



CONCEPTUAL FRAMEWORK

Statement of Financial Accounting Concepts No. 8
December 2021

Conceptual Framework for Financial Reporting

Chapter 7, *Presentation*

Financial Accounting Standards Board

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Conceptual Framework for Financial Reporting

CHAPTER 7: PRESENTATION

Introduction

PR1. This chapter describes the information to be included in general purpose financial reporting and how appropriate presentation can contribute to achieving the objective¹ of financial reporting. *Presentation* refers to display of line items,² totals, and subtotals on the financial statements. The line items displayed on those statements are depictions in words and numbers of elements of financial statements—assets, liabilities, equity, revenues, expenses, gains, losses, and contributions from and distributions to owners as well as the cash flows of the entity.

PR2. The concepts in this chapter are not premised on any specific formats or subtotals. For example, they apply equally to a single statement of comprehensive income and to separate statements of earnings (or net income) and other comprehensive income (OCI). Practices exist for determining formats and subtotals, and future updates to accounting standards may change them.

PR3. This chapter addresses concepts related to presenting in a financial statement information about items that have been recognized. This chapter does not address recognition decisions. Neither definitions of elements nor recognition requirements provide a basis for making presentation decisions. Therefore, presentation decisions rely heavily on the objective of financial reporting and the qualitative characteristics of useful financial information.

The Objective of Financial Reporting

PR4. A discussion of presentation begins with the objective of financial reporting, which is described in Chapter 1, *The Objective of General Purpose Financial Reporting*. This section provides a summary of the objective of financial reporting and how presentation furthers that objective. Financial statements are a principal means of communicating financial information to those outside an entity. Financial statements are directed toward the common interest of different resource providers, and that is feasible only because resource providers have similar needs in general. But “general purpose” does not mean “all purpose,” and financial

¹The term *objective* as used in this chapter refers to the objective of general purpose financial reporting as described in Chapter 1, *The Objective of General Purpose Financial Reporting*, of this Concepts Statement. See paragraphs PR4–PR6 for a discussion of those objectives.

²The term *line items* refers to amounts other than subtotals that appear on the face of financial statements and are included in totals.

statements do not necessarily satisfy all resource providers or other possible users equally well.

PR5. The financial statements of an entity are a related set; each articulates with the others, and all are derived from the same underlying data. Financial statements, individually and collectively, have the same objective as financial reporting in general, which paragraph OB2 of Chapter 1 describes as follows:

... 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. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit.

PR6. The Board has concluded that the objective of financial reporting is the same for all entities, both business entities and not-for-profit entities. There are differences between aspects of not-for-profit entities and business entities, for example, resource providers for a not-for-profit entity are members, donors, and grantors. The objective of financial reporting incorporates an interest in providing information to users that is helpful in assessing the services that a not-for-profit entity provides as well as its ability to continue to provide those services.

PR7. Thus, the parties that are noted in paragraph OB2 of Chapter 1, along with existing and potential contributors to or creditors of not-for-profit entities, are referred to throughout this chapter as resource providers.

PR8. Paragraph OB3 of Chapter 1 states that investors' and creditors' decisions are based on their expectations about returns from their investments, including loans or other forms of credit, and that those expectations ultimately may depend directly on an assessment of prospects for net cash inflows to the reporting entity. To make that assessment, a resource provider needs information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities in using the resources of the entity.

PR9. Those expectations also are based on the nature of the specific investment or credit instrument—the rights to cash flows that an investment or claim conveys to its holder and its relationship to other claims against the entity. That includes the level of subordination or seniority; collateral, if any; the interest rate; and any other relevant terms of the right to distributions from the entity.

PR10. The information needs of certain resource providers, such as lenders, suppliers, and employees, may be essentially the same for a not-for-profit entity and a business entity. Although not-for-profit entities do not have shareholders, they have members and contributors (also referred to as donors). Donors are not entitled to economic returns of the entity or a share of residual assets in the event of liquidation. However, they do have many of the same information needs as shareholders. Beyond the informational needs that donors to not-for-profit entities share with shareholders of business entities, donors may seek particular information about the nature of and relation between inflows and outflows of resources and information about service efforts.

PR11. Individually and collectively, financial statements provide much of the financial information needed to achieve the objective of general purpose financial reporting.³ However, significant financial information that is useful to resource providers is better provided, or can only be provided, by notes to financial statements, in supplementary information, or by other means of financial reporting. Some examples include:

- a. Information disclosed in notes or parenthetically on the face of financial statements, such as significant accounting policies or specific information about the nature of an asset or a liability, amplifies or explains information recognized in the financial statements. That sort of information is essential to understanding the information recognized in financial statements and is discussed further in Chapter 8, *Notes to Financial Statements*.
- b. Supplementary schedules, such as disclosures of the effects of changing prices, and other means of financial reporting, such as Management's Discussion and Analysis, add information to that in the financial statements or notes, including information that may be relevant but does not meet the definitions of elements.

PR12. The distinction between information that should be depicted in line items, subtotals, and totals on the face of a financial statement and information that should be provided by other means is based on the definitions of the elements of financial statements and the related recognition and measurement concepts.⁴ Providing information only in a note, parenthetically on the face of a financial statement, in a supplementary schedule, or by other means of financial reporting is not an acceptable alternative to recognizing an element of financial statements that meets the recognition criteria.

PR13. There are choices for determining whether detailed information about a recognized item is best provided on the face of the financial statements or in the notes. Those decisions are made by considering the qualitative characteristics of useful financial information as well as by cost-benefit considerations.⁵ For example, the relevance of a recognized item may influence the prominence or priority that an entity assigns to the detailed information of that item in determining the information's presentation. Furthermore, understandability of detailed information, via clear and concise presentation, may enhance the usefulness of the information. Resource providers can aggregate line items on financial statements or create their own subtotals, but without the underlying details, they may have no way to disaggregate information provided in a single line item.

³Some information that is very important to resource providers is not included in any form of financial reporting because it is not financial. That information is beyond the scope of the Concepts Statements.

⁴Recognition criteria are in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.

⁵Paragraphs QC35–QC39 of Chapter 3, *Qualitative Characteristics of Useful Financial Information*, of this Concepts Statement provide comprehensive principles about cost considerations, and those principles can be applied to decisions on presentation.

Information Provided by Financial Statements

PR14. By their nature, financial statements articulate with each other. Financial statements reflect different aspects of the same transactions or other events and circumstances affecting an entity.⁶ Although each presents information different from the others, none is likely to serve only a single purpose or to provide all the financial information that is useful for a particular kind of assessment or decision.

PR15. Significant tools of financial analysis, such as rates of return and turnover ratios, depend on interrelationships between financial statements and their components. To facilitate financial statement users' understanding of those relationships, the association between (a) revenues, expenses, gains, losses, and cash flows that result from changes in assets, liabilities, and equity instruments and (b) the assets, liabilities, and equity instruments that changed should be made apparent in financial statements or associated notes.

PR16. Assessing prospects for future cash flows to either the entity or the resource provider necessarily involves forming expectations about future events. Financial statements are not predictions, and their purpose is not to create specific expectations. Instead, to achieve the objective of financial reporting, financial statements must provide information that assists resource providers in forming their own expectations.⁷

PR17. The basis for forming expectations is information about past transactions and other events, existing conditions and circumstances, and changes in those conditions and circumstances. To form a part of that basis, information presented in financial statements should help resource providers to:

- a. Distinguish between the types of transactions, events, and changes in circumstances that are likely to occur in the future and those that are not
- b. Estimate the amounts and timing of future flows of cash or other economic value to the resource provider and make assessments of the probability (uncertainty) of occurrence
- c. Understand the existing resources of an entity and the claims against the entity
- d. Estimate how and when existing resources are likely to be used to settle claims against the entity and the probabilities and timing of those outflows.

PR18. To address those purposes, resource providers need a variety of types of information, including information about:

- a. Assets, liabilities, and equity at the end of the period
- b. Comprehensive income, including revenues, expenses, gains, and losses during the period
- c. Cash flows during the period

⁶The introduction to this Concepts Statement explains the use of the terms *transaction*, *events*, and *circumstances*.

⁷Paragraphs QC6–QC10 of Chapter 3 of this Concepts Statement explain the concept of predictive value in providing useful financial information.

d. Investments by and distributions to owners.

PR19. The information that financial statements provide is used for different purposes. Each resource provider determines what information is most useful based on the decision-making techniques to be used. Other information that may be useful includes the nature of the entity and its activities and the information already possessed or obtainable from other sources. The resource provider's individual decision-making preferences, including its capacity to process the information, also may influence what information resource providers determine to be most useful.

Definition of Full Set of Financial Statements

PR20. General purpose financial reporting is defined as a full set of financial statements plus the notes to the financial statements and required supplemental information. A *full set of financial statements* is meant to present the elements of financial statements and the recognition and measurement related to those elements, including the information presented in paragraph PR18. Notes to financial statements are not considered to be part of a full set of financial statements. The scope of this chapter is limited to items recognized and, consequentially, measured in financial statements. That limitation on scope does not alter the status of notes or supplementary information; those types of information remain important and useful in meeting the objective of financial reporting.

PR21. The relationships between an entity's assets, liabilities, and equity and the effects on comprehensive income and cash flows of the changes in those assets and liabilities should be clear. Issues about the articulation and relationship between financial statements, including the coordination between the income statement and statement of cash flows, should be resolved at the standards level.

PR22. This chapter focuses on information about assets, liabilities, equity, revenues, expenses, gains, losses, and investments by and distributions to owners rather than requiring specific financial statements. This chapter also describes the purpose of the information in financial statements and highlights the potential importance of their relationships.

Assets, Liabilities, and Equity

PR23. Information about an entity's assets, liabilities, and equity and their relationships to each other at a moment in time helps users to assess the entity's liquidity, financial flexibility,⁸ net resources available, the capability of generating future net cash flows, and exposures to risk. It also provides information about the entity's ability to meet its long-term financial obligations.

PR24. Information provided about an entity's assets, liabilities, and equity does not show the value of a business. Instead, together with other financial information,

⁸Financial flexibility is the ability of an entity to take effective actions to alter amounts and timing of cash flows so it can respond to unexpected needs and opportunities.

it provides insight that may enable resource providers to make their own estimates of the appropriate prices for the entity's equity interests. It also provides the basis against which performance of the entity can be measured, as described in paragraphs PR15 and PR23.

Revenues, Expenses, Gains, and Losses—Components of Comprehensive Income

PR25. Information about revenues, expenses, gains, and losses (components of comprehensive income) reflects the extent to which, and the ways in which, the equity of an entity increased or decreased other than from investments by or distributions to owners. It helps resource providers evaluate how well the entity has been able to use its assets and other resources, such as its ability to generate net cash flows, and how efficiently it has financed and otherwise supported its activities. Components of comprehensive income also provide information about the financial reporting effects of events or changes in circumstances that have affected the cash flows the entity has generated in the past or that can affect cash flows the entity may generate in the future.

PR26. For example, resource providers may use information about revenues and expenses to help estimate amounts that they perceive as representative of the long-term earning ability of an entity. That is a significant step for resource providers in comparing the market price of an equity security with what they estimate its "intrinsic value" to be. Those estimates and analyses are a part of financial analysis and not financial reporting, but financial reporting facilitates financial analysis by, among other things, classifying financial information into the most homogeneous groups possible.

Cash Flows

PR27. Information about an entity's cash receipts and payments helps to assess factors such as the entity's financial flexibility and risk. Estimates and allocations of cash flows are necessary if a single cash receipt or payment involves more than one category of cash flows.

PR28. Information about cash flows helps resource providers understand and analyze the information about assets, liabilities, equity, investments by owners, distributions to owners, revenues, expenses, gains, and losses. Information about the type of transaction or event that caused the cash inflow or outflow helps resource providers assess the prospects for future net cash flows to the entity and, potentially, to resource providers. Resource providers need information about amounts, causes, and intervals of time between components of comprehensive income and cash receipts and outlays. Resource providers commonly consider that information in assessing the relationship between comprehensive income, its components, and associated cash flows.

Investments by and Distributions to Owners

PR29. Information about investments by and distributions to owners reflects the extent to and ways in which the equity of an entity increased or decreased from

transactions with equity investors in their capacity as equity investors during a period.

PR30. Investments by owners establish or increase ownership interests in the entity and may be received in the form of cash, goods or services, or satisfaction or conversion of the entity's liabilities. Distributions decrease ownership interests and include not only cash dividends when declared (or other cash withdrawals by owners of noncorporate entities), but also transactions such as reacquisitions of the entity's equity securities and distributions "in kind" of noncash assets. Information about those events is useful, in conjunction with other financial statement information, to resource providers as an aid in assessing factors such as the entity's financial flexibility, capacity to generate future cash flows, and risk.

Comprehensive Income and Net Income (Earnings)

PR31. Comprehensive income summarizes the net effects of all recognized changes in equity of an entity during a period from transactions and other events and circumstances except those resulting from investments by owners and distributions to owners. For entities without owners, such as not-for-profit entities, comprehensive income includes all changes in net assets.

PR32. Developing components of comprehensive income because they represent changes in assets and liabilities present no distinct recognition or measurement problems beyond recognizing or measuring the assets and liabilities themselves. Differences between net income and comprehensive income of business entities exist because past standards have required or permitted several types of items to be excluded from net income and later reclassified into net income. There is no conceptual basis for determining which items qualify for that treatment.

Netting of Line Items

PR33. There is confusion about the term *netting* when it comes to financial statement items because there are many potential circumstances in which netting is considered to have been applied in all financial statements. There is no consistent conceptual basis for netting assets and liabilities on the balance sheet. There are circumstances in which netting is routinely done in presenting items in comprehensive income. For example, in the sale of a building classified as property, plant, and equipment, one may net the proceeds of the sale against the carrying amount of the building to determine a gain or loss. One also may net the commission fee against the sales price to measure the proceeds from the sale. Both cases are an aggregation of a debit against a credit and, therefore, may be applications of netting. There is no particular conceptual basis for the aggregation of debits and credits, and each circumstance should be determined at the standards level.

PR34. Certain forms of gains and losses have been a result of netting a debit or credit, but that does not determine the difference between a revenue and a gain or an expense and a loss. The nature of the transaction is what determines what is a gain or a loss. Practice and standards have determined that net presentation of some gains and losses is appropriate. However, that is not because net

presentation is an essential characteristic of a gain or a loss, but rather how practice and standards have decided to treat those elements in the case of certain transactions.

