combined with other

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

resources to produce needed or desired goods or services gives the resource utility and value (present and future economic benefit).

E12. Business entities and not-for-profit entities obtain resources from various sources. Business entities and some not-for-profit entities sell the goods and services they produce or acquire for cash or claims to cash. Both buy goods and services for cash or incur obligations to transfer cash or other things of value. Business entities receive resources from investments in the entity by owners, while not-for-profit entities commonly receive at least some resources from donors that do not expect to receive either repayment or economic benefits proportionate to resources provided.[5] Those contributions are the major source of resources for some not-for-profit entities but are not significant for other not-for-profit entities or for most business entities.[6]

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

E14. In contrast to business entities, not-for-profit entities generally do not have defined ownership interests that can be sold, transferred, or redeemed or that convey entitlement to a share of a residual distribution of resources in the event of liquidation of the entity. A not-for-profit entity is required to use its resources to provide goods and services to its constituents and beneficiaries as specified in its articles of incorporation (or comparable document for an unincorporated entity) or in its bylaws and generally is prohibited from distributing assets as dividends to its members, directors, officers, or others.[7] Thus, not-for-profit entities have operating

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[5]The term *donor* is used throughout this chapter and is intended to include contributors, donors and prospective donors, grantors and prospective grantors, and federated fundraising organizations that solicit contributions and then redistribute those contributions to not-for-profit entities after deducting fund raising and other costs.

[6]Paragraph OB23 of Chapter 1, *The Objective of General Purpose Financial Reporting*, of this Concepts Statement lists the distinguishing characteristics of not-for-profit entities.

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

purposes other than to provide goods or services at a profit or profit equivalent, and resource providers do not focus primarily on profit as an indicator of a not-for-profit entity's performance.

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

[8]Chapter 1 of this Concepts Statement, paragraph OB28.

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 others' access to the benefits.[9]

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

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[9]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.

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.

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.[10]

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, 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

[10]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.

the force of law.[11] 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

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[11]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.

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.

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.

Equity or Net Assets

E61. The terms *equity* or *net assets* represent the residual interest in the assets of an entity that remains after deducting its liabilities.[12]

E62. The equity or net assets of a business entity and a not-for-profit entity is the difference between the entity's assets and its liabilities. It is a residual that is affected by all events that increase or decrease total assets by amounts different from the amounts that increase or decrease total liabilities from those same events. Thus, equity or net assets of both a business entity and a not-for-profit entity is increased or decreased by the entity's operations and certain other events and circumstances affecting the assets and liabilities of the entity.

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

E63. Common and preferred shareholders hold instruments that represent equity of an entity, absent circumstances or conditions that create a present obligation and, therefore, a liability. A second class of instrument considered an equity interest in an entity is a contract or an arrangement that permits the holder to acquire a fixed number of equity instruments of the entity. Holders of this type of instrument participate in the results of the issuer's operations, just not in the same manner that a holder of an outstanding share does. For example, a holder of a written call option on the issuer's common shares participates in the upside potential in the same manner that a common shareholder does. However, it is subject to a different downside risk, that is, the loss of the premium paid for the instrument.

Characteristics of Equity of Business Entities

E64. In a business entity, equity is the ownership interest.[13] Equity stems from ownership rights (or the equivalent)[14] and involves a relationship between an entity and its owners as owners rather than as employees, suppliers, customers, lenders, or in some other nonowner role.[15]Equity is the difference between assets and liabilities of the entity and, therefore, is the residual interest of the entity. Equity is enhanced or reduced by increases and decreases in net assets from nonowner sources as well as investments by owners and distributions to owners.

E65. An entity may have several classes of equity interests (for example, one or more classes each of common stock or preferred stock) with different rights to participate in distributions of entity assets or different priorities of claims on entity assets in the event of liquidation. That is, some classes of owners may bear

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

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

[15]The same entities, or individuals, may simultaneously be both owners and employees, owners and creditors, owners and customers, creditors and customers, or some other combination. For example, an investor may hold both debt and equity securities of the same entity, or an owner of an entity also may become its creditor by lending to it or by receiving rights to declared and unpaid cash dividends. Wages due, products or services due, accounts payable due, and other amounts due to owners in their roles as employees, customers, suppliers, and the like are liabilities and not part of equity.

relatively more of the risks of the entity's unprofitability or may benefit relatively more from its profitability (or both) than other classes of owners. However, all classes depend at least to some extent on entity profitability for distributions of entity assets, and no class of equity interests carries an unconditional right to receive future transfers of assets from the entity except in liquidation, and then only after liabilities have been satisfied.

E66. A major distinguishing characteristic of the equity of a business entity is that it may be increased through investments of assets by owners that also may receive distributions of assets from the entity. Owners invest in a business entity with the expectation of obtaining a return on their investment. Owners benefit if the entity is profitable and bear the risk that it may be unprofitable. The distinguishing characteristic of equity is that it inevitably is affected by the entity's operations and other events and circumstances affecting the entity (which together constitute comprehensive income; see paragraph E75).

Characteristics of Net Assets of Not-for-Profit Entities

E67. In a not-for-profit entity, as in a business entity, net assets (equity) is a residual, the difference between the entity's assets and its liabilities. In contrast to equity of a business entity, net assets of a not-for-profit entity is not typically an ownership interest. Distinguishing characteristics of a not-for-profit entity include the absence of ownership interest(s) in the same sense as a business entity, operating purposes not centered on profit, and significant receipts of contributions, many involving donor-imposed restrictions.

E68. Net assets of not-for-profit entities is divided into two mutually exclusive classes—net assets with donor restrictions and net assets without donor restrictions.

E69. Restrictions impose responsibilities on management to ensure that an entity uses donated resources in a manner specified by resource providers. Sometimes donor-imposed restrictions limit an entity's ability to sell or exchange an asset. For example, a donor may give a painting to a museum subject to the requirement that it must be publicly displayed, properly maintained, and never sold.