Line Items, Subtotals, and Summary Information

PR35. Nearly all reporting entities would find it excessively difficult and expensive to provide full information about every detail of their activities during a reporting period. Even if that were feasible, the resulting masses of data would be very difficult for resource providers to understand and use. Consequently, preparing financial statements for all but the simplest and smallest entities requires simplifying, condensing, and aggregating data into meaningful line items, subtotals, and totals.

PR36. Conversely, too high a level of aggregation would result in the loss of useful information. For example, presenting only line items labeled total assets, total liabilities, and total equity would not be very helpful in differentiating the characteristics of an entity's assets and liabilities and the capacity of those assets to generate returns for resource providers. Similarly, presenting only four line items—total revenues, total expenses, total gains, and total losses—would not be very helpful in assessing prospects for returns to resource providers. Comparable issues arise in providing information about cash flows and investments by and distributions to owners.

PR37. Many discussions about financial information focus on summary, total, or subtotal data, such as the amounts of net assets, revenue, net income (earnings), and earnings per share. Such highly simplified condensations may be general indicators and often are used to compare entities. However, those data are only a starting point for analysis. Because they result from combining the effects of many unlike transactions and events, they are not sufficiently detailed for the purposes of many resource providers.

PR38. Although standards requiring specific presentations in financial statements usually address line items, most financial statements include subtotals. Only a few subtotals are defined in current accounting standards. In current practice, subtotals providing information about comprehensive income or cash flows that are required or allowed by standards are sometimes based on the activity with which a recognized item is associated. Subtotals of assets and liabilities, if any, usually are based on the length of time until realization or settlement. Subtotals provide information about investments by and distributions to owners that are identified separately from other changes in equity.

PR39. Subtotals represent broad classes of often heterogeneous items. In contrast, line items can reflect more homogeneous classes of items and usually are more useful to resource providers in faithfully representing the differences in effects of transactions, events, and circumstances. Therefore, creating line items that include classes of items that are as nearly homogeneous as possible is a critical aspect of presentation. Homogeneity enhances the ability to faithfully represent a line item.

PR40. The following are some important considerations in determining the line items that are necessary in a particular financial statement and the individual items to include in each line item:

- a. The event that caused an item to be recognized, for example, a transaction, a change in circumstances or conditions, an accounting adjustment like systematic allocation, or an accounting change
- b. The activity with which an item is associated
- c. Similarities and differences in the frequency with which similar components of comprehensive income are expected to result in similar amounts to be recognized in the future
- d. The expected time until realization or settlement of an asset or a liability
- e. The expected form (for example, cash or shares) of realization or settlement of an asset, a liability, or in certain circumstances an equity instrument
- f. The types of changes in economic conditions that can affect the cash flows related either to an existing asset or a liability or to similar revenues, expenses, and gains or losses in the future
- g. Similarities and differences in measurement methods.

Factors (a), (b), and (c) relate closely to one another and are more useful in grouping items in comprehensive income and cash flows than in grouping assets and liabilities. Factors (d) and (e) relate to assets and liabilities, and in certain circumstances factor (e) relates to equity. Factors (f) and (g) relate to line items in comprehensive income as well as assets and liabilities.

PR41. Factors should be applied to meet the objective of financial reporting and the fundamental qualitative characteristics of useful financial information. The fundamental qualitative characteristics are relevance and faithful representation. Financial information is relevant if it is capable of making a difference in the decisions made by users. Financial information is capable of making a difference in a decision if it has predictive value, confirmatory value, or both. To be useful, information must faithfully represent in words and numbers the economic phenomena that it purports to represent.

Cause, Activity, and Frequency

PR42. Financial statements depict the results of different types of transactions, other events, changes in circumstances, and accounting adjustments such as systematic allocations. The phenomena depicted in financial statement line items vary on frequency and predictability, including variability that is caused by changes in economic conditions. Some phenomena occur repeatedly, and others occur rarely or only once. For transactions, other events, changes in circumstances, and accounting adjustments that occur repeatedly, the amounts and timing of the effects on financial statements can vary widely.

PR43. Many financial analysis techniques involve identifying trends in amounts and timing of transactions and other events. The difference between items recognized as a result of transactions, especially routine transactions that result in recognizing revenue or costs of generating revenue as expenses, and those

recognized for other reasons is fundamental in meeting the objective of providing information to help resource providers assess the amount, timing, and uncertainty of potential future net cash flows to an entity and, potentially, to the resource providers. Some types of revenue and expense transactions tend to occur frequently in amounts that can be anticipated at least in general because an entity can influence (though not control) the occurrence of those transactions.

PR44. Other events and changes in conditions and circumstances often are beyond an entity's ability to influence and a resource provider's ability to anticipate. Different events have different effects on or send different signals about future profitability and, ultimately, cash flows. Some might clearly be one-time occurrences, but others might indicate the beginning, continuation, or end of a pattern of similar events. Distinguishing between different types of events with different implications for predictive value or confirmatory value, where possible, can be very useful for analysis.

PR45. Most entities engage in more than one activity. For example, an entity may produce or purchase goods and services, sell goods and services, and invest in assets not currently employed in producing goods and services. Information about the activities that components of comprehensive income are associated with can be very useful. Transactions associated with different activities may have significantly different effects on profitability and cash flows. The probability that transactions similar to those that occurred in the past will occur in the future also may differ significantly from activity to activity.

PR46. Gains or losses also can provide useful information about a particular activity even though gains or losses in similar amounts probably would not be expected to occur frequently or at all. For example, a loss that results from recognizing the impairment of an operating asset may indicate that future performance associated with that asset is likely to be different than it was in prior years.

PR47. Reporting revenues and expenses associated with a particular activity separately from the gains and losses related to that activity provides resource providers with information that may enable them to make predictions about how frequently transactions will recur. In some cases, that may be the only way to provide information about relative frequency. However, for some entities, it might be feasible to group classes of individual transactions within a particular activity according to how frequently they have occurred in the past or are expected to occur in the future. That would mean reporting on separate lines classes of transactions for which future amounts and timings can be predicted with less uncertainty and those that are subject to more uncertainty. While resource providers could benefit from receiving that information, not all entities' activities and transactions lend themselves to that kind of grouping.

PR48. Revenues and gains and expenses and losses are distinct elements, but combining them for presentation might be appropriate in meeting presentation objectives. For example, impairment recognized related to inventory might better

be combined particularly in a subtotal with other inventory costs to meet the objectives of factors (a), (b), and (c) in paragraph PR40.

PR49. Many decisions by investors, lenders, and other creditors are based on predictions about the amount and timing of the return on an equity investment, loan, or other credit instrument. Therefore, information is relevant if it helps form predictions (predictive value) about the outcomes of future events or if it confirms or corrects expectations (confirmatory value). Information about the present status of economic benefits or obligations and the recurrence of amounts or timing of certain transactions, events, or circumstances enhances the predictive value and confirmatory value of information in the financial statements.

Expected Time until Realization or Settlement

PR50. Information about the amount of expected time until an asset is expected to be realized or a liability settled helps meet the objective of predicting the timing of future cash flows. Grouping recognized items on the basis of contractual terms, such as those that are due within one year and those that have uncertain settlement dates, provides users with information about timing and uncertainty of future cash flows.

Expected Form of Realization or Settlement

PR51. The expected form of realization or settlement of an asset, a liability, or in certain circumstances an equity instrument also is important to resource providers. Grouping recognized items on the basis of the expected form of settlement or realization, such as financial instruments that are required to be settled with the entity's shares and financial instruments that are required to be settled with cash, provides users with information about the nature of the entity's obligations and expected cash flows.

Response to Changes in Economic Conditions and Other Factors

PR52. Not all recognized items are affected by changes in economic conditions and other factors in the same way. For example, the prices of fixed-income securities and equity securities are likely to change differently as interest rates change. The way in which items change in response to changes in economic conditions or other factors could be highly relevant for assessing the prospects for future net cash flows. Grouping gains or losses on the basis of which type of economic event or other factor caused the change in the carrying amount can help provide information to meet the objective of assessing the amounts, timing, and uncertainty of the prospects for future cash flows.

Measurement

PR53. Different measurement methods result in reporting information with different implications for future cash flow prospects. For example, depreciation charges may be considered very different from impairment losses or other losses resulting from changes in market prices. Measurement differences affect assets and liabilities as well as components of comprehensive income. Combining items

measured differently into a single line item produces information that either is less meaningful or is more difficult to use in predicting amounts of future cash flows.

Relationships with Other Information

PR54. Information that should be depicted in words and numbers on the face of financial statements is determined by the definitions of assets, liabilities, equity, revenues and expenses, gains and losses, and the related recognition, measurement, and presentation requirements. That information is aggregated into line items in financial statements using the factors in paragraph PR40. Those aggregation factors also may be helpful in considering subtotals. Chapter 8 of this Concepts Statement explains what information should be considered for inclusion in notes.

This chapter of Concepts Statement 8 was adopted by the affirmative vote of six members of the Financial Accounting Standards Board. Ms. Botosan dissented.

Ms. Botosan believes that the principles of aggregation/disaggregation in this chapter will facilitate Board members' consideration of issues concerning the combination of items into financial statement line items. Nevertheless, Ms. Botosan does not support the issuance of this chapter because she views it as incomplete because of the omission of principles related to the structure of financial statements and gross presentation versus net presentation. Also, in her opinion, the lack of a conceptual basis for OCI is inconsistent with a framework that is a coherent system of interrelated objectives and fundamental concepts.

This chapter acknowledges that financial statements are a related set; each statement articulating with the others. Nevertheless, this chapter does not include concepts to guide the structure of financial statements, which is key to a decision-useful articulation of financial statements. Ms. Botosan disagrees with the conclusion that issues on the articulation of financial statements, including the coordination between the performance statement and the statement of cash flows, should be resolved at the standards level. Ms. Botosan notes that the Board has previously attempted to address coordination among financial statements at the standards level and that those attempts have proven unsuccessful. Ms. Botosan believes that a lack of principles on the structure of financial statements represents a chief obstacle to successful standard setting in this arena.

Ms. Botosan believes that the creation of a coherent and interrelated system of fundamental concepts necessitates the joint development of element definitions, measurement concepts, and presentation concepts all aligned with the objective of financial reporting. Ms. Botosan's preferred approach for developing such concepts, including concepts on the structure of financial statements, is outlined in the next several paragraphs.

The objective of financial reporting is to provide information that is useful in making decisions about buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit. Those decisions depend on investors' assessments of expected returns, which depend, in turn, on their

assessments of expected cash flows. Accordingly, in Ms. Botosan's view, to meet the objective of financial reporting, the cash flows resource providers are attempting to predict the information that would be relevant to those efforts should guide the joint development of measurement and presentation principles.

Ms. Botosan notes that an asset produces market-participant expected cash flows or entity-specific expected cash flows depending on how the asset is used. Paragraph 32 of FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, acknowledges that market-participant and entity-specific expected cash flows can differ for the same asset. Ms. Botosan refers to assets that produce market-participant expected cash flows as "in-exchange" assets and assets that produce entity-specific expected cash flows as "in-use" assets.

Ms. Botosan believes that because the expected cash flow from an in-exchange asset is the same expected cash flow impounded in fair value, fair value is the relevant measurement attribute. Furthermore, when an in-exchange asset is measured at fair value, the statement of financial position plays a dominant role in conveying information that is useful in forecasting expected cash flows from in-exchange assets.

The expected cash flow from in-use assets is entity specific, however, and the historical relationships among revenues, expenses, and the amount invested in in-use assets are a critical starting point for forecasting the entity-specific expected cash flow from in-use assets. Accordingly, Ms. Botosan believes that a measurement attribute that preserves those historical relationships provides information that is useful in assessing entity-specific expected cash flows from in-use assets. Furthermore, all three financial statements—the statement of financial position, the performance statement, and the cash flow statement—convey information that is useful in forecasting expected cash flows from in-use assets.

Because of the incrementally vital role that the performance and cash flow statements play in providing information that is useful in assessing the expected cash flow from in-use assets, Ms. Botosan believes that the relevance of financial statement information would be enhanced by segregating information pertaining to in-use assets across the statement of financial position, the performance statement, and the cash flow statement and using the distinction between in-use assets and in-exchange assets as a mechanism to develop a decision-useful articulation across financial statements.

Ms. Botosan also disagrees with the conclusion that principles to facilitate the Board's consideration of gross presentation versus net presentation issues do not belong in the framework. The framework supports Board deliberations by providing a common foundation and basic reasoning on which to evaluate the merits of various alternatives. Ms. Botosan believes that principles related to gross presentation versus net presentation could provide the basic reasoning that would facilitate the promulgation of consistent presentation standards. For example, Ms. Botosan believes that a principle that recognizes that gross presentation is more

decision useful when margin information is relevant for forecasting future cash flows, whereas net presentation is more decision useful when it is not, would help facilitate the Board's consistent consideration of gross presentation versus net presentation issues on the performance statement.

This chapter notes that the Board concluded that there is no conceptual basis for OCI. Ms. Botosan agrees with that conclusion within the context of the existing framework, but she believes that use of a mechanism in standard setting for which the Board can offer no conceptual basis reveals a deficiency in the framework rather than a deficiency in standard setting. Ms. Botosan believes that the framework's inability to offer a conceptual basis for certain changes in net assets from nonowner sources to be reported outside the measure of performance stems from the framework's existing formulaic definition of comprehensive income.

The framework defines comprehensive income as the change in net assets from nonowner sources. Ms. Botosan believes that this definition, which is derived from the basic accounting equation, forces comprehensive income to mechanically reflect the recognition and measurement decisions afforded to assets and liabilities. As a result, it does not provide a framework to help the Board consider whether certain changes in net assets from nonowner sources (for example, a change in the fair value of a liability due to a change in an entity's own creditworthiness) should be reported outside the measure of performance on the performance statement, which is the outcome when items are reported in OCI. Ms. Botosan is concerned that concluding that there is no conceptual basis for certain changes in net assets from nonowner sources to be reported outside income accruing to equity holders leaves the Board without a framework to consider such issues. Instead, Ms. Botosan would have preferred to reassess the definition of comprehensive income and provide a conceptual basis for certain changes in net assets from nonowner sources that are not informative of income accruing to equity holders to be excluded from comprehensive income.

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 A: Basis for Conclusions

Introduction

BC7.1. 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.

BC7.2. In August 2016, the Board issued proposed FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 7, Presentation*, for public comment and received 17 comment letters. Additional outreach was conducted to gather feedback including individual stakeholder meetings and meetings with the FASB's advisory groups.

BC7.3. Among other things, FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, addresses recognition, measurement, and certain concepts for presentation of information on the face of financial statements. The Board concluded that the discussion of presentation could be further developed and improved with the objective of providing a foundation for future standards that enhance resource providers' abilities to assess prospects for future cash flows by addressing how to:

- a. Group individual recognized items into line items and subtotals
- b. Clarify the relationships between an entity's assets, liabilities, and equity and the effects on comprehensive income and cash flows of the changes in those assets and liabilities.

BC7.4. Paragraphs PR35–PR53 address the issues in paragraph BC7.3 above. The remaining paragraphs in this chapter are based on Concepts Statement 5 and have been revised from Concepts Statement 5 as follows:

- a. To make language internally consistent
- b. To eliminate repetition
- c. To reflect changes:
 1. In practices and standards since Concepts Statement 5 was issued
 2. Based on the Board's experience in using those concepts in setting standards, including standards for not-for-profit entities.

Because there was no basis for conclusions in Concepts Statement 5, this chapter provides no basis for conclusions for (a)–(c).

BC7.5. Many decisions by existing and potential investors, lenders, and other creditors (resource providers) are based on implicit or explicit predictions about the amount, timing, and uncertainty of a return on an equity investment, loan, or other credit instrument. Information is relevant—capable of making a difference in those decisions—if it will help resource providers make new predictions, confirm or revise prior predictions, or both. The Board identified the items in the list of factors in paragraph PR40 in considering how resource providers might make those

predictions, confirm them, or revise them—that is, how prospects for their future cash flows might be assessed. Also, aggregating homogeneous items results in a more faithful representation of differences between line items.

BC7.6. Resource providers generally are interested in the capacity of an entity's assets to generate future inflows and the claims against the entity that cause future outflows.

BC7.7. This chapter also acknowledges that for many types of entities, one of the most significant determinants of future cash flows is an entity's ability to use its assets to acquire or produce and provide goods and services to its customers (or beneficiaries in the case of not-for-profit entities). Those activities require the use of not only recognized assets but also other unrecognized resources such as the knowledge and capabilities of the entity's workforce, its reputation, and other competitive advantages or disadvantages.

BC7.8. Information about many factors outside the scope of financial statements normally is necessary to assess the prospects for future net cash inflows from those activities. Those factors include, among other things, correlation of an entity's past performance with changes in general economic conditions and conditions in its industry and markets, the current business and social environment, technological change affecting the supply or demand for the entity's products or services, and turnover among management and key employees.

Definition of Full Set of Financial Statements

BC7.9. The proposed chapter did not explicitly define the term *full set of financial statements* despite addressing presentation of information within financial statements. The Board received feedback that it should define financial statements to include related notes and to address the boundaries of financial statements. In considering the comment letter feedback, the Board also considered the notion of general purpose financial statements and whether they are different from a full set of financial statements.

BC7.10. The Board decided to eliminate the term *general purpose financial statements* and replace it with the term *general purpose financial reporting*. The Board also decided to define the term *full set of financial statements* as financial statements that show the information listed in paragraph PR18. The Board also concluded that the notes to financial statements are not considered to be part of a full set of financial statements; however, notes and supplementary information are a required part of general purpose financial reporting. Although notes serve to provide useful information, categorizing notes as an integral part of basic financial statements has been attributed to auditing literature rather than accounting standards with the exception of APB Opinion No. 22, *Disclosure of Accounting Policies*. While notes help meet the objective of general purpose financial reporting, they are not financial statements.

BC7.11. The Board also concluded that this chapter along with Chapter 8 of this Concepts Statement sufficiently address the boundaries of financial statements. More specificity about information that should or should not be included in financial

statements and information associated with financial statements is a standards-level issue.

Presenting Line Items and Subtotals in Financial Statements

BC7.12. The Board considered how to determine the amount of detail to be provided in each financial statement and how the information in a statement might be organized. Specifying certain line items that all entities must present would make it easier for resource providers to locate information. However, the Board concluded that at a conceptual level no single set of line items, subtotals, and totals for the income statement would serve all entities equally well.⁹ The Board also briefly considered that identifying different sets of subtotals and line items for different types or classes of entities would enhance the comparability of reported information. However, that is not feasible in a Concepts Statement because of the wide variety of activities in which different entities engage and the fact that some individual entities engage in several very different activities. Ultimately, the Board concluded that specifying line items for different entities could be done only in standards, if at all. Consequently, this chapter describes what the Board should consider when setting standards that involve general or specific requirements for presentation in financial statements.

BC7.13. Respondents to the proposed chapter observed that it did not address concepts for totals and subtotals. Those respondents noted that an important part of preparing financial statements is simplifying, condensing, and aggregating data into meaningful items, subtotals, and totals. The Board concluded that if information is initially aggregated utilizing the presentation factors, there is no need for intermediate subtotals within the financial statements in concept. In standard setting, the Board could decide that one of those factors is predominant to others and warrants a subtotal. Accordingly, ordering of presentation for items presented above net income is a matter for standards-level projects. Furthermore, even if it were possible to develop a separate set of concepts for the structure of the statements of comprehensive income and cash flows, those concepts would result in conflicts with the factors for line items because those factors are not mutually exclusive. The Board would need to resolve which factors are applied first, which, in the Board's view, is not possible at the concepts level.

BC7.14. Similarly, while the aggregation factors can help identify the objective behind a subtotal, it is not easy to consistently capture and apply a particular objective across industries. Subtotals will look different across different industries because entities can decide what is relevant to a subtotal based on their own circumstances. There is no consistent conceptual basis that exists for grouping certain line items into subtotals, which is why resolution of that matter should be a standard-setting issue.

⁹At a standards level, however, net income is prescribed as a subtotal in comprehensive income.

Presentation Factors

BC7.15. The order of the seven factors listed in paragraph PR40 does not establish the order in which the different factors should be considered and applied. The Board considered but decided not to establish an order of priority in which to consider the matters discussed in that paragraph. Although the order in which they are applied affects the results, no single order will produce results that best predict future cash flow prospects in all cases. In other words, one factor may be predominant and another subordinate in one circumstance, but the role of the factors may be reversed in another circumstance. For example, the activity that the recognized item resulted from seems to be of most importance in the income statement. The activity that the recognized item resulted from or the activity in which it is used may not be as important for balance sheet line items as it is for the income statement for many reasons. One such reason is that assets can be used for different purposes.

BC7.16. Respondents to the proposed chapter suggested that the factors in paragraph PR40 should be prioritized to ensure that they are applied consistently. The Board concluded that the lack of prioritization should not lead to conceptual inconsistency because different circumstances would warrant different prioritization of factors. Because the presentation concept indicates that no factor has primacy and that the factors are not intended to be applied in a specific order, different weighting and ordering of the factors at the standards level would not be considered conceptually inconsistent. Concepts are driven from the objective of financial reporting. Because different entities operate under different circumstances, the Board concluded that prioritizing any one factor would not uniformly produce information that best meets the objective of financial reporting. Rather, the Board concluded that if it applies the factors at the standards level in a way that is consistent with meeting the objective of financial reporting, the results will be conceptually consistent.

BC7.17. Some comment letter respondents suggested that the list of factors for determining how individual items should be aggregated into line items in financial statements was incomplete. Respondents offered several additional factors for the Board to consider, including:

- a. Operating versus nonoperating
- b. Risk profile associated with activities and balances
- c. Ease or difficulty of converting items to cash
- d. Level of subordination or seniority of items
- e. Significance of the item.

BC7.18. The Board concluded that the factors for grouping line items included in the proposed chapter are comprehensive in that all aspects of how users predict operations and cash flows should be covered by at least one of the factors.

Associating Revenues, Expenses, Gains, and Losses with Assets, Liabilities, and Equity

BC7.19. Because conducting its activities requires an entity to use its assets and incur liabilities or issue equity, there is a relationship between the results of those activities and the related assets, liabilities, and equity. That relationship is not necessarily constant or direct, but it exists. Changes in assets, liabilities, and equity affect an entity's ability to conduct and finance future activities, indicate the level of success in conducting or financing past activities, or both.

BC7.20. Individual types of revenues, expenses, gains, losses, and cash flows generally are related to specific assets, liabilities, and equity but not necessarily to all of an entity's assets, liabilities, and equity. Therefore, making apparent the associations between the changes in particular assets, liabilities, and equity (or groups of assets, liabilities, and equity) and specific revenues, expenses, gains, losses, and cash flows (or groups of revenues, expenses, gains, and losses) enhances a resource provider's ability to assess the implications of those changes for future cash flow prospects.

Other Comprehensive Income (OCI)

BC7.21. In developing the proposed chapter, the Board concluded that it was not possible to identify a consistent set of circumstances in which components of comprehensive income should be reported in OCI. In other words, there is no conceptual basis for OCI. For every item that is currently reported in OCI, there is an item of similar nature that is included outside OCI as well. The basis for conclusions of each standard that allows or requires items to be included in OCI rarely suggests why the item has been included in OCI. It is also important to note that a discussion of OCI in the Conceptual Framework would not be complete without mentioning recycling. Because there is no conceptual basis for excluding items from net income, there is no conceptual basis for reclassifying those items into net income at a later date. After reconsideration, the Board affirmed the conclusions stated in this paragraph.

Netting of Line Items

BC7.22. Some respondents to the proposed chapter commented on whether the Board should address netting financial statement line items. Some respondents suggested that the Board should develop concepts on the presentation of exchanges of assets with counterparties. The Board considered whether there is a consistent underlying concept that connects all circumstances in which netting is deemed appropriate. The Board was unable to identify a concept and, therefore, concluded that there is no consistent conceptual basis for netting financial statement line items. At a standards level, the Board may conclude that netting is useful in achieving the objective of financial reporting.

Cost Benefit

BC7.23. Some respondents to the proposed chapter suggested that the Board more thoroughly address complexity and cost-benefit factors. Paragraphs QC35–

QC39 of Chapter 3, *Qualitative Characteristics of Useful Financial Information*, of this Concepts Statement discuss cost constraints and provide comprehensive principles about cost constraints, and those five paragraphs can all be applied to decisions on presentation. Thus, the Board concluded that additional specificity on cost constraints that relate to presentation should be addressed at the standards level.

Appendix B: Concepts Statement 5 Marked to Show Superseded Text

B1. The text highlighted in grey is superseded by this chapter.

NOTE: The text highlighted in grey has been superseded. The superseded text was left in the document for context. Mr. March's dissent has not been edited as portions of his dissent may be applicable to areas that have been retained in Concepts Statement No. 5.

Statements of Financial Accounting Concepts

This Statement of Financial Accounting Concepts is one of a series of publications in the Board's conceptual framework for financial accounting and reporting. Statements in the series are intended to set forth objectives and fundamentals that will be the basis for development of financial accounting and reporting standards. 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, events, and circumstances 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.

The conceptual framework is a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and reporting. It is expected to serve the public interest by providing structure and direction to financial accounting and reporting to facilitate the provision of evenhanded financial and related information that helps promote the efficient allocation of scarce resources in the economy and society, including assisting capital and other markets to function efficiently.

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 the Statements in this series. They will guide the Board in developing accounting and reporting standards 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 standards also should enable those who are affected by or interested in financial accounting standards 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 concepts also may provide some guidance in

analyzing new or emerging problems of financial accounting and reporting in the absence of applicable authoritative pronouncements.

Statements of Financial Accounting Concepts do not establish standards prescribing accounting procedures or disclosure practices for particular items or events, which are issued by the Board as Statements of Financial Accounting Standards. Rather, Statements in this series describe concepts and relations that will underlie future financial accounting standards and practices and in due course serve as a basis for evaluating existing standards and practices.*

The Board recognizes that in certain respects current generally accepted accounting principles may be inconsistent with those that may derive from the objectives and concepts set forth in Statements in this series. However, a Statement of Financial Accounting Concepts does not (a) require a change in existing generally accepted accounting principles; (b) amend, modify, or interpret Statements of Financial Accounting Standards, Interpretations of the FASB, Opinions of the Accounting Principles Board, or Bulletins of the Committee on Accounting Procedure that are in effect; or (c) justify either changing existing generally accepted accounting and reporting practices or interpreting the pronouncements listed in item (b) based on personal interpretations of the objectives and concepts in the Statements of Financial Accounting Concepts.

Since a Statement of Financial Accounting Concepts does not establish generally accepted accounting principles or standards 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).†

Like other pronouncements of the Board, a Statement of Financial Accounting Concepts may be amended, superseded, or withdrawn by appropriate action under the Board's *Rules of Procedure*.

*Pronouncements such as APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, and the Accounting Terminology Bulletins will continue to serve their intended purpose—they describe objectives and concepts underlying standards and practices existing at the time of their issuance.

†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 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 standards promulgated by the Financial Accounting Standards Board for the disclosure of information outside of financial statements in published financial reports.

Statement of Financial Accounting Concepts No. 5

Recognition and Measurement in Financial Statements of
Business Enterprises

December 1984

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HIGHLIGHTS

[Best understood in context of full Statement]

- This Statement sets forth recognition criteria and guidance on what information should be incorporated into financial statements and when. The Statement provides a basis for consideration of criteria and guidance by first addressing financial statements that should be presented and their contribution to financial reporting. It gives particular attention to statements of earnings and comprehensive income. The Statement also addresses certain measurement issues that are closely related to recognition.
- Financial statements are a central feature of financial reporting—a principal means of communicating financial information to those outside an entity. Some useful information is better provided by financial statements and some is better provided, or can only be provided, by notes to financial statements, supplementary information, or other means of financial reporting. For items that meet criteria for recognition, disclosure by other means is not a substitute for recognition in financial statements.
- Recognition is the process of formally incorporating an item in the financial statements of an entity as an asset, liability, revenue, expense, or the like. A recognized item is depicted in both words and numbers, with the amount included in the statement totals.
- A full set of financial statements for a period should show:
 - Financial position at the end of the period
 - Earnings for the period
 - Comprehensive income for the period
 - Cash flows during the period
 - Investments by and distributions to owners during the period.
- Financial statements individually and collectively contribute to meeting the objectives of financial reporting. No one financial statement is likely to provide all the financial statement information that is useful for a particular kind of decision.
- The parts of a financial statement also contribute to meeting the objectives of financial reporting and may be more useful to those who make investment, credit, and similar decisions than the whole.
- Financial statements result from simplifying, condensing, and aggregating masses of data. As a result, they convey information that would be obscured if great detail were provided. Although those simplifications, condensations, and aggregations are both necessary and useful, the Board believes that it is important to avoid focusing attention almost exclusively on “the bottom line,” earnings per share, or other highly simplified condensations.
- A statement of financial position provides information about an entity’s assets, liabilities, and equity and their relationships to each other at a moment in time. The statement delineates the entity’s resource structure—major classes and amounts of assets—and its financing structure—major classes and amounts of liabilities and equity.