E70. More commonly, donors' restrictions do not prohibit an entity from pooling the donated assets with other assets to sell or exchange the donated assets for other suitable assets as long as the economic benefits of the donated assets are not consumed or used for a purpose that does not comply with the restriction. For example, a donor may contribute 100 shares of Security A to an entity's endowment, thereby requiring that the amount of the gift be restricted but not requiring that the specific shares be held indefinitely. Thus, net assets with donor restrictions generally refers to amounts of net assets that are restricted by donor-imposed limits, not to specific assets.

Investments by and Distributions to Owners

E71. Investments by owners are increases in equity of an entity resulting from transfers to the entity from other entities of something valuable to obtain or increase ownership interests (or equity) in the entity. Assets are the most common form of investments by owners, but owners' investments also may take the form of providing services or satisfying or converting liabilities of the entity.

E72. Distributions to owners are decreases in equity of an entity resulting from transferring assets, rendering services, or incurring liabilities by the entity to owners. Distributions to owners decrease ownership interest (or equity) in an entity.

Characteristics of Investments by and Distributions to Owners

E73. Investments by owners and distributions to owners are transactions between an entity and its owners *as owners*. Through investments by owners, an entity obtains resources (a) to begin or expand operations, (b) to retire debt or other liabilities, or (c) for other business purposes. As a result of investing resources in the entity, other entities obtain ownership interests in that entity or increase ownership interests that they already have. Not all investments in the equity interests of an entity by other entities are investments by owners as that concept is defined in this chapter. In an investment by owners, the entity that issues the interests acquired by an owner always receives the proceeds or benefits; therefore, the entity's net assets increase. If the purchaser of equity interests becomes an owner or increases its ownership interest in an entity by purchasing those interests from another owner that is decreasing or terminating its ownership interest, the transfer does not affect the net assets of the entity.

E74. An entity's distributions to its owners decrease the entity's net assets and may decrease or terminate ownership interests of owners that receive the distributions. An entity's reacquisition of its own equity interests by transferring assets or incurring liabilities to owners is a distribution to owners as that concept is defined in this chapter. Because owners become creditors for a dividend that is declared until it is paid, an entity's incurrence of a liability to transfer assets to owners in the future converts a part of the equity or ownership interest of the entity into creditors' claims. That is, equity is reduced by the incurrence of the liability to owners, not by the settlement of the liability.

Comprehensive Income

E75. Comprehensive income is the change in equity of a business entity during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

Characteristics of Comprehensive Income

E76. Although an entity's revenues and expenses from its business activities are generally the primary source of comprehensive income, they are not the only source. The various sources of comprehensive income may vary in stability, risk, and predictability. That is, characteristics of various sources of comprehensive income may differ significantly from one another, indicating a need for information about various components of comprehensive income. That need underlies the distinctions between revenues and gains, between expenses and losses, and between various kinds of gains and losses.

E77. A concept of maintenance of capital or recovery of cost is a prerequisite for separating return on capital from return of capital because only inflows exceeding the amount needed to maintain capital are a return on equity. Two major concepts of capital maintenance exist, both of which can be measured in units of either money or constant purchasing power—the financial capital concept and the physical capital concept (which is often expressed in terms of maintaining operating capability, that is, maintaining the capacity of an entity to provide a constant supply of goods or services). The financial capital concept is the traditional view and is generally the capital maintenance concept in financial reporting. Comprehensive income as defined is a return on financial capital.

Elements of Comprehensive Income[16]

E78. The definitions of revenues, expenses, gains, and losses serve a different purpose than the definitions of the six elements described in the beginning of this chapter—assets, liabilities, equity, investment by owners, distributions to owners, and comprehensive income. Those six elements constitute the complete set of fundamental elements of financial statements of business entities. In contrast, the definitions of revenues, expenses, gains, and losses are not needed to determine comprehensive income. Because comprehensive income is determined by changes in assets and liabilities other than investments by and distributions to owners, it can be derived without being separated into its various components.

E79. Definitions of the components of comprehensive income are significant because satisfying the objective of financial reporting requires more information about comprehensive income than just its amount. Investors and creditors want and need to know how and why equity has changed, not just the amount that it has changed. Reflecting those changes is a matter of presentation. The sources of comprehensive income are significant to those attempting to use financial statements to help them with investment, credit, and similar decisions.

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

Revenues

E80. Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities.[17]

Expenses

E81. Expenses are outflows or other using up of assets of an entity or incurrences of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities.

Gains

E82. Gains are increases in equity (net assets) from transactions and other events and circumstances affecting an entity except those that result from revenues or investments by owners.

Losses

E83. Losses are decreases in equity (net assets) from transactions and other events and circumstances affecting an entity except those that result from expenses or distributions to owners.

Revenues, expenses, gains, and losses

E84. Revenues and expenses result from delivering or producing goods, rendering services, or carrying out other activities. Other activities, as referenced in the definitions of revenues and expenses in this chapter, are those activities that permit others to use the entity's resources, which, for example, result in interest, rent, royalties, and fees. Other activities also include charitable contributions received and made.

E85. Gains and losses typically result from one of the following three circumstances:

a. Nonreciprocal transactions or events such as natural catastrophes
b. Exchange transactions
c. Holding gains and losses.

Additionally, current updates or adjustments of estimates of prior periods are often referred to in practice as gains and losses. These are not gains and losses; they are adjustments to previously recognized revenues, expenses, gains, or losses that should be reported as initially recognized.

E86. Nonreciprocal transactions or events are generally distinguishable from revenues and expenses. Holding gains and losses can be a result of a contractual

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

change in value of an asset or a liability from a passage of time, as is the case of interest, or a change in the value of the asset or liability. Those value changes would be distinguished between those that are classified as revenues and expenses or those that are classified as gains and losses. Distinctions between revenues and gains and expenses and losses from exchange transactions of an entity depend to a significant extent on the nature of the entity and the activity with which an item is associated. An identical item can be used by entities differently. As a result, the proceeds from the sale of an asset may be revenue for one entity and may be a factor in determining gain or loss for another. For example, the proceeds from the sale of a machine displayed as inventory would be considered revenue, and the cost of that machine would be considered an expense. However, the proceeds from the sale of a machine used by an entity in a productive capacity would not be considered revenue, and the entity would report a gain or a loss upon disposition of that machine to be consistent with the representations in the statement of financial position.