- A statement of financial position does not purport to show the value of a business enterprise but, together with other financial statements and other information, should provide information that is useful to those who desire to make their own estimates of the enterprise's value. Those estimates are part of financial analysis, not of financial reporting, but financial accounting aids financial analysis.
- Statements of earnings and of comprehensive income together reflect the extent to which and the ways in which the equity of an entity increased or decreased from all sources other than transactions with owners during a period.
- The concept of earnings set forth in this Statement is similar to net income for a period in present practice; however, it excludes certain accounting adjustments of earlier periods that are recognized in the current period—cumulative effect of a change in accounting principle is the principal example from present practice. The Board expects the concept of earnings to be subject to the process of gradual change or evolution that has characterized the development of net income.
- Earnings is a measure of entity performance during a period. It measures the extent to which asset inflows (revenues and gains) associated with cash-to-cash cycles substantially completed during the period exceed asset outflows (expenses and losses) associated, directly or indirectly, with the same cycles.
- Comprehensive income is a broad measure of the effects of transactions and other events on an entity, comprising all recognized changes in equity (net assets) of the entity during a period from transactions and other events and circumstances except those resulting from investments by owners and distributions to owners.
- A variety of terms are used for net income in present practice. The Board anticipates that a variety of terms will be used in future financial statements as names for earnings (for example, net income, profit, or net loss) and for comprehensive income (for example, total nonowner changes in equity or comprehensive loss).
- Earnings and comprehensive income are not the same because certain gains and losses are included in comprehensive income but are excluded from earnings. Those items fall into two classes that are illustrated by certain present practices:
 - Effects of certain accounting adjustments of earlier periods that are recognized in the current period (already described)
 - Certain other changes in net assets (principally certain holding gains and losses) that are recognized in the period but are excluded from earnings, such as some changes in market values of investments in marketable equity securities classified as noncurrent assets, some changes in market values of investments in industries having specialized accounting practices for marketable securities, and foreign currency translation adjustments.
- The full set of financial statements discussed in this Statement is based on the concept of financial capital maintenance.

- Future standards may change what is recognized as components of earnings. Future standards may also recognize certain changes in net assets as components of comprehensive income but not of earnings.
- A statement of cash flows directly or indirectly reflects an entity's cash receipts classified by major sources and its cash payments classified by major uses during a period, including cash flow information about its operating, financing, and investing activities.
- A statement of investments by and distributions to owners reflects an entity's capital transactions during a period—the extent to which and in what ways the equity of the entity increased or decreased from transactions with owners as owners.
- An item and information about it should meet four fundamental recognition criteria to be recognized and should be recognized when the criteria are met, subject to a cost-benefit constraint and a materiality threshold. Those criteria are:
 - *Definitions.* The item meets the definition of an element of financial statements.
 - *Measurability.* It has a relevant attribute measurable with sufficient reliability.
 - *Relevance.* The information about it is capable of making a difference in user decisions.
 - *Reliability.* The information is representationally faithful, verifiable, and neutral.
- Items currently reported in the financial statements are measured by different attributes (for example, historical cost, current [replacement] cost, current market value, net realizable value, and present value of future cash flows), depending on the nature of the item and the relevance and reliability of the attribute measured. The Board expects use of different attributes to continue.
- The monetary unit or measurement scale in current practice in financial statements is nominal units of money, that is, unadjusted for changes in purchasing power of money over time. The Board expects that nominal units of money will continue to be used to measure items recognized in financial statements.
- Further guidance in applying the criteria for recognizing components of earnings is necessary because of the widely acknowledged importance of earnings as a primary measure of entity performance. Guidance for recognizing components of earnings is concerned with identifying which cycles are substantially complete and with associating particular revenues, gains, expenses, and losses with those cycles.
- In assessing the prospect that as yet uncompleted transactions will be concluded successfully, a degree of skepticism is often warranted. As a reaction to uncertainty, more stringent requirements have historically been imposed for recognizing revenues and gains as components of earnings than for recognizing expenses and losses. Those conservative reactions influence the guidance for applying the recognition criteria to components of earnings.
- Guidance for recognizing revenues and gains is based on their being:

- *Realized or realizable.* Revenues and gains are generally not recognized as components of earnings until realized or realizable and
- *Earned.* Revenues are not recognized until earned. Revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. For gains, being earned is generally less significant than being realized or realizable.
- Guidance for expenses and losses is intended to recognize:
 - *Consumption of benefit.* Expenses are generally recognized when an entity's economic benefits are consumed in revenue-earning activities or otherwise or
 - *Loss or lack of benefit.* Expenses or losses are recognized if it becomes evident that previously recognized future economic benefits of assets have been reduced or eliminated, or that liabilities have been incurred or increased, without associated economic benefits.
- In a limited number of situations, the Board may determine that the most useful information results from recognizing the effects of certain events in comprehensive income but not in earnings, and set standards accordingly. Certain changes in net assets that meet the fundamental recognition criteria may qualify for recognition in comprehensive income even though they do not qualify for recognition as components of earnings.
- Information based on current prices should be recognized if it is sufficiently relevant and reliable to justify the costs involved and more relevant than alternative information.
- Most aspects of current practice are consistent with the recognition criteria and guidance in this Statement, but the criteria and guidance do not foreclose the possibility of future changes in practice. When evidence indicates that information that is more useful (relevant and reliable) than information currently reported is available at a justifiable cost, it should be included in financial statements.

Statement of Financial Accounting Concepts No. 5

Recognition and Measurement in Financial Statements of Business Enterprises

December 1984

INTRODUCTION, SCOPE, AND LIMITATIONS

1. This Statement sets forth fundamental recognition criteria and guidance on what information should be formally incorporated into financial statements and when. It builds on the foundation laid by earlier concepts Statements, bringing those concepts together to apply them to broad recognition issues. As a basis for considering recognition criteria, the Statement first addresses financial statements that should be presented and how those financial statements contribute to the objectives of financial reporting. Both that discussion and the later discussion of recognition give particular attention to statements of earnings and comprehensive income.

2. The recognition criteria and guidance in this Statement are generally consistent with current practice and do not imply radical change. Nor do they foreclose the possibility of future changes in practice. The Board intends future change to occur in the gradual, evolutionary way that has characterized past change.

3. This Statement also addresses certain measurement issues that are closely related to recognition. Measurement involves choice of an attribute by which to quantify a recognized item and choice of a scale of measurement (often called "unit of measure"). The Statement notes that different attributes are currently used to measure different items in financial statements and that the Board expects the use of different attributes to continue. The Statement further notes that the measurement scale in current practice is nominal units of money (that is, unadjusted for changes in purchasing power over time) and that the Board expects use of nominal units to continue.

4. This Statement is not intended to apply to organizations other than business enterprises. Recognition criteria and guidance on what information should be formally incorporated into financial statements of nonbusiness organizations can be considered only after completion of another Board project that concerns significant underlying concepts upon which recognition criteria and guidance are built. The Board issued its Exposure Draft, *Proposed Amendments to FASB Concepts Statements 2 and 3 to Apply Them to Nonbusiness Organizations*, on July 7, 1983 and held public hearings on that matter on November 14 and 15, 1983. Since that project is still in progress, all references in this Statement are to the original Statements, FASB Concepts Statements No. 2, *Qualitative Characteristics of Accounting Information*, and No. 3, *Elements of Financial Statements of Business Enterprises*.

FINANCIAL STATEMENTS

Financial Statements, Financial Reporting, and Recognition

5. Financial statements are a central feature of financial reporting—a principal means of communicating financial information to those outside an entity. In external general purpose financial reporting, a financial statement is a formal tabulation of names and amounts of money derived from accounting records that displays either financial position of an entity at a moment in time or one or more kinds of changes in financial position of the entity during a period of time. Items that are recognized in financial statements are financial representations of certain resources (assets) of an entity, claims to those resources (liabilities and owners' equity), and the effects of transactions and other events and circumstances that result in changes in those resources and claims. The financial statements of an entity are a fundamentally related set that articulate with each other and derive from the same underlying data.¹

6. Recognition is the process of formally recording or incorporating an item into the financial statements of an entity as an asset, liability, revenue, expense, or the like. Recognition includes depiction of an item in both words and numbers, with the amount included in the totals of the financial statements. For an asset or liability, recognition involves recording not only acquisition or incurrence of the item but also later changes in it, including changes that result in removal from the financial statements.²

7. Although financial statements have essentially the same objectives as financial reporting, some useful information is better provided by financial statements and some is better provided, or can only be provided, by notes to financial statements or by supplementary information or other means of financial reporting.³

- a. Information disclosed in notes or parenthetically on the face of financial statements, such as significant accounting policies or alternative measures for assets or liabilities, amplifies or explains information

¹FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, pars. 6 and 18; Concepts Statement 3, pars. 6 and 14 and 15. *Financial position* and *changes in financial position* are used here in a broad sense and do not refer to specific financial statements. "Used broadly, financial position refers to state or status of assets or claims to assets at moments in time, and changes in financial position refers to flows or changes in assets or claims to assets over time" (Concepts Statement 3, par. 14, footnote 6). "Through the financial accounting process, the myriad and complex effects of the economic activities of an enterprise are accumulated, analyzed, quantified, classified, recorded, summarized, and reported as information of two basic types: (1) financial position, which relates to a point in time, and (2) changes in financial position, which relate to a period of time" (APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, par. 10).

²Concepts Statement 3, pars. 83, 6, 25, 26, and 34 and 35.

³Concepts Statement 1, par. 5.

recognized in the financial statements.⁴ That sort of information is essential to understanding the information recognized in financial statements and has long been viewed as an integral part of financial statements prepared in accordance with generally accepted accounting principles.

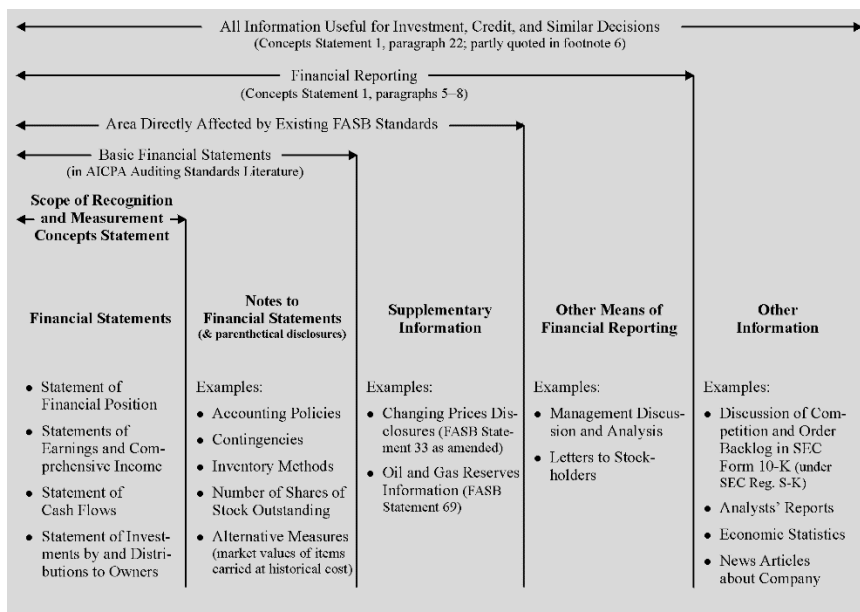
- b. Supplementary information, such as disclosures of the effects of changing prices, and other means of financial reporting, such as management discussion and analysis, add information to that in the financial statements or notes, including information that may be relevant but that does not meet all recognition criteria.⁵

8. The scope of this concepts Statement is limited to recognition (and measurement) in financial statements. That limitation on scope does not alter the status of notes, supplementary information, or other means of financial reporting; those types of information remain important and useful for the reasons discussed in the preceding paragraph. To clarify the scope of this concepts Statement, the diagram on page 32 illustrates the types of information used in investment, credit, and similar decisions. Since recognition means depiction of an item in both words and numbers, with the amount included in the totals of the financial statements, disclosure by other means is *not* recognition.

9. Disclosure of information about the items in financial statements and their measures that may be provided by notes or parenthetically on the face of financial statements, by supplementary information, or by other means of financial reporting is not a substitute for recognition in financial statements for items that meet recognition criteria. Generally, the most useful information about assets, liabilities, revenues, expenses, and other items of financial statements and their measures (that with the best combination of relevance and reliability) should be recognized in the financial statements.

⁴For example, notes provide essential descriptive information for long-term obligations, including when amounts are due, what interest they bear, and whether important restrictions are imposed by related covenants. For inventory, the notes provide information on the measurement method used—FIFO cost, LIFO cost, current market value, etc. For an estimated litigation liability, an extended discussion of the circumstances, counsel's opinions, and the basis for management's judgment may all be provided in the notes. For sales, useful information about revenue recognition policies may appear only in the notes (FASB Statement No. 47, *Disclosure of Long-Term Obligations*; ARB No. 43, Chapter 4, "Inventory Pricing," statement 8; FASB Statement No. 5, *Accounting for Contingencies*, par. 10; and APB Statement 4, par. 199).

⁵Concepts Statement 1, pars. 6, 7, and 22. Supplementary financial statements, complete or partial, may be useful, especially to introduce and to gain experience with new kinds of information. Criteria for including information in supplementary statements may have much in common with recognition criteria for primary statements discussed here, but the criteria discussed in this Statement apply specifically to primary financial statements.



Financial Statements and Objectives of Financial Reporting

10. FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, describes the broad purposes of financial reporting, including financial statements.⁶ Financial reporting should provide:

Information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions (paragraphs 34–36)

Information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise because their prospects for receiving cash from investments in, loans to, or other participation in the enterprise depend significantly on its cash flow prospects (paragraphs 37–39)

⁶Paragraphs 8–33 of Concepts Statement 1 give needed background. They describe factors affecting the objectives of general purpose external financial reporting, such as characteristics of the environment in the United States, characteristics and limitations of information provided, potential users and their interests, and the nature of the objectives. For example, “financial reporting is but one source of information needed by those who make economic decisions about business enterprises” (par. 22).

Information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change resources and claims to those resources (paragraph 40).

11. Concepts Statement 1 also gives guidance about the kinds of information that financial reporting, including financial statements, should provide:

Information about an enterprise's economic resources, obligations, and owners' equity (paragraph 41)

Information about an enterprise's performance provided by measures of earnings and comprehensive income⁷ and their components measured by accrual accounting (paragraphs 42–48)

Information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital (equity) transactions, including cash dividends and other distributions of enterprise resources to owners, and about other factors that may affect an enterprise's liquidity or solvency (paragraph 49)

Information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it (paragraphs 50–53).

12. A full, articulated set of several financial statements that provide those various kinds of information about an entity's financial position and changes in its financial position is necessary to satisfy the broad purposes of financial reporting.

Full Set of Financial Statements

13. The amount and variety of information that financial reporting should provide about an entity require several financial statements. A full set of financial statements for a period should show:

Financial position at the end of the period

Earnings (net income)⁸ for the period

Comprehensive income (total nonowner changes in equity)⁸ for the period

Cash flows during the period

Investments by and distributions to owners during the period.

⁷Concepts Statement 3 used the term *comprehensive income* for the concept that was called *earnings* in Concepts Statement 1 and reserved the term *earnings* for possible use to designate a component part of comprehensive income (par. 1, footnote 1). Earnings, including its relationship to comprehensive income, is a major topic of this Statement.

⁸Pars. 33 and 40

Information about earnings, comprehensive income, cash flows, and transactions with owners have in common that they are different kinds of information about the effects of transactions and other events and circumstances that change assets and liabilities during a period.

14. This Statement does not consider details of displaying those different kinds of information and does not preclude the possibility that some entities might choose to combine some of that information in a single statement. In present practice, for example, a reconciliation of beginning and ending balances of retained earnings is sometimes appended to an income statement.

Purposes and Limitations of Financial Statements

General Purpose Financial Statements and Individual Users

15. General purpose financial statements, to which the objectives of financial reporting apply, are directed toward the common interest of various potential users in the ability of a business enterprise to generate favorable cash flows.⁹ General purpose financial statements are feasible only because groups of users of financial information have generally similar needs. But “general purpose” does not mean “all purpose,” and financial statements do not necessarily satisfy all users equally well.

16. Each decision maker judges what accounting information is useful, and that judgment is influenced by factors such as the decisions to be made, the methods of decision making to be used, the information already possessed or obtainable from other sources, and the decision maker’s capacity (alone or with professional help) to process the information. Even users of financial statement information who make generally similar kinds of decisions differ from each other in those matters.¹⁰

Usefulness of Financial Statements, Individually and Collectively

17. Financial statements of an entity individually and collectively contribute to meeting the objectives of financial reporting. Component parts of financial statements also contribute to meeting the objectives.

18. Each financial statement provides a different kind of information, and, with limited exceptions (paragraph 14), the various kinds of information cannot be combined into a smaller number of statements without unduly complicating the information. Moreover, the information each provides is used for various purposes, and particular users may be especially interested in the information in one of the

⁹Concepts Statement 1, par. 30.

¹⁰Concepts Statement 2, pars. 23–26 and 32–41. For example, information cannot be useful to decision makers who cannot understand it, even though it may otherwise be relevant to a decision and be reliable. Understandability of information is related to the characteristics of the decision maker as well as to the characteristics of the information itself.

statements. Paragraphs 26–57 of this Statement summarize how individual financial statements provide the information listed in paragraph 13.

19. The following two sections first describe how classification and aggregation, if done and used with care, enhance the decision usefulness of financial statements and how financial statements complement each other.

Classification and Aggregation in Financial Statements

20. Classification in financial statements facilitates analysis by grouping items with essentially similar characteristics and separating items with essentially different characteristics. Analysis aimed at objectives such as predicting amounts, timing, and uncertainty of future cash flows requires financial information segregated into reasonably homogeneous groups. For example, components of financial statements that consist of items that have similar characteristics in one or more respects, such as continuity or recurrence, stability, risk, and reliability, are likely to have more predictive value than if their characteristics are dissimilar.

21. Financial statements result from processing vast masses of data and involve needs to simplify, to condense, and to aggregate.¹¹ Real things and events that affect a dynamic and complex business enterprise are represented in financial statements by words and numbers, which are necessarily highly simplified symbols of the real thing. Real transactions and other events are voluminous and are interpreted, combined, and condensed to be reflected in financial statements. Numerous items and components are aggregated into sums or totals. The resulting financial statements convey information that would be obscured from most users if great detail, such as descriptions of each transaction or event, were provided.

22. Although those simplifications, condensations, and aggregations are both necessary and useful, the Board believes it is important to avoid focusing attention almost exclusively on “the bottom line,” earnings per share, or other highly simplified condensations. Summary data, such as the amounts of net assets, comprehensive income, earnings, or earnings per share, may be useful as general indicators of the amount of investment or overall past performance and are often used in efforts to compare an entity with many other entities. But, in a complex business enterprise, summary amounts include many heterogeneous things and events. Components of a financial statement often reflect more homogeneous classes of items than the whole statement. The individual items, subtotals, or other parts of a financial statement may often be more useful than the aggregate to those who make investment, credit, and similar decisions.

¹¹“... It is a very fundamental principle indeed that knowledge is always gained by the *orderly* loss of information, that is, by condensing and abstracting and indexing the great buzzing confusion of information that comes from the world around us into a form which we can appreciate and comprehend” (Kenneth E. Boulding, *Economics as a Science* [New York: McGraw-Hill Book Company, 1970], p. 2, emphasis added).

Complementary Nature of Financial Statements

23. Financial statements interrelate (articulate) because they reflect different aspects of the same transactions or other events affecting an entity.¹² Although each presents information different from the others, none is likely to serve only a single purpose or provide all the financial statement information that is useful for a particular kind of assessment or decision. Significant tools of financial analysis, such as rates of return and turnover ratios, depend on interrelationships between financial statements and their components.

24. Financial statements complement each other. For example:

- a. Statements of financial position include information that is often used in assessing an entity's liquidity and financial flexibility,¹³ but a statement of financial position provides only an incomplete picture of either liquidity or financial flexibility unless it is used in conjunction with at least a cash flow statement.
- b. Statements of earnings and comprehensive income generally reflect a great deal about the profitability of an entity during a period, but that information can be interpreted most meaningfully or compared with that of the entity for other periods or that of other entities only if it is used in conjunction with a statement of financial position, for example, by computing rates of return on assets or equity.
- c. Statements of cash flows commonly show a great deal about an entity's current cash receipts and payments, but a cash flow statement provides an incomplete basis for assessing prospects for future cash flows because it cannot show interperiod relationships. Many current cash receipts, especially from operations, stem from activities of earlier periods, and many current cash payments are intended or expected to result in future, not current, cash receipts. Statements of earnings and comprehensive income, especially if used in conjunction with statements of financial position, usually provide a better basis for assessing future cash flow prospects of an entity than do cash flow statements alone.¹⁴
- d. Statements of investments by and distributions to owners provide information about significant sources of increases and decreases in assets, liabilities, and equity, but that information is of little practical value unless used in conjunction with other financial statements, for example, by comparing distributions to owners with earnings and comprehensive income or by comparing investments by and distributions to owners with borrowings and repayments of debt.

¹²Concepts Statement 3, pars. 14 and 15.

¹³Liquidity reflects an asset's or liability's nearness to cash. Financial flexibility is the ability of an entity to take effective actions to alter amounts and timing of cash flows so it can respond to unexpected needs and opportunities.

¹⁴Concepts Statement 1, pars. 42–46.

Individual Financial Statements

25. This discussion summarizes how individual financial statements provide the information listed in paragraph 13. It also introduces recognition considerations, which are the subject of the sections following.

Statement of Financial Position

26. A statement of financial position provides information about an entity's assets, liabilities, and equity and their relationships to each other at a moment in time. The statement delineates the entity's resource structure—major classes and amounts of assets—and its financing structure—major classes and amounts of liabilities and equity.

27. A statement of financial position does not purport to show the value of a business enterprise¹⁵ but, together with other financial statements and other information, should provide information that is useful to those who desire to make their own estimates of the enterprise's value. As a result of limitations stemming from uncertainty and cost-benefit considerations, not all assets and not all liabilities are included in a statement of financial position, and some assets and liabilities that are included are affected by events, such as price changes or accretion, that are not recognized. Statements of financial position also commonly use different attributes to measure different assets and liabilities.¹⁶

28. Uncertainty and related limitations of financial accounting put the burden of estimating values of business enterprises and of investments in them on investors, creditors, and others. Information about components of earnings and comprehensive income often plays a significant part in that analysis. For example, investors may use that information to help estimate "earning power," or other amounts that they perceive as representative of long-term earning ability of an enterprise, as a significant step in comparing the market price of an equity security with its "intrinsic value." Those estimates and analyses are part of financial analysis, not financial reporting,¹⁷ but financial accounting facilitates financial analysis by, among other things, classifying financial statement information in homogeneous groups.¹⁸

¹⁵Ibid., par. 41.

¹⁶The different attributes are defined and their current use illustrated in paragraphs 66-70 of this Statement.

¹⁷"... [A]ccrual accounting provides measures of earnings rather than evaluations of management's performance, estimates of 'earning power,' predictions of earnings, assessments of risk, or confirmations or rejections of predictions or assessments. Investors, creditors, and other users of the information do their own evaluating, estimating, predicting, assessing, confirming, or rejecting. For example, procedures such as averaging or normalizing reported earnings for several periods and ignoring or averaging out the financial effects of 'nonrepresentative' transactions and events are commonly used in estimating 'earning power.' However, both the concept of 'earning power' and the techniques for estimating it are part of financial analysis and are beyond the scope of financial reporting" (Concepts Statement 1, par. 48).

¹⁸Par. 20-22 of this Statement.

29. Important uses of information about an entity's financial position include helping users to assess factors such as the entity's liquidity, financial flexibility, profitability, and risk. Comparisons among entities and computations of rates of return are enhanced to the extent that significant asset and liability groupings are homogeneous in general characteristics and measurement.

Statements of Earnings and Comprehensive Income

30. Statements of earnings and comprehensive income together reflect the extent to which and the ways in which the equity of an entity increased or decreased from all sources other than transactions with owners during a period. Investors, creditors, managers, and others need information about the causes of changes in an entity's assets and liabilities—including results of its ongoing major or central operations, results of its incidental or peripheral transactions, and effects of other events and circumstances stemming from the environment that are often partly or wholly beyond the control of the entity and its management.

31. Effects of an entity's various activities, transactions, and events differ in stability, risk, and predictability, indicating a need for information about various components of earnings and comprehensive income. That need underlies the distinctions between revenues and gains, between expenses and losses, between various kinds of gains and losses, and between measures found in present practice such as income from continuing operations and net income.¹⁹

32. Since the parts of a financial statement may be more useful to decision makers than the whole (paragraphs 20–22), this Statement emphasizes usefulness of components, interrelationships, and different perspectives as well as usefulness, collectively and individually, of financial statements.

Earnings

33. The concept of earnings described in this Statement is similar to net income in present practice. It includes almost all of what is in present net income for a period, and a statement of earnings based on it will be much like a present income statement. Present practice accepts a variety of terms for net income, and the Board anticipates that net income, profit, net loss, and other equivalent terms will continue to be used in financial statements as names for earnings. However, earnings is not exactly the same as present net income, and this Statement uses the term *earnings* in part to distinguish the concept described here from present net income.

34. Earnings does not include the cumulative effect of certain accounting adjustments of earlier periods that are recognized in the current period.²⁰ The principal example that is included in present net income but excluded from earnings is the cumulative effect of a change in accounting principle, but others may be identified in the future. Earnings is a measure of performance for a period

¹⁹Concepts Statement 3, pars. 61 and 151.

²⁰That is, the cumulative effect on equity at the beginning of the period for which an earnings statement is provided, sometimes called a "catch-up adjustment."

and to the extent feasible excludes items that are extraneous to that period—items that belong primarily to other periods.²¹ The following condensed statements show the similarities and major existing difference between earnings and present net income.

	Present		Earnings
	<u>Net Income</u>		
Revenues	100		100
Expenses	80		80
Gain from unusual source	<u>(3)</u>		<u>(3)</u>
Income from continuing operations	23		23
Loss on discontinued operations			
Income from operating discontinued segment	10		10
Loss on disposal of discontinued segment	<u>12</u>	<u>2</u>	<u>12</u>
Income before extraordinary items			2
and effect of a change in accounting principle	21		21
Extraordinary loss	6		6
Cumulative effect on prior years of a change in accounting principle	<u>2</u>	<u>8</u>	
Earnings			<u>15</u>
Net Income	<u>13</u>		

35. The Board expects the concept of earnings to be subject to the process of gradual change or evolution that has characterized the development of net income. Present practice has developed over a long time, and that evolution has resulted in significant changes in what net income reflects, such as a shift toward what is commonly called an “all-inclusive” income statement. Those changes have resulted primarily from standard-setting bodies’ responses to several factors, such as changes in the business and economic environment and perceptions about the nature and limitations of financial statements, about the needs of users of financial statements, and about the need to prevent or cure perceived abuse(s) in financial reporting. Those factors sometimes may conflict or appear to conflict. For example, an all-inclusive income statement is intended, among other things, to avoid discretionary omissions of losses (or gains) from an income statement, thereby avoiding presentation of a more (or less) favorable report of performance or stewardship than is justified. However, because income statements also are used as a basis for estimating future performance and assessing future cash flow prospects, arguments have been advanced urging exclusion of unusual or nonrecurring gains and losses that might reduce the usefulness of an income statement for any one year for predictive purposes.

²¹Prior period adjustments as defined in FASB Statement No. 16, *Prior Period Adjustments*, are not included in net income in present practice and are not, therefore, differences between earnings in this Statement and present net income. Statement 16 narrowed considerably the definition of prior period adjustments in APB Opinions No. 9, *Reporting the Results of Operations*, and No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. Some items that were prior period adjustments under those Opinions are included in net income in present practice, and some argue that the existing definition is too narrow because as a result net income includes items that belong to other periods.