E87. The difference between items recognized as a result of transactions, especially routine transactions that result in recognizing revenues or expenses, and those recognized from other events and circumstances is fundamental in meeting the objective of providing information to help resource providers assess the amount, timing, and uncertainty of potential future cash flows. Gains and losses also can provide useful information about a particular activity even though gains and losses in similar amounts would not be expected to reoccur frequently or at all.

E88. Revenues, expenses, gains, and losses arise from different transactions and events. Revenues and gains are similar in that they both increase comprehensive income, and expenses and losses are similar in that they both decrease comprehensive income. Consequently, the presentation factors in Chapter 7, *Presentation*, of this Concepts Statement should be used to determine whether particular gains or losses should be presented with related revenues and expenses. Examples would include impairments of inventory or other productive assets.

E89. Gains and losses can be so basic and fundamental to an entity’s routine activities that distinguishing those gains and losses from revenues and expenses may not be as informative as presenting them with revenues and expenses. Examples include charitable contributions received and made from not-for-profit entities or gains and losses from trading activities of an entity engaged in trading securities or commodities.

E90. The primary purpose of distinguishing gains and losses from revenues and expenses is to make displays of financial information about an entity’s sources of comprehensive income as useful as possible. Ultimately, those decisions will be made at a standards level with considerations for the objective of financial reporting and presentation concepts.

Appendix A: Amendments to the Introduction of the Conceptual Framework before Chapter 1 of Concepts Statement 8

A1. The introduction of the Conceptual Framework before Chapter 1 of Concepts Statement 8 is amended as described below. Added text is underlined, and deleted text is ~~struck out~~.

Statements of Financial Accounting Concepts

~~This Statement of Financial Accounting Concepts (Concepts Statement) is one of a series of publications in the Board's Conceptual Framework for financial accounting and reporting. Since the publication of the last Concepts Statement, the Board has undertaken a project with the International Accounting Standards Board (IASB) to improve and converge their frameworks. This Concepts Statement, which includes two chapters of that new conceptual framework, supersedes FASB Concepts Statements No. 1, *Objectives of Financial Reporting by Business Enterprises,* and No. 2, *Qualitative Characteristics of Accounting Information*. As the Board and the IASB complete additional phases of their joint project, new chapters will be added to this Concepts Statement, and other Concepts Statements will be superseded.~~

~~Concepts Statements are~~The Conceptual Framework is intended to set forth ~~objectives and~~ fundamental concepts that will be the basis for development of financial accounting and reporting standards~~guidance~~. ~~The objectives identify the goals and purposes of financial reporting.~~ The fundamentals are the underlying concepts of financial accounting—concepts that guide the selection of transactions and other events and circumstances~~conditions~~ to be accounted for; their recognition and measurement; and the means of summarizing and communicating them to interested parties. Concepts of that type are fundamental in the sense that other concepts flow from them and repeated reference to them will be necessary in establishing, interpreting, and applying accounting and reporting standards~~guidance~~.

The Conceptual Framework is a coherent system of interrelated objectives and fundamental concepts that prescribes the nature, function, and limits of financial accounting and reporting and that is expected to lead to consistent standards~~guidance~~. It is intended to serve the public interest by providing structure and direction to financial accounting and reporting to facilitate the provision of unbiased financial and related information. That information helps capital and other markets to function efficiently in allocating scarce resources in the economy and society. Establishment of objectives and identification of fundamental concepts will not directly solve financial accounting and reporting problems. Rather, objectives give direction, and concepts are tools for solving problems.

The Board itself is likely to be the most direct beneficiary of the guidance provided by Concepts Statements. They will guide the Board in developing accounting and reporting standards~~guidance~~ by providing the Board with a common foundation and basic reasoning on which to consider merits of alternatives. However, knowledge of the objectives and concepts the Board will use in developing new standards~~guidance~~ also should enable those who are affected by or interested in generally accepted accounting principles (GAAP) to understand better the purposes, content, and characteristics of information provided by financial accounting and reporting. That knowledge is expected to enhance the usefulness of, and confidence in, financial accounting and reporting. ~~The objectives and fundamental concepts also may provide some guidance in analyzing new or emerging problems of financial accounting and reporting in the absence of applicable authoritative pronouncements.~~

Concepts Statements are not part of the *FASB Accounting Standards Codification*~~™~~®, which is the source of authoritative GAAP recognized by the FASB to be applied by nongovernmental entities (Topic 105, Generally Accepted Accounting Principles). Rather, Concepts Statements describe concepts that will be considered in developing~~underlie guidance on~~ future financial ~~accounting practices and in due course will~~reporting standards and, in due course, should serve as a basis for evaluating existing guidance and standards~~practices~~.

The Board recognizes that in certain respects current ~~generally accepted accounting principles~~GAAP may be inconsistent with what might be derived~~those that may derive~~ from the objectives and fundamental concepts set forth in Concepts Statements. However, a Concepts Statement does not (a) require a change in existing ~~U.S.~~ GAAP; (b) amend, modify, or interpret the Accounting Standards Codification; or (c) justify either changing existing generally accepted accounting and reporting practices or interpreting the Accounting Standards Codification based on personal interpretations of the objectives and concepts in the Concepts Statements.

Because a Concepts Statement does not establish ~~U.S.~~ GAAP ~~for the disclosure of financial information outside of financial statements in published financial reports~~, it is not intended to invoke application of Rule 203 ~~or 204~~ of the Rules of Conduct of the Code of Professional Ethics of the American Institute of Certified Public Accountants (or successor rules or arrangements of similar scope and intent).*

A Concepts Statement may be amended, superseded, or withdrawn by appropriate action under the Board's *Rules of Procedure.*

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*Rule 203 prohibits a member of the American Institute of Certified Public Accountants from expressing an opinion that financial statements conform with generally accepted accounting principles (GAAP) if those statements contain a material departure from an accounting principle promulgated by the Financial Accounting Standards Board, unless the member can demonstrate that because of unusual circumstances the financial statements otherwise would have been misleading. ~~Rule 204 requires members of the Institute to justify departures from guidance promulgated by the Financial Accounting Standards Board for the disclosure of information outside of financial statements in published financial reports.~~

[Note: The following content was originally in paragraphs 134–152 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, and has been amended as shown and moved here. Some paragraphs have been moved, combined, or omitted. Paragraph numbers and footnotes have been omitted.]

Accrual Accounting and Related Concepts

Items that qualify under the definitions of elements of financial statements and that meet criteria for recognition and, therefore would be measured, ~~measurement (paragraph 23)~~ are accounted for and included in financial statements by ~~the use of~~using accrual accounting procedures. Accrual accounting and related concepts are~~ therefore~~ significant ~~not only for defining elements of financial statements but also~~ for understanding and considering several~~other~~ aspects of the Conceptual Framework~~conceptual framework for financial accounting and reporting~~. ~~Paragraphs 135–152~~The following paragraphs define or describe ~~several~~ significant financial accounting and reporting concepts that are used in ~~this Statement and other concepts Statements~~the Conceptual Framework.

Transactions, Events, and Circumstances

The Conceptual Framework~~This Statement commonly~~ uses the phrase *transactions and other events and circumstances affecting an entity* to describe the sources or causes of changes in assets, liabilities, and equity or net assets. An event is a happening of consequence to an entity. It may be an internal event that occurs within an entity~~, such as using raw materials or equipment in production~~, or it may be an external event that involves interaction between an entity and its environment, such as a transaction with another entity.~~entity, a change in price of a good or service that an entity buys or sells, a flood or earthquake, or an improvement in technology by a competitor. Many events are combinations. For example, acquiring services of employees or others involves exchange transactions, which are external events; using those services, often simultaneously with their acquisition, is part of production, which involves a series of internal events (paragraph 79, footnote 40). An event may be initiated by an entity, such as a purchase of merchandise or use of a building, or it may be partly or wholly beyond the control of an entity and its management, such as an interest rate change, an act of vandalism or theft, the imposition of taxes, or the expiration of a donor-imposed time restriction.~~ A transaction is a particular kind of external event, namely, an external event involving a transfer of something of value~~ (future economic benefit)~~ between two (or more) entities. The transaction may be either an exchange in which each participant both receives and sacrifices value, such as purchases or sales of goods or services, or~~; or the transaction may be~~ a nonreciprocal transfer in which an entity incurs a liability or transfers an asset to another entity (or receives an asset or cancellation of a liability) without directly receiving (or giving) value in exchange. Nonreciprocal transfers contrast with exchanges (which are reciprocal transfers) and include, for example, ~~investments by owners, distributions to owners,~~ impositions of taxes, gifts, ~~charitable or educational~~contributions given or received, and thefts.

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

Accrual Accounting

Accrual accounting attempts to record the financial effects on an entity of transactions and other events and circumstances~~ that have cash consequences for the entity~~ in the periods in which those transactions, events, and circumstances occur~~ rather than only in the periods in which cash is received or paid by the entity~~. Accrual accounting thus provides information about an entity's assets and liabilities and changes in them that cannot be obtained by accounting for only cash receipts and outlays.~~is concerned with an entity's acquiring of goods and services and using them to produce and distribute other goods or services. It is concerned with the process by which cash expended on resources and activities is returned as more (or perhaps less) cash to the entity, not just with the beginning and end of that process. It recognizes that the buying, producing, selling, distributing, and other operations of an entity during a period, as well as other events that affect entity performance, often do not coincide with the cash receipts and payments of the period (FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, paragraph 44, and FASB Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, paragraph 50).~~ Accrual accounting~~ uses~~ includes using accrual, deferral, and allocation procedures~~ whose goal~~, the result of which is~~ to relate~~ the recognition of revenues, expenses, gains, and losses ~~to~~in periods that depict~~to reflect~~ an entity's performance during a period instead of merely listing its cash receipts and outlays. Thus, the recognition of revenues, expenses, gains, and losses dependent upon ~~and the related~~ increments or decrements in assets and liabilities~~—including matching of costs and revenues, allocation, and amortization—~~ is the essence of using accrual accounting to measure the performance of entities.~~ The goal of accrual accounting is to account in the periods in which they occur for the effects on an entity of transactions and other events and circumstances, to the extent that those financial effects are recognizable and measurable.~~

~~Accrual and Deferral~~Accrual, Deferral, and Allocation (Including ~~Allocation and~~ Amortization)

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

Deferral is concerned with past cash receipts and payments~~—~~ and with prepayments received ~~(often described as collected in advance)~~ or paid~~: it is~~ ; deferral is the accounting process of recognizing a liability resulting from a current cash receipt (or the equivalent) or an asset resulting from a current cash payment (or the equivalent) with deferred recognition of related revenues, expenses, gains, or losses. ~~Their recognition~~Recognition of those related elements is deferred until the obligation underlying the liability is partly or wholly satisfied or until the ~~future~~ economic benefit underlying the asset is partly or wholly used or lost. ~~Common examples of accruals include purchases and sales of goods or services on account, interest, rent (not yet paid), wages and salaries, taxes, and decreases and increases in marketable securities accounted for at the lower of cost and market.~~ Common examples of deferrals include prepaid ~~insurance~~expenses and ~~unearned subscriptions~~customer deposits.