36. Earnings is a measure of performance during a period that is concerned primarily with the extent to which asset inflows associated with cash-to-cash cycles²² substantially completed (or completed) during the period exceed (or are less than) asset outflows associated, directly or indirectly, with the same cycles. Both an entity's ongoing major or central activities and its incidental or peripheral transactions involve a number of overlapping cash-to-cash cycles of different lengths. At any time, a significant proportion of those cycles is normally incomplete, and prospects for their successful completion and amounts of related revenues, expenses, gains, and losses vary in degree of uncertainty. Estimating those uncertain results of incomplete cycles is costly and involves risks, but the benefits of timely financial reporting based on sales or other more relevant events, rather than on cash receipts or other less relevant events, outweigh those costs and risks.

37. Final results of incomplete cycles usually can be reliably measured at some point of substantial completion (for example, at the time of sale, usually meaning delivery) or sometimes earlier in the cycle (for example, as work proceeds on certain long-term, construction-type contracts), so it is usually not necessary to delay recognition until the point of full completion (for example, until after receivables have been collected and warranty obligations have been satisfied). Guidance for applying recognition criteria to components of earnings (paragraphs 78–87) helps define earnings by aiding in making those determinations.

38. Earnings focuses on what the entity has received or reasonably expects to receive for its output (revenues) and what it sacrifices to produce and distribute that output (expenses). Earnings also includes results of the entity's incidental or peripheral transactions and some effects of other events and circumstances stemming from the environment (gains and losses).²³

Comprehensive Income

39. Comprehensive income is a broad measure of the effects of transactions and other events on an entity, comprising all recognized changes in equity (net assets) of the entity during a period from transactions and other events and circumstances except those resulting from investments by owners and distributions to owners.²⁴

40. Just as a variety of terms are used for net income in present practice, the Board anticipates that total nonowner changes in equity, comprehensive loss, and

²²The patterns of cash-to-cash cycles vary by industry. "Descriptions of operations of business enterprises commonly describe a cycle that begins with cash outlays and ends with cash receipts. That description . . . generally fits manufacturing, merchandising, financial, and service enterprises whose operations comprise primarily activities such as acquiring goods and services, increasing their value by adding time, place, or form utility, selling them, and collecting the selling price. Cash receipts may precede cash payments, however, and commonly do in the operations of some service and financial enterprises" (Concepts Statement 1, par. 39, footnote 8).

²³Concepts Statement 3, paragraphs 50 and 63–73, defines revenues, expenses, gains, and losses.

²⁴*Ibid.*, pars. 50, 56–62, and 147–152.

other equivalent terms will be used in future financial statements as names for comprehensive income.

41. Components of comprehensive income other than those that are included in earnings present no recognition problems in addition to those involved in recognizing assets and liabilities, for which fundamental criteria are described later (paragraphs 58–77).

Relationships between Earnings and Comprehensive Income

42. Earnings and comprehensive income have the same broad components—revenues, expenses, gains, and losses—but are not the same because certain classes of gains and losses are included in comprehensive income but are excluded from earnings.²⁵ Those items fall into two classes that are illustrated by certain present practices:

- a. Effects of certain accounting adjustments of earlier periods that are recognized in the period, such as the principal example in present practice—cumulative effects of changes in accounting principles—which are included in present net income but are excluded from earnings as set forth in this Statement (paragraphs 33 and 34)
- b. Certain other changes in net assets (principally certain holding gains and losses) that are recognized in the period, such as some changes in market values of investments in marketable equity securities classified as noncurrent assets, some changes in market values of investments in industries having specialized accounting practices for marketable securities, and foreign currency translation adjustments.²⁶

Both classes and the items they comprise are subject to evolutionary change (paragraph 35).

43. Differences between earnings and comprehensive income require some distinguishing terms. The items in both classes described in paragraph 42 are gains and losses under the definitions in Concepts Statement 3 (paragraphs 67–73), but to refer to *some* gains and losses that are included in earnings and *other* gains and losses that are included in comprehensive income but are excluded from earnings is not only clumsy but also likely to be confusing. This Statement

²⁵That possibility was noted in Concepts Statement 3: “. . . the reason for using *comprehensive income* rather than *earnings* in this Statement is that the Board has decided to reserve *earnings* for possible use to designate a different concept that is a component part of—that is, is narrower than or less than—comprehensive income. . . .” (par. 58, footnote reference omitted).

²⁶FASB Statements No. 12, *Accounting for Certain Marketable Securities*; No. 60, *Accounting and Reporting by Insurance Enterprises*; and No. 52, *Foreign Currency Translation*. Changes in market values of marketable securities are included in earnings by some other entities having specialized accounting practices for marketable securities (for example, securities brokers and dealers and investment companies) and for some classes of marketable securities (for example, securities held in trading accounts of banks and futures contracts that are considered speculative [FASB Statement No. 80, *Accounting for Futures Contracts*]).

therefore uses *gains* and *losses* for those included in earnings and uses *cumulative accounting adjustments* and *other nonowner changes in equity* for those excluded from earnings but included in comprehensive income.

44. The relationships between earnings and comprehensive income described in the foregoing paragraphs mean that statements of earnings and comprehensive income complement each other something like this:²⁷

+	Revenues	100	+	Earnings	15
–	Expenses	80	–	Cumulative accounting adjustments	2
+	Gains	3			
–	Losses	<u>8</u>	+	Other nonowner changes in equity	<u>1</u>
=	Earnings	<u>15</u>	=	Comprehensive income	<u>14</u>

Financial Capital Maintenance

45. The full set of articulated financial statements discussed in this Statement is based on the concept of financial capital maintenance.

46. An enterprise receives a return only after its capital has been maintained or recovered. The concept of capital maintenance, therefore, is critical in distinguishing an enterprise’s return *on* investment from return *of* its investment. Both investors and the enterprises in which they acquire an interest invest financial resources with the expectation that the investment will generate more financial resources than they invested.

47. A return on financial capital results only if the financial (money) amount of an enterprise’s net assets at the end of a period exceeds the financial amount of net assets at the beginning of the period after excluding the effects of transactions with owners. The financial capital concept is the traditional view and is the capital maintenance concept in present financial statements.²⁸ In contrast, a return on physical capital results only if the physical productive capacity of the enterprise at the end of the period (or the resources needed to achieve that capacity) exceeds the physical productive capacity at the beginning of the period, also after excluding the effects of transactions with owners. The physical capital maintenance concept can be implemented only if inventories and property, plant, and equipment (and perhaps other assets) are measured by their current costs, while the financial capital maintenance concept does not require measurement by a particular attribute.

²⁷Earnings and its components are the same as in the example in paragraph 34. Both *cumulative accounting adjustments* and *other nonowner changes in equity* may be either additions to or deductions from earnings. The signs used in the example are for illustration only.

²⁸Concepts Statement 3, par. 58. “Comprehensive income as defined in paragraph 56 is a return *on* financial capital” (Ibid.).

48. The principal difference between the two capital maintenance concepts involves the effects of price changes during a period on assets while held and liabilities while owed. Under the financial capital concept, if the effects of those price changes are recognized, they are conceptually holding gains and losses (though they are commonly reported under other names)²⁹ and are included in the return on capital. Under the physical capital concept, those changes would be recognized but conceptually would be capital maintenance adjustments that would be included directly in equity and not included in return on capital. Both earnings and comprehensive income as set forth in this Statement, like present net income, include holding gains and losses that would be excluded from income under a physical capital maintenance concept.

Recognition Implications of Earnings

49. Although recognition involves considerations of relevance and comparability, recognition criteria, conventions, and rules are primarily intended to increase reliability—they are means of coping with the uncertainty that surrounds business and economic activities. Uncertainty in business and economic affairs is a continuum, ranging from mere lack of absolute sureness to a degree of vagueness that precludes anything other than guesswork. Since uncertainty surrounds an entity's incomplete cash-to-cash cycles in varying degrees, measuring progress reliably involves determining whether uncertainty about future cash flows has been reduced to an acceptable level.

50. In response to uncertainty, there has been a general tendency to emphasize purchase and sale transactions and to apply conservative procedures in accounting recognition. Perceptions about characteristics such as realizability and volatility may also help to explain why some events are recognized in present practice while others are not. For example, revenues are sometimes recognized before sale if readily realizable (if sale is a more-or-less effortless or perfunctory activity, and uncertainty about amounts involved is reduced to an acceptable level by quoted prices for interchangeable units in active markets or other reliable measures).³⁰ Those characteristics may also help to explain certain special recognition rules. For example, so-called translation adjustments from translating foreign currency financial statements are excluded from net income but are reported separately in comprehensive income (paragraphs 39 and 42) because they are considered not only unrealized but also unrealizable short of sale or liquidation of the investment in the entity. Effects of exchange rate changes on the net investment are considered too uncertain and remote to be included in operating results.³¹ Similarly, a reason commonly given for the same treatment for certain changes in market values of investments in marketable equity securities is that they may be temporary, and temporary fluctuations in market values of long-term investments should not be included in net income.³²

²⁹For example, under the FIFO method in present practice, gains from price increases on inventory while held reduce cost of goods sold.

³⁰ARB No. 43, Chapter 4, par. 16; FASB Statement 12, pars. 14–16, 27, and 28.

³¹Statement 52, pars. 111–113.

³²Statement 12, pars. 21, 29, and 30.

51. Since earnings in this Statement is similar to net income for a period in present practice, criteria and guidance given in the Statement for recognizing components of earnings (paragraphs 58–87) are generally similar to revenue and expense recognition criteria or rules in present practice. Future standards may change what is recognized as components of earnings (paragraph 35). Moreover, because of the differences between earnings and comprehensive income, future standards also may recognize certain changes in net assets as components of comprehensive income but not as components of earnings.³³

Statement of Cash Flows

52. A statement of cash flows directly or indirectly reflects an entity's cash receipts classified by major sources and its cash payments classified by major uses during a period. It provides useful information about an entity's activities in generating cash through operations to repay debt, distribute dividends, or reinvest to maintain or expand operating capacity; about its financing activities, both debt and equity; and about its investing or spending of cash. Important uses of information about an entity's current cash receipts and payments include helping to assess factors such as the entity's liquidity, financial flexibility, profitability, and risk.

53. Since neither earnings nor comprehensive income measured by accrual accounting is the same as cash flow from operations, cash flow statements provide significant information about amounts, causes, and intervals of time between earnings and comprehensive income and cash receipts and outlays. Users commonly consider that information in assessing the relationship between earnings or comprehensive income and associated cash flows.

54. Statements of cash flows present few recognition problems because all cash receipts and payments are recognized when they occur. Reporting cash flows involves no estimates or allocations and few judgments except regarding classification in cash flow statements.³⁴

Statement of Investments by and Distributions to Owners

55. A statement of investments by and distributions to owners reflects the extent to which and in what ways the equity of an entity increased or decreased from transactions with owners as owners³⁵ during a period. That is, it reflects the capital

³³A possibility that has been suggested is the "inventory profits" that would result if cost of goods sold were reported on LIFO while inventories were reported on FIFO.

³⁴Determinations about the particular items to be reported within cash flow statements and the form of those statements are matters that may be developed further in Statements of Financial Accounting Standards or in practice.

³⁵Rather than as its employees, suppliers, customers, lenders, or the like (Concepts Statement 3, par. 44); that Statement defines investments by and distributions to owners in paragraphs 52–55.

transactions³⁶ of the entity, in contrast to its income transactions—those with nonowners—which are reflected in statements of earnings and comprehensive income. Statements of comprehensive income and statements of transactions with owners together include all changes in equity (net assets) recognized during a period.

56. Investments by owners establish or increase ownership interests in the entity and may be received in the form of cash, goods or services, or satisfaction or conversion of the entity's liabilities. Distributions decrease ownership interests and include not only cash dividends when declared (or other cash withdrawals by owners of noncorporate entities) but also transactions such as reacquisitions of the entity's equity securities and distributions "in kind" of noncash assets. Information about those events is useful, in conjunction with other financial statement information, to investors, creditors, and other users as an aid in assessing factors such as the entity's financial flexibility, profitability, and risk.

57. Transactions with owners are now normally recognized when they occur. Recognition problems concerning them can be difficult; for example, problems sometimes arise in distinguishing transactions with owners from transactions with certain creditors, and investments and dividends in kind may present measurement problems.³⁷ However, the recognition implications of earnings that lead to special guidance do not apply to transactions with owners, and that sort of special guidance is not needed for them.

RECOGNITION CRITERIA

58. As noted in paragraphs 6–9, recognition is the process of formally recording or incorporating an item into the financial statements of an entity as an asset, liability, revenue, expense, or the like. A recognized item is depicted in both words and numbers, with the amount included in the statement totals. Recognition comprehends both initial recognition of an item and recognition of subsequent changes in or removal of a previously recognized item.

Purposes of Criteria

59. Criteria are set forth in this Statement to provide direction for resolving issues that involve accounting recognition. An entity's assets and liabilities and the effects

³⁶Capital transactions are transactions with owners that affect ownership interests (equity) in an entity:

Although *capital* is not a precise term in referring to ownership interests because it is also applied to assets and liabilities in various ways, it is used in this discussion because *capital* is part of so many terms commonly used to describe aspects of ownership interests; for example, investments by owners are commonly called capital contributions, distributions to owners are commonly called capital distributions, and discussions of comprehensive income and its components often refer to capital maintenance. [Concepts Statement 3, par. 144]

³⁷Concepts Statement 3, par. 49, and APB Opinion No. 29, *Accounting for Nonmonetary Transactions*.

of events on them and on its equity are candidates for recognition in its financial statements.

60. Some events that affect assets, liabilities, or equity are not recognized in financial statements at the time they occur. Some events that result in future benefits, for example, creation of product awareness by advertising and promotion, may perhaps never be recognized as separate assets. Other events, for example, a disaster loss of unknown dimension, are recognized only when sufficient information about the effects of the event has become available at a justifiable cost to reduce uncertainty to an acceptable level. Recognition criteria aid in making those determinations.

Structure of Recognition Criteria

61. The recognition criteria in this Statement are derived from the qualitative characteristics of financial information in Concepts Statement 2 and are helpful in making the definitions of elements of financial statements in Concepts Statement 3 operational in resolving financial reporting issues.

62. The fundamental criteria apply to all recognition decisions. Further guidance is provided in paragraphs 78–87 for applying the fundamental criteria to components of earnings.