Allocation is the accounting process of assigning or distributing an amount according to a plan or a formula. ~~It is broader than and~~Allocation includes amortization, which is the accounting process of reducing an amount by periodic payments or write-downs. ~~Specifically, amortization is the process of reducing a liability recorded as a result of a cash receipt by recognizing revenues or reducing an asset recorded as a result of a cash payment by recognizing expenses or costs of production. That is, amortization is an allocation process for accounting for prepayments and deferrals.~~ Common examples of allocations include (a) assigning manufacturing costs to production departments or cost centers and ~~thence~~ to units of product to determine “product cost,” (b) apportioning the cost of a “basket purchase” to the individual assets acquired on the basis of their relative market values, and (c) spreading the cost of an insurance policy or a building to two or more accounting periods. Expenses resulting from ~~their~~the use of assets are normally allocated to the periods of their estimated useful lives (the periods over which they are expected to provide benefits) by a "systematic and rational" allocation procedure~~, for example, by recognizing depreciation or other amortization~~. ~~Common examples of amortizations include recognizing expenses for depreciation, depletion, and insurance and recognizing earned subscription revenues.~~ Other costs ~~are~~ also are recognized as expenses in the period in which they are incurred because the period to which they otherwise relate is indeterminable or not worth the effort to determine.

Amortization is also a form of allocation. The cost of an asset is said to be amortized (depreciated) by assigning a portion of the cost over the benefit period of the asset. Amortization also refers to the allocation of payments made or received on debt instruments between interest earned or paid and the principal that is reduced by periodic payments.

~~Accrual accounting recognizes numerous noncash assets, liabilities, and transactions and other events that affect them (paragraphs 139–141). Thus, a~~A major difference between accrual accounting and accounting based on cash receipts and outlays is the timing of recognition of revenues, expenses, gains, and losses. Investments by an entity in goods and services for its operations or other activities commonly do not all occur in the same period as revenues or other proceeds from selling the resulting products or providing the resulting services. Several periods may elapse between the time cash is invested in raw materials or ~~plant~~fixed assets, for example, and the time cash is ~~returned by~~received from collecting the sales price of products from customers. A report showing cash receipts and cash outlays of an enterprise for a short period (such as a statement of cash flows) cannot indicate how much of the cash received is return *of* investment and how much is return *on* investment ~~and thus~~and, thus, cannot indicate whether or to what extent an enterprise is successful or unsuccessful. Similarly, goods or services that a not-for-profit entity~~organization~~ provides gratis to beneficiaries commonly result from using goods or services acquired with cash received and spent in earlier periods. A report showing cash receipts and outlays of the entity~~organization~~ for a short period cannot tell much about the ~~relation of~~relationship between the goods or services provided ~~to~~and the resources used to provide them ~~and thus~~ and, thus, cannot indicate ~~whether or~~ to what extent an entity~~organization~~ is successful or unsuccessful in carrying out its service objectives. Cash receipts in a particular period largely may ~~largely~~ reflect the effects of the activities of a business ~~enterprise~~entity or a not-for-profit ~~organization~~entity in earlier periods, while many of the cash outlays may relate to ~~its~~the entity's activities and efforts expected in future periods.

~~Matching of costs and revenues is simultaneous or combined recognition of the revenues and expenses that result directly and jointly from the same transactions or other events.~~ In most entities, ~~some~~ transactions or events occur that result ~~simultaneously~~ in simultaneous recognition of ~~both a~~ revenue and one or more expenses that result directly and jointly from the same transactions or other events. ~~The revenue and expense(s) are directly related to each other and require recognition at the same time. In present practice, for~~For example, a sale of a product or merchandise involves ~~both revenue (sales revenue) for~~revenues from the receipt of cash or a receivable and expense ~~(cost of goods sold)~~ for the sacrifice of ~~the~~ a product or merchandise sold to the customer~~customers~~. ~~Other examples of expenses that may result from the same transaction and be directly related to sales revenues are transportation to customers, sales commissions, and perhaps certain other selling costs.~~If all assets and liabilities are recorded from the transaction, recognition of revenues and expenses in the same period is achieved by applying the asset and liability definitions.

Many expenses, however, are not related directly to particular revenues but can be related to a period on the basis of transactions or events occurring in that period or by allocation. ~~Recognition of those expenses is largely independent of recognition of particular revenues, but they are deducted from particular revenues by being recognized in the same period.~~ Some costs that cannot be related directly ~~related~~ to particular revenues are incurred to obtain benefits that are exhausted in the period in which the costs are incurred. ~~For example, salesmen's monthly salaries and electricity used to light an office building usually fit that description and are usually recognized as expenses in the period in which they are incurred. Other costs are also recognized as expenses in the period in which they are incurred because the period to which they otherwise relate is indeterminable or not worth the effort to determine. However, many assets yield their benefits to an entity over several periods, for example, prepaid insurance, buildings, and various kinds of equipment. Although the purpose of expense allocation is the same as that of other expense recognition—to reflect the using up of assets as a result of transactions or other events or circumstances affecting an entity—allocation is applied if causal relations are generally, but not specifically, identified. For example, wear and tear from use is known to be a major cause of the expense called depreciation, but the amount of depreciation caused by wear and tear in a period normally cannot be measured. Those expenses are not related directly to either specific revenues or particular periods. Usually no traceable relationship exists, and they are recognized by allocating costs to periods in which assets are expected to be used and are related only indirectly to the revenues that are recognized in the same period.~~

This chapter and the amendments to the introduction of Concepts Statement 8 were adopted by the affirmative vote of six members of the Financial Accounting Standards Board. Ms. Botosan dissented.

The Conceptual Framework is designed to be a robust judgment and decision-making framework that supports the setting of high-quality accounting and financial reporting standards. For reasons discussed below, Ms. Botosan believes that certain aspects of this chapter fail to enhance, and could potentially reduce, the usefulness of the Conceptual Framework.

Specifically, Ms. Botosan disagrees with the following aspects:

1. Removal of the term *control* from the definition of an asset

2. Retention of the existing prescriptive definitions of equity and comprehensive income
3. The definitions of revenue, gain, expense, and loss.

Paragraph 25 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, defines assets as "probable future economic benefits obtained or *controlled* by a particular entity as a result of past transactions or events" (emphasis added; footnote reference omitted). Concepts Statement 6 describes an entity's ability to obtain an economic benefit and control others' access to it as an essential characteristic of an asset.[18] In addition, Concepts Statement 6 notes that including the term *control* in the definition serves to exclude economic resources such as public highways, air, or water from the set of economic resources that might otherwise meet the definition of an asset.[19]

The International Accounting Standards Board's (IASB) definition of an asset is "a present economic resource *controlled* by the entity as a result of past events" (emphasis added).[20] The IASB concluded that including the term *control* in the definition is important to link an economic resource to a specific entity.[21] The IASB considered, but rejected, a proposal to remove the term *control* from the definition of an asset. The IASB acknowledged that *control* may be implied by having a right to an economic resource but concluded that *control* is sufficiently important to warrant explicit inclusion in the definition.

Like Concepts Statement 6 and the IASB, Ms. Botosan believes that explicit inclusion of the term *control* in the asset definition strengthens the critical link between an economic resource and a particular entity, which is necessary for an item to be considered an asset of the entity. Ms. Botosan believes that including the term *control* in the definition would mitigate potential misapplication of the definition to economic resources to which an entity has a right (such as a public highway) but no ability to control.

Ms. Botosan also believes that differences between U.S. GAAP and IFRS Standards should be limited to situations in which significant cost and/or benefit differences arise because of different legal, regulatory, or social norms. Given the foundational role that the Conceptual Framework plays in standard setting, Ms. Botosan believes that it is particularly important to limit differences in the conceptual frameworks to situations for which there is a compelling justification. Ms. Botosan believes that both the IASB and the FASB intend to restrict assets to rights *controlled* by the entity. Ms. Botosan is concerned, however, that the Boards' different decisions about explicit reference to the term *control* in the definition raise

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[18]FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraph 26.

[19]Concepts Statement 6, paragraph 188.

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

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

the risk of different application outcomes. Ms. Botosan also believes that the definition of an asset in this chapter would be more robust if *control* were included.

Control also plays an essential role in principles guiding the derecognition of an asset. This chapter does not address principles of derecognition; however, the Conceptual Framework is intended to be a coherent system of interrelated objectives and fundamental concepts. Ms. Botosan is concerned that the removal of the term *control* from the definition of an asset risks complicating subsequent development of principles guiding the derecognition of an asset.

Ms. Botosan also disagrees with the definition of equity in this chapter, which is unchanged from the definition in Concepts Statement 6. Equity is defined as “the residual interest in the assets of an entity that remains after deducting its liabilities.” Ms. Botosan believes that “assets minus liabilities,” a mathematical statement derived from the basic accounting equation, falls far short of a conceptual definition of equity. She notes that the definitions of assets and liabilities draw on the underlying economic concepts of economic resources and economic obligations, respectively. Ms. Botosan believes that a definition of equity that similarly draws on the underlying economic concept of a residual claim would offer a more powerful tool in standard setting. Ms. Botosan finds the existing definition of equity to be of little use in standard setting because equity, by definition, is simply a mechanical outcome of the recognition and measurement decisions afforded to assets and liabilities.

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

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

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

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

The amendments in Update 2016-01 addressed this issue by requiring that those changes in fair value be reported in other comprehensive income. However, the Board acknowledges that there is no conceptual basis for classifying items in other comprehensive income. Ms. Botosan believes that having to resort to a mechanism for which the Board can offer no conceptual foundation is the direct result of the prescriptive definition of comprehensive income and evidence of a deficiency in the framework.

The elements definitions in the Conceptual Framework are intended to help the FASB objectively and consistently identify and classify items included in financial reports. For example, the definition of an asset has proven useful in standard setting because it provides a framework for considering what items should be reported in financial statements as assets. Ms. Botosan believes that the existing prescriptive definitions of equity and comprehensive income have not served the Board well in past standard-setting efforts. She believes that retaining those definitions, which emphasize the practical balancing function of the equity section in a statement of financial position to the detriment of conceptual definitions of equity and comprehensive income, represents a missed opportunity to improve the available tools to support the setting of high-quality accounting and financial reporting standards.

Finally, Ms. Botosan does not support the amended definitions of revenue, gain, expense, and loss. The definitions in Concepts Statement 6 and in this chapter link revenue to the provision of goods or services or conduct of other activities and gain to activities that are not revenue producing. To further distinguish revenue from gain (expense from loss), however, the Concepts Statement 6 definitions of revenue and expense include a reference to an entity's ongoing major or central operations, and the Concepts Statement 6 definitions of gain and loss include a reference to peripheral or incidental activities. The amended definitions eliminate that language. Ms. Botosan acknowledges that the Concepts Statement 6 definitions of revenue and gain (expense and loss) are not perfect, but she believes that removing that language will make the definitions less useful when deciding between revenue or gain (expense or loss) classification in standard setting.

Ms. Botosan questions the benefit of separately defining revenue and gain (expense and loss) because the definitions offer limited assistance in distinguishing between them. In addition, Ms. Botosan believes that distinguishing between revenue and gain (expense and loss) is not a definitional issue but a gross versus net presentation issue. Specifically, revenue and expense (that is, gross) presentation is more decision useful when margin information is relevant, whereas gain and loss (that is, net) presentation is more decision useful when margin information is not relevant. In addition, Ms. Botosan notes that addressing the distinction between revenue, expense, gain, and loss in presentation concepts would be more consistent with the IASB's *Conceptual Framework for Financial Reporting*.

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

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

Appendix B: Basis for Conclusions

Introduction

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

BC4.2. In July 2020, the Board issued proposed Chapter 4, *Elements of Financial Statements*, of this Concepts Statement for public comment and received 56 comment letters. Additional outreach included individual stakeholder meetings and meetings with the FASB's various advisory groups.