Fundamental Recognition Criteria

63. An item and information about it should meet four fundamental recognition criteria to be recognized and should be recognized when the criteria are met, subject to a cost-benefit constraint and a materiality threshold. Those criteria are:

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

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

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

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

All four criteria are subject to a pervasive cost-benefit constraint: the expected benefits from recognizing a particular item should justify perceived costs of providing and using the information.³⁸ Recognition is also subject to a materiality threshold: an item and information about it need not be recognized in a set of financial statements if the item is not large enough to be material and the aggregate

³⁸Concepts Statement 2, pars. 32 and 33 and 133–144.

of individually immaterial items is not large enough to be material to those financial statements.³⁹

Definitions

64. The definitions are those in FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*.⁴⁰ To be recognized in financial statements, a resource must meet the definition of an asset, and an obligation must meet the definition of a liability. A change in equity must meet the definition of a revenue, expense, gain, or loss to be recognized as a component of comprehensive income.⁴¹

Measurability

65. The asset, liability, or change in equity must have a relevant attribute⁴² that can be quantified in monetary units with sufficient reliability. Measurability must be considered together with both relevance and reliability.

Measurement Attributes

66. Items currently reported in financial statements are measured by different attributes, depending on the nature of the item and the relevance and reliability of the attribute measured. The Board expects the use of different attributes to continue.

67. Five different attributes of assets (and liabilities) are used in present practice:

- a. *Historical cost (historical proceeds)*. Property, plant, and equipment and most inventories are reported at their historical cost, which is the amount of cash, or its equivalent, paid to acquire an asset, commonly adjusted after acquisition for amortization or other allocations. Liabilities that involve obligations to provide goods or services to customers are generally reported at historical proceeds, which is the amount of cash, or

³⁹“Individual judgments are required to assess materiality. . . . The essence of the materiality concept is clear. The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item” (Concepts Statement 2, par. 132).

⁴⁰Concepts Statement 3 does not define elements of cash flow statements but notes classes of items that may be called elements of financial statements, for example, cash provided by operations, cash provided by borrowing, cash provided by issuing equity securities, and so forth (par. 4). However, all items in cash flow statements involve cash receipts or payments, which for recognition purposes are covered by the definitions in that Statement.

⁴¹As already noted (pars. 42 and 43), the items called *cumulative accounting adjustments* and *other nonowner changes in equity* are gains and losses under the definitions in Concepts Statement 3.

⁴²*Attribute* “refers to the traits or aspects of an element to be quantified or measured, such as historical cost/historical proceeds, current cost/current proceeds, etc. Attribute is a narrower concept than measurement, which includes not only identifying the attribute to be measured but also selecting a scale of measurement (for example, units of money or units of constant purchasing power)” (Concepts Statement 1, par. 2, footnote 2).

its equivalent, received when the obligation was incurred and may be adjusted after acquisition for amortization or other allocations.

- b. *Current cost.* Some inventories are reported at their current (replacement) cost, which is the amount of cash, or its equivalent, that would have to be paid if the same or an equivalent asset were acquired currently.
- c. *Current market value.* Some investments in marketable securities are reported at their current market value, which is the amount of cash, or its equivalent, that could be obtained by selling an asset in orderly liquidation. Current market value is also generally used for assets expected to be sold at prices lower than previous carrying amounts. Some liabilities that involve marketable commodities and securities, for example, the obligations of writers of options or sellers of common shares who do not own the underlying commodities or securities, are reported at current market value.
- d. *Net realizable (settlement) value.* Short-term receivables and some inventories are reported at their net realizable value, which is the nondiscounted amount of cash, or its equivalent, into which an asset is expected to be converted in due course of business less direct costs, if any, necessary to make that conversion. Liabilities that involve known or estimated amounts of money payable at unknown future dates, for example, trade payables or warranty obligations, generally are reported at their net settlement value, which is the nondiscounted amounts of cash, or its equivalent, expected to be paid to liquidate an obligation in the due course of business, including direct costs, if any, necessary to make that payment.
- e. *Present (or discounted) value of future cash flows.* Long-term receivables are reported at their present value (discounted at the implicit or historical rate), which is the present or discounted value of future cash inflows into which an asset is expected to be converted in due course of business less present values of cash outflows necessary to obtain those inflows. Long-term payables are similarly reported at their present value (discounted at the implicit or historical rate), which is the present or discounted value of future cash outflows expected to be required to satisfy the liability in due course of business.

68. The different attributes often have the same amounts, particularly at initial recognition. As a result, there may be agreement about the appropriate amount for an item but disagreement about the attribute being used. Present financial statements frequently are characterized as being based on the historical cost (historical proceeds) attribute. That no doubt reflects the fact that, for most enterprises, a great many of the individual events recognized in financial statements are acquisitions of goods or services for cash or equivalent that are recorded at historical cost. Although the "historical cost system" description may be convenient and describes well present practice for some major classes of assets (most inventories, property, plant, and equipment, and intangibles), it describes less well present practice for a number of other classes of assets and liabilities—for example, trade receivables, notes payable, and warranty obligations.

69. “Historical exchange price” is more descriptive of the quantity most generally reflected in financial statements in present practice (and “transaction-based system” would be a better description of the present accounting model than “historical cost system”). Amounts initially recorded for trade receivables and long-term notes payable, for example, generally fit the historical exchange price description. But some assets are acquired, and some liabilities are incurred, without exchanges—for example, assets found or received as contributions and income tax or litigation liabilities. There is no historical exchange price in those situations, and some other attribute must be used. Moreover, carrying amounts of assets (liabilities) are frequently reduced (increased) from historical exchange price to a lower (higher) current cost, current market value, or net realizable value, even though no subsequent exchange of the assets held or liabilities owed has occurred. And some assets are carried at current market value, independent of historical exchange price.

70. Rather than attempt to characterize present practice as being based on a single attribute with numerous major exceptions for diverse reasons, this concepts Statement characterizes present practice as based on different attributes. Rather than attempt to select a single attribute and force changes in practice so that all classes of assets and liabilities use that attribute, this concepts Statement suggests that use of different attributes will continue, and discusses how the Board may select the appropriate attribute in particular cases.⁴³

Monetary Unit or Measurement Scale

71. The monetary unit or measurement scale in financial statements in current practice is nominal units of money, that is, unadjusted for changes in purchasing power of money over time. An ideal measurement scale would be one that is stable over time. At low rates of change in general purchasing power (inflation or deflation), nominal units of money are relatively stable. Also, preparation and use of financial statements is simpler with nominal units than with other units of measure, such as units of constant general purchasing power (used, for example, in supplementary disclosures of the effects of changing prices),⁴⁴ artificial monetary units (for example, the European Currency Unit or ECU), or units of a commodity (for example, ounces of gold). However, as rates of change in general purchasing power increase, financial statements expressed in nominal units of money become progressively less useful and less comparable.

72. The Board expects that nominal units of money will continue to be used to measure items recognized in financial statements. However, a change from present circumstances (for example, an increase in inflation to a level at which distortions became intolerable) might lead the Board to select another, more stable measurement scale.

⁴³This discussion of measurement attributes is based in part on the FASB Discussion Memorandum, *Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement* (December 2, 1976), paragraphs 388–574, which further describes and illustrates each of the attributes and remains a useful reference.

⁴⁴FASB Statement No. 33, *Financial Reporting and Changing Prices*, as amended.

Relevance

73. Relevance is a primary qualitative characteristic. To be relevant, information about an item must have feedback value or predictive value (or both) for users and must be timely.⁴⁵ Information is relevant if it has the capacity to make a difference in investors', creditors', or other users' decisions. To be recognized, the information conveyed by including an asset, liability, or change therein in the financial statements must be relevant.

74. The relevance of particular information about an item being considered for recognition cannot be determined in isolation. Relevance should be evaluated in the context of the principal objective of financial reporting: providing information that is useful in making rational investment, credit, and similar decisions.⁴⁶ Relevance should also be evaluated in the context of the full set of financial statements—with consideration of how recognition of a particular item contributes to the aggregate decision usefulness.

Reliability

75. Reliability is the other primary qualitative characteristic. To be reliable, information about an item must be representationally faithful, verifiable, and neutral.⁴⁷ To be reliable, information must be sufficiently faithful in its representation of the underlying resource, obligation, or effect of events and sufficiently free of error and bias to be useful to investors, creditors, and others in making decisions. To be recognized, information about the existence and amount of an asset, liability, or change therein must be reliable.

76. Reliability may affect the timing of recognition. The first available information about an event that may have resulted in an asset, liability, or change therein is sometimes too uncertain to be recognized: it may not yet be clear whether the effects of the event meet one or more of the definitions or whether they are measurable, and the cost of resolving those uncertainties may be excessive. Information about some items that meet a definition may never become sufficiently reliable at a justifiable cost to recognize the item. For other items, those uncertainties are reduced as time passes, and reliability is increased as additional information becomes available.

77. Unavailability or unreliability of information may delay recognition of an item, but waiting for virtually complete reliability or minimum cost may make the information so untimely that it loses its relevance. At some intermediate point, uncertainty may be reduced at a justifiable cost to a level tolerable in view of the perceived relevance of the information. If other criteria are also met, that is the appropriate point for recognition. Thus, recognition may sometimes involve a trade-off between relevance and reliability.

⁴⁵Concepts Statement 2, pars. 46–57.

⁴⁶Concepts Statement 1, pars. 34–40.

⁴⁷Concepts Statement 2, pars. 58–110.

GUIDANCE IN APPLYING CRITERIA TO COMPONENTS OF EARNINGS

78. This section discusses the need for and provides further guidance in applying the fundamental criteria in recognizing components of earnings. Changes in net assets are recognized as components of earnings if they qualify under the guidance in paragraphs 83–87. Certain changes in net assets (discussed in paragraphs 42–44 and 49–51) that meet the four fundamental recognition criteria just described may qualify for recognition in comprehensive income even though they do not qualify for recognition as components of earnings based on that guidance.

79. Further guidance in applying the recognition criteria to components of earnings is necessary because of the widely acknowledged importance of information about earnings and its components as a primary measure of performance for a period. The performance measured is that of the entity, not necessarily that of its management, and includes the recognized effects upon the entity of events and circumstances both within and beyond the control of the entity and its management.⁴⁸ The widely acknowledged importance of earnings information leads to guidance intended in part to provide more stringent requirements for recognizing components of earnings than for recognizing other changes in assets or liabilities.

80. As noted in paragraph 36, earnings measures the extent to which asset inflows (revenues and gains) associated with substantially completed cash-to-cash cycles exceed asset outflows (expenses and losses) associated, directly or indirectly, with the same cycles. Guidance for recognizing components of earnings is concerned with identifying which cycles are substantially complete and with associating particular revenues, gains, expenses, and losses with those cycles.

81. In assessing the prospect that as yet uncompleted transactions will be concluded successfully, a degree of skepticism is often warranted.⁴⁹ Moreover, as a reaction to uncertainty, more stringent requirements historically have been imposed for recognizing revenues and gains than for recognizing expenses and losses, and those conservative reactions influence the guidance for applying the recognition criteria to components of earnings.

82. The guidance stated here is intended to summarize key considerations in a form useful for guidance for future standard setting—guidance which also is consistent with the vast bulk of current practice. The following paragraphs provide guidance separately for recognition of revenues and gains and for expenses and losses as components of earnings.

⁴⁸“What happens to a business enterprise is usually so much a joint result of a complex interaction of many factors that neither accounting nor other statistical analysis can discern with reasonable accuracy the degree to which management, or any other factor, affected the joint result” (Concepts Statement 1, par. 53).

⁴⁹Concepts Statement 2, par. 97.

Revenues and Gains

83. Further guidance for recognition of revenues and gains is intended to provide an acceptable level of assurance of the existence and amounts of revenues and gains before they are recognized. Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved, and recognition involves consideration of two factors, (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration.

- a. *Realized or realizable.* Revenues and gains generally are not recognized until realized or realizable.⁵⁰ Revenues and gains are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash. Readily convertible assets have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.
- b. *Earned.* Revenues are not recognized until earned. An entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations,⁵¹ and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. Gains commonly result from transactions and other events that involve no "earning process," and for recognizing gains, being earned is generally less significant than being realized or realizable.

84. In recognizing revenues and gains:

- a. The two conditions (being realized or realizable and being earned) are usually met by the time product or merchandise is delivered or services are rendered to customers, and revenues from manufacturing and selling

⁵⁰The terms *realized* and *realizable* are used in the Board's conceptual framework in precise senses, focusing on conversion or convertibility of noncash assets into cash or claims to cash (Concepts Statement 3, par. 83). *Realized* has sometimes been used in a different, broader sense: for example, some have used that term to include *realizable* or to include certain conversions of noncash assets into other assets that are also not cash or claims to cash. APB Statement 4, paragraphs 148–153, used the term *realization* even more broadly as a synonym for *recognition*.

⁵¹"Most types of revenue are the joint result of many profit-directed activities of an enterprise and revenue is often described as being 'earned' gradually and continuously by the whole of enterprise activities. *Earning* in this sense is a technical term that refers to the activities that give rise to the revenue—purchasing, manufacturing, selling, rendering service, delivering goods, allowing other entities to use enterprise assets, the occurrence of an event specified in a contract, and so forth. All of the profit-directed activities of an enterprise that comprise the process by which revenue is earned may be called the *earning process*" (APB Statement 4, par. 149). Concepts Statement 3, paragraph 64, footnote 31, contains the same concept.

activities and gains and losses from sales of other assets are commonly recognized at time of sale (usually meaning delivery).⁵²

- b. If sale or cash receipt (or both) precedes production and delivery (for example, magazine subscriptions), revenues may be recognized as earned by production and delivery.
- c. If product is contracted for before production, revenues may be recognized by a percentage-of-completion method as earned—as production takes place—provided reasonable estimates of results at completion and reliable measures of progress are available.⁵³
- d. If services are rendered or rights to use assets extend continuously over time (for example, interest or rent), reliable measures based on contractual prices established in advance are commonly available, and revenues may be recognized as earned as time passes.
- e. If products or other assets are readily realizable because they are salable at reliably determinable prices without significant effort (for example, certain agricultural products, precious metals, and marketable securities), revenues and some gains or losses may be recognized at completion of production or when prices of the assets change. Paragraph 83(a) describes readily realizable (convertible) assets.
- f. If product, services, or other assets are exchanged for nonmonetary assets that are not readily convertible into cash, revenues or gains or losses may be recognized on the basis that they have been earned and the transaction is completed. Gains or losses may also be recognized if nonmonetary assets are received or distributed in nonreciprocal transactions. Recognition in both kinds of transactions depends on the provision that the fair values involved can be determined within reasonable limits.⁵⁴
- g. If collectibility of assets received for product, services, or other assets is doubtful, revenues and gains may be recognized on the basis of cash received.