BC4.3. FASB Concepts Statement No. 6, *Elements of Financial Statements*, defined the following 10 elements:

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

BC4.4. The Board concluded that the discussion of elements in Concepts Statement 6 could be further developed and improved with the objective of providing a foundation for future standards. Many of the decisions reflect changes in practices and standards since Concepts Statement 6 was issued and are based on the Board's experience in using those concepts in setting standards. The decisions discussed in this chapter principally clarify the elements definitions in Concepts Statement 6 by:

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

BC4.5. Beyond the decisions described in paragraph BC4.4, parts of this chapter have been carried forward from Concepts Statement 6. Accordingly, because there was no basis for conclusions in Concepts Statement 6, this chapter provides no basis for those paragraphs that were brought forward. However, in developing this chapter, the Board decided to revise the language from Concepts Statement 6 as follows:

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

BC4.6. The objective of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. This chapter provides the means for carrying out that objective; it defines elements of financial statements to be applied to both business entities and not-for-profit entities. Those elements provide a foundation for information that is relevant to the objective of financial reporting.

BC4.7. Assets and liabilities have conceptual and definitional primacy. The conceptual primacy of assets and liabilities is axiomatic such that the other elements are dependent on those two elements or changes in those elements. Given the conceptual primacy of assets and liabilities, this chapter defines those elements to support recognition in financial statements. Thus, to be recognized in financial statements an item must meet the definition of an asset or a liability. By only recognizing assets and liabilities and changes in those elements, recognition of items that are not grounded in concept is prevented and, thus, the integrity of financial reporting is maintained.

BC4.8. Assets, liabilities, equity, investment by owners, distributions to owners, and comprehensive income constitute the complete set of fundamental elements of financial statements of business entities. In contrast, the definitions of revenue, expenses, gains, and losses serve a different purpose than the definitions of the other six elements because they are not needed to determine comprehensive income but, instead, serve as presentation elements for comprehensive income.

Assets and Liabilities

BC4.9. 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. The definitions of both 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*.

BC4.34. A liability in Concepts Statement 6 is a present obligation that requires the transfer of assets of an entity or the provision of services to other entities. Under that definition, obligations that require future transfers of equity instruments of the entity are not liabilities. Current GAAP and practices are inconsistent with that definition. The inconsistency in the application of the Conceptual Framework definition has led to ad hoc standard-setting decisions, which in turn has resulted in a complex accounting model for financial instruments that have characteristics of both liabilities and equity. The Board recognizes that resolving the distinction between liabilities and equity at the standards level begins with a conceptually sound definition of a liability in the Conceptual Framework that the Board can apply in standard setting.

BC4.35. Distinguishing a liability from equity has been a difficult issue that the Board has considered several times in the past, both at a conceptual level and at the standards level. For many, distinguishing between liabilities and equity is more about the effect on net income than it is about the balance sheet classification. That is because of very different views on how particular financial instruments should be subsequently measured and how changes in values are reflected in the statement of comprehensive income. However, that discussion is a question of measurement and presentation, rather than one of elements and their definitions. A particular financial instrument meeting the definition of a liability does not imply that it must be subsequently measured using a particular measurement method. Similarly, when an instrument does not meet the definition of a liability (that is, it is an equity instrument), that does not imply that the instrument should not be remeasured or that a gain or a loss should not be recognized upon settlement of the arrangement.

BC4.36. Common and preferred shares represent the equity interest in an entity. Those outstanding instruments do not create an obligation to transfer or provide economic benefits. The debate has focused on the classification of obligations that require or may require the issuance of the entity's own shares.

BC4.37. Some argue that all obligations should meet the definition of a liability regardless of whether the obligation is settled with assets or an entity's own shares. The Board concluded that an obligation to transfer either assets or a variable number of shares of the entity's own shares meets the definition of a liability. Under the Board's proposed definition, there are instruments that create obligations and that are considered equity interests of the entity. Those are instruments (a) in which the value of the instrument varies with the value of the outstanding stock (indexed to the entity's shares) and (b) that are settled with the entity's fixed number of shares. The Board notes that the holder of that instrument, although not currently a shareholder of the entity, is on the path to potentially becoming a shareholder of the entity. Holders of that type of instrument participate in the risks and rewards of the issuer's operations, just not the same way in which a counterparty of an outstanding share does. For example, a holder of a written call option on the issuer's common shares participates in the upside potential in the same way a common shareholder does. That holder also participates in a downside risk, that is, the loss of the premium paid for the instrument. The Board notes that an obligation that requires the issuance of a sufficient number of shares to equal a specific value when issued is a liability. The value to the recipient is fixed; as such, the obligation conveys nothing like the returns and rewards of an equity shareholder.

BC4.38. The majority of the respondents to the proposed Concepts Statement supported the Board's decision on the concept to distinguish liabilities from equity. Many of the comments received centered on providing (a) additional clarifications in describing when obligations to deliver an entity's own shares meet the proposed definition of a liability and (b) explanatory examples to help illustrate the concept of distinguishing between liabilities and equity. The Board added explanatory information in paragraph E56 to clarify when obligations to deliver an entity's own shares meet the definition of a liability. The Board decided not to add examples illustrating the application of the concept to specific financial instruments. The Board reasoned that the objective of the concepts is to provide the Board with theoretical guidance to help the Board in making standard-setting decisions. Adding examples to the framework to illustrate the concept is an issue for standard setting.

Net Assets of Not-for-Profit Entities

BC4.39. Net assets of not-for-profit entities may be divided into two mutually exclusive classes, dependent upon the existence or absence of donor-imposed restrictions. That requirement modifies Concepts Statement 6, which divided net assets into three classes:

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

BC4.40. The Board concluded that the two-class distinction was preferable because the prior distinction between permanently restricted classes and temporarily restricted classes had been blurred because of changes in laws. Additionally, the term *unrestricted* implies to some that the unrestricted portion of net assets is without contractual, legal, or other restriction. For those reasons, the Board decided to combine temporarily and permanently restricted net assets into net assets with donor restrictions and to rename unrestricted net assets to net assets without donor restrictions, thereby dividing net assets for not-for-profit entities into two classes rather than three.

Investments by and Distributions to Owners

BC4.41. The fundamental criticism of the existing definitions of investments by and distributions to owners in Concepts Statement 6 is that the elements use the term *owners*, which was not defined. This chapter clarifies those elements by defining the term *owners*. The definition of owners is derived from the Board's decisions made to distinguish between liabilities and equity in this chapter. That is, obligations to issue a fixed number of shares (common or preferred) would be classified as equity. Holders of those instruments and holders of outstanding common and preferred shares, absent circumstances or conditions that create a present obligation, are considered owners.

Comprehensive Income

BC4.42. The Board decided to retain the definition of comprehensive income in Concepts Statement 6. The Board notes that the term *comprehensive income* should continue to be a function of the accounting equation represented by the changes in the recorded assets and liabilities other than from investments by and distributions to owners. As a result, the Board concluded that all revenues, expenses, gains, and losses should be included in comprehensive income. The Board also notes that describing what is meant by the term *owner*, and consequently *transactions with owners*, helps to clarify the definition of comprehensive income.

Revenues, Expenses, Gains, and Losses

BC4.43. In discussing revenues, expenses, gains, and losses, some Board members questioned whether defining those elements was necessary given that they are essentially matters of presentation. However, the Board decided to retain all four elements of comprehensive income—revenues, expenses, gains, and losses. The Board concluded that retaining the elements gains and losses as distinct from the elements revenues and expenses was informative in understanding the composition of comprehensive income.

BC4.44. Concepts Statement 6 uses the phrases *other activities* and *ongoing major or central operations* to distinguish revenues from gains and expenses from losses. It is not clear whether the phrase *ongoing major or central operations* is intended to refer to all revenues and expenses or only those that relate to revenues and expenses from other activities. As a result, the Board decided to remove the phrase *ongoing major or central operations* from the proposed definitions of revenue and expense in this chapter. The Board concluded that delivering or producing goods and rendering services are primary factors in distinguishing revenue from gains and expenses from losses, regardless of whether they are considered major or central to an entity. There are certain circumstances in which distinguishing between revenues and gains and expenses and losses can be difficult. In those circumstances, the Board decided that presentation concepts are helpful when distinguishing between those elements to meet the objective of financial reporting.

BC4.45. The majority of respondents to the proposed Concepts Statement did not support removing the phrase *ongoing major or central operations* from the definition of revenue. Some respondents commented that the proposed definitions would reduce clarity and, therefore, be less decision useful. Others suggested that removing that phrase expands the scope of revenue, potentially leaving it open for broader interpretation, Similarly, some respondents did not support removing the phrase *from peripheral or incidental transactions* of an entity from gains and losses. Those respondents stated that the removal of that phrase would reduce clarity of the definitions. The Board affirmed its decision to remove the phrases from the definitions of revenue, expense, gain, and loss. The Board notes that delivery of or producing goods or rendering services should always result in revenues and expenses.

BC4.46. The Board decided to retain the phrase *other activities* in the definitions in this chapter. The inclusion of that phrase allows sources such as investment income to be considered revenue and charitable contributions made to be considered an expense. It is not the Board's intention to suggest that the phrase *other activities* is an all-encompassing notion that captures every inflow and outflow. The Board's description of the phrase *other activities* is derived from a description of revenues and general activities in APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*. In APB Statement 4, the phrase *general activities* is described as those activities that permit others to use economic resources of the entity, which result in interest, rent, royalties, fees, and the like.

BC4.47. Respondents to the proposed Concepts Statement commented on the use of the phrase *carrying out other activities* within the proposed definitions of revenues and expenses. Most of those respondents suggested clarifications of the phrase *other activities*. Because the phrase is derived from APB Statement 4, the Board decided that no additional clarifications were necessary.

Accrual Accounting and Related Concepts

BC4.48. The proposed Concepts Statement included "Appendix A: Accrual Accounting and Related Concepts." That information was originally a section in Concepts Statement 6. The Board decided to carry relevant information from that section over to an appendix in the proposed Concepts Statement. Some respondents suggested that the information does not belong in a chapter on elements.

BC4.49. The Board decided that the information describes accrual accounting and important related concepts that apply to the entire Conceptual Framework. As such, the Board concluded that the information should be included in the introduction to the Conceptual Framework.

Appendix C: Amendments to the Conceptual Framework for Financial Reporting

Replacement of Concepts Statement 6

C1. Chapter 4 of Concepts Statement 8 replaces Concepts Statement 6.

C2. All references to Concepts Statement 6 are replaced by Chapter 4 of this Concepts Statement.

Amendments to Concepts Statement 7

C3. FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, is amended as described in paragraph C4. Added text is underlined, and deleted text is ~~struck out~~.

C4. Amend paragraph 91 as follows:

> 91. In principle, the purpose of all accounting allocations is to report changes in the value, utility, or substance of assets and liabilities over time. ~~Paragraph 149 of~~The introduction to FASB Concepts Statement No. ~~6, *Elements of Financial Statements,*~~8, *Conceptual Framework for Financial Reporting,* describes the use of accounting allocations as follows:
>
> > ~~However, many assets yield their benefits to an entity over several periods, for example, prepaid insurance, buildings, and various kinds of equipment.~~ Expenses resulting from ~~their~~ the use of assets are normally allocated to the periods of their estimated useful lives (the periods over which they are expected to provide benefits) by a "systematic and rational" allocation procedure~~, for example, by recognizing depreciation or other amortization.~~. ~~Although *the purpose of expense allocation is the same as that of other expense recognition—to reflect the using up of assets as a result of transactions or other events or circumstances affecting an entity*—allocation is applied if causal relations are generally, but not specifically, identified. [Emphasis added.]~~