Expenses and Losses

85. Further guidance for recognition of expenses and losses is intended to recognize consumption (using up) of economic benefits or occurrence or discovery of loss of future economic benefits during a period. Expenses and losses are generally recognized when an entity's economic benefits are used up in delivering or producing goods, rendering services, or other activities that constitute its

⁵²The requirement that revenue be earned before it is recorded “usually causes no problems because the earning process is usually complete or nearly complete by the time of [sale]” (APB Statement 4, par. 153).

⁵³If production is long in relation to reporting periods, such as for long-term, construction-type contracts, recognizing revenues as earned has often been deemed to result in information that is significantly more relevant and representationally faithful than information based on waiting for delivery, although at the sacrifice of some verifiability. (Concepts Statement 2, paragraphs 42–45, describes trade-offs of that kind.)

⁵⁴APB Opinion 29.

ongoing major or central operations or when previously recognized assets are expected to provide reduced or no further benefits.

Consumption of Benefits

86. Consumption of economic benefits during a period may be recognized either directly or by relating it to revenues recognized during the period:⁵⁵

- a. Some expenses, such as cost of goods sold, are matched with revenues—they are recognized upon recognition of revenues that result directly and jointly from the same transactions or other events as the expenses.
- b. Many expenses, such as selling and administrative salaries, are recognized during the period in which cash is spent or liabilities are incurred for goods and services that are used up either simultaneously with acquisition or soon after.
- c. Some expenses, such as depreciation and insurance, are allocated by systematic and rational procedures to the periods during which the related assets are expected to provide benefits.

Loss or Lack of Future Benefit

87. An expense or loss is recognized if it becomes evident that previously recognized future economic benefits of an asset have been reduced or eliminated, or that a liability has been incurred or increased, without associated economic benefits.

RECOGNITION OF CHANGES IN ASSETS AND LIABILITIES

88. Initial recognition of assets acquired and liabilities incurred generally involves measurement based on current exchange prices at the date of recognition. Once an asset or a liability is recognized, it continues to be measured at the amount initially recognized until an event that changes the asset or liability or its amount occurs and meets the recognition criteria.

89. Events that change assets and liabilities are of two types: (a) inflows (acquisitions of assets or incurrences of liabilities) and outflows (sale or other disposal or loss of assets and settlement or cancellation of liabilities) and (b) changes of amounts of assets while held or of liabilities while owed by the entity. The latter also are of two types: (i) changes in utility or substance and (ii) changes in price. Examples of changes in utility or substance that are recognized in current practice include use of assets in production, depreciation of assets used in administrative activities, and fire damage to assets.

90. Information based on current prices should be recognized if it is sufficiently relevant and reliable to justify the costs involved and more relevant than alternative information. The merits of recognizing changes in prices may be clear in certain

⁵⁵Concepts Statement 3, pars. 84–89.

cases, and, as already noted, some price changes are recognized in present practice. In other cases, the relative merits of information based on current prices and alternative information may be unclear or may be a matter of dispute. In considering the application of the fundamental recognition criteria, those relative merits must be evaluated in the light of the circumstances of each case.

SUMMARY

91. Most aspects of current practice are consistent with the recognition criteria and guidance in this Statement, but the criteria and guidance do not foreclose the possibility of future changes in practice. This Statement is intended to provide guidance for orderly change in accounting standards when needed. When evidence indicates that information about an item that is more useful (relevant and reliable) than information currently reported is available at a justifiable cost, it should be included in financial statements.

This Statement was adopted by the affirmative vote of six members of the Financial Accounting Standards Board. Mr. March dissented.

Mr. March dissents from this Statement because (a) it does not adopt measurement concepts oriented toward what he believes is the most useful single attribute for recognition purposes, the cash equivalent of recognized transactions reduced by subsequent impairments or loss of service value—instead it suggests selecting from several different attributes without providing sufficient guidance for the selection process; (b) it identifies all nonowner changes in assets and liabilities as comprehensive income and return on equity, thereby including in income, incorrectly in his view, capital inputs from nonowners, unrealized gains from price changes, amounts that should be deducted to maintain capital in real terms, and foreign currency translation adjustments; (c) it uses a concept of income that is fundamentally based on measurements of assets, liabilities, and changes in them, rather than adopting the Statement's concept of earnings as the definition of income; and (d) it fails to provide sufficient guidance for initial recognition and derecognition of assets and liabilities.

Mr. March would not, in general, recognize increases in prices of assets and decreases in prices of liabilities before they are realized. He believes present measurement practice can be characterized as largely using a single attribute, the cash equivalent of recognized transactions reduced by subsequent impairments or loss of service value, and that present practices that recognize revenues or gains from changes in prices before realization, such as the uses of current market values and net realizable values cited in paragraphs 67(c) and (d) and 69, are exceptions to the general use of that single attribute. Mr. March is concerned that the guidance in paragraph 90 would permit, and perhaps point toward, more recognition of changes in current prices before realization. He believes that income, recognition, and measurement concepts based largely on the single attribute that he proposes are most relevant to reporting capital committed, performance, and the investment and realization of resources.

Mr. March objects to comprehensive income, defined in Concepts Statement 3 and confirmed in this Statement, as a concept of income because it includes all

recognized changes (including price changes) in assets and liabilities other than investments by owners and distributions to owners. He would exclude from income, and include in the amount of capital to be maintained (in addition to transactions with owners), what he would consider to be direct capital inputs to the enterprise from nonowner sources. Those include governmental and other capital contributions or grants and capital arising in reorganizations, recapitalizations, and extinguishments or restatements of debt capital.

Mr. March would also require that income must first deduct a provision for maintenance of capital in real terms (adjusted for changes in purchasing power of money over time, paragraphs 71–72). He believes that is necessary to avoid reporting a return of capital as income. Complex implementation should not be necessary to provide for the erosion of capital caused by the effects of inflation on the unit of measure. A “rubber yardstick” is a poor measuring tool. Mr. March would also exclude from income foreign currency translation adjustments (excluded from earnings but included in comprehensive income by paragraph 42(b)), which he believes are analogous to provisions for maintenance of capital in real terms.

The description of earnings (paragraphs 33–38) and the guidance for applying recognition criteria to components of earnings (paragraphs 78–87) is consistent with Mr. March’s view that income should measure performance and that performance flows primarily from an entity’s fulfillment of the terms of its transactions with outside entities that result in revenues, other proceeds on resource dispositions (gains), costs (expenses) associated with those revenues and proceeds, and losses sustained. However, Mr. March believes that those concepts are fundamental and should be embodied in definitions of the elements of financial statements and in basic income recognition criteria rather than basing income on measurements of assets, liabilities, and changes in them.

Disregarding the foregoing objections, Mr. March believes this Statement offers insufficient guidance for the near-term future work of the Board. To be useful, it needs to be supplemented with more specific guidance for selecting measurement attributes for specific assets, liabilities, and transactions and for deciding when the criteria require recognition or derecognition of an asset or a liability.

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
Victor H. Brown
Raymond C. Lauer
John W. March
David Mosso
Robert T. Sprouse

Appendix

BACKGROUND INFORMATION

92. The Board's study of recognition and measurement concepts has spanned several years. The need to develop those concepts was identified early in the conceptual framework project, and the first FASB Concepts Statement, *Objectives of Financial Reporting by Business Enterprises*, listed them among several separate matters to be covered:

... Later Statements are expected to cover the elements of financial statements and their recognition, measurement, and display . . . , criteria for distinguishing information to be included in financial statements from that which should be provided by other means of financial reporting, and criteria for evaluating and selecting accounting information (qualitative characteristics). [paragraph 2].

93. During that period, three FASB Research Reports,⁵⁶ a Discussion Memorandum,⁵⁷ a concepts Statement,⁵⁸ and an Exposure Draft⁵⁹ have dealt in whole or in part with recognition and measurement matters, and the Board has discussed those matters extensively.

94. The once-separate projects on recognition and on measurement were combined, principally because in the Board's view certain recognition questions, which are among the most important to be dealt with, are so closely related to measurement issues that it is not productive to discuss them separately. For example, the question of whether the appropriate attribute to measure a particular item is a past exchange price or a current exchange price is not easily separable from the question of whether events such as price changes should be recognized.

95. The Board issued an Exposure Draft, *Recognition and Measurement in Financial Statements of Business Enterprises*, on December 30, 1983 and received 104 letters of comment on it.

96. The changes made to the Exposure Draft were largely in response to suggestions in those comment letters and are intended to improve the clarity and

⁵⁶*Recognition of Contractual Rights and Obligations: An Exploratory Study of Conceptual Issues*, by Yuji Ijiri, December 1980; *Survey of Present Practices in Recognizing Revenues, Expenses, Gains, and Losses*, by Henry R. Jaenicke, January 1981; and *Recognition in Financial Statements: Underlying Concepts and Practical Conventions*, by L. Todd Johnson and Reed K. Storey, July 1982.

⁵⁷FASB Discussion Memorandum, *Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement*, December 2, 1976, Part III.

⁵⁸FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*, pars. 16 and 17, 37–43, and 74–89.

⁵⁹FASB Exposure Draft, *Reporting Income, Cash Flows, and Financial Position of Business Enterprises*, November 1981, pars. 13–16 and elsewhere. This Statement supersedes that Exposure Draft.

organization of the ideas presented in the Exposure Draft. The Board believes that the substance of this Statement is not significantly changed from the Exposure Draft. Noteworthy changes made and changes suggested but not made are discussed below.

97. The discussion of financial statements, financial reporting, and recognition in paragraphs 5–12 has been expanded and reorganized in response to comments that the status of notes, supplementary information, and other means of financial reporting outside of financial statements (all of which are outside the scope of this concepts Statement) was unclear.

98. The term *full set* of financial statements has been used in paragraph 13 and elsewhere in response to comments that *complete set*, the term used in the Exposure Draft, implied that no further information beyond the listed financial statements was needed and to comments that *complete set* had been used in some standards in a different way.

99. A number of respondents inferred from the discussion of cash flow statements in the Exposure Draft that the Board had decided one or more specific issues about cash flow reporting. Those issues include the direct and indirect methods of presentation; whether or not “cash” should include equivalents to cash and, if so, what instruments qualify; whether or not the nonmonetary transactions currently reported in statements of changes in financial position should appear in cash flow statements; and the definitions of cash provided by (or used for) operations, financing activities, and investing activities. Those and other specific cash flow statement issues mentioned by respondents are beyond the scope of this concepts Statement. The discussion of the statement of cash flows was revised to emphasize that.

100. Many respondents criticized the term *comprehensive income* and some criticized the term *earnings* as unwarranted innovations likely to cause confusion and legal difficulties. Those terms are not new. They were first used in their present senses in Concepts Statement 3, in which the Board defined comprehensive income as an element of financial statements and reserved the term *earnings* for possible later use to designate a component part of comprehensive income. This Statement carries forward the concept of comprehensive income and describes a concept for earnings. The Board retained the idea of two separate measures both to reflect present practice for the items discussed in paragraph 42(b) and to allow for the possibility that future standards may recognize some items, for example, the cumulative accounting adjustments discussed in paragraph 42(a), in comprehensive income but not in earnings.

101. The Board explored the alternative terms for *comprehensive income* and *earnings* suggested by respondents, as well as other possibilities suggested by its staff, but concluded that the other terms had disadvantages greater than those attaching to the terms originally selected. The Statement was revised to indicate that the Board anticipates that, as with net income in present practice, a variety of terms will be used in future financial statements as names for earnings (for example, net income, profit, or net loss) and for comprehensive income (for example, total nonowner changes in equity or comprehensive loss).

102. Some respondents urged the Board to clarify the concept of earnings. The discussion in paragraphs 36–38, the table in paragraph 44, and footnote 26 have been rewritten to explain more fully what the Board intended.

103. The materiality threshold for recognition, implicit in the conceptual framework, has been made explicit in paragraph 63 at the suggestion of several respondents. Some respondents suggested that materiality and cost-benefit considerations should be fundamental recognition criteria. No change was made because the Board believes that, while those considerations affect the application of the criteria, they are different in character from the four fundamental recognition criteria.

104. Several respondents urged the Board to include the question of the monetary unit or measurement scale within the scope of the Statement. The Exposure Draft described present practice as using nominal units of money but left the unit of measure outside its scope. The Board clarified the matter by indicating in paragraph 72 that it expects that nominal units of money will continue to be used to measure items recognized in financial statements.

105. The discussion of measurement has been expanded, in response to the suggestions of several respondents, to explain and illustrate the different attributes more fully and to discuss why different attributes are needed to describe present practice and are expected to continue to be used to measure items in financial statements.

106. Some respondents expressed concern that the guidance in paragraph 84(e) (concerning circumstances under which revenue or gain may be recognized at completion of production or when prices of assets change) and the guidance in paragraph 87 (concerning recognition of losses when it becomes evident that assets have been reduced or eliminated or liabilities incurred or increased without associated benefits) meant significant change from present practice. Those paragraphs describe concepts that the Board believes underlie many current practices and standards, just as do the other parts of the guidance for recognition of components of earnings. They have been retained and clarified.

107. Several respondents urged the Board to address in this Statement certain specific recognition and measurement issues including definitive guidance for recognition of contracts that are fully executory (that is, contracts as to which neither party has as yet carried out any part of its obligations, which are generally not recognized in present practice) and selection of measurement attributes for particular assets and liabilities. Those issues have long been, and remain, unresolved on a general basis. As noted in the introductory statement to this and earlier concepts Statements (page 21), establishment of objectives and identification of fundamental concepts will not directly solve specific financial accounting and reporting problems. Rather, objectives give direction, and concepts are tools for solving problems.

108. The Board and others who use this Statement will be guided and aided by the concepts it sets forth, but judgments, based on the particular circumstances of each case, will continue to play a major role in solving problems of recognition and

measurement in financial statements. The Board believes that further development of recognition, measurement, and display matters will occur as the concepts are applied at the standards level.

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Appendix C: Amendments to the Conceptual Framework for Financial Reporting

Amendments to Chapter 8 of Concepts Statement 8

C1. Chapter 8 of this Concepts Statement is amended as described in paragraphs C2–C6. Added text is underlined, and deleted text is ~~struck out~~.

C2. Amend paragraph D2 as follows:

D2. There are limits to the information that can and should be provided in ~~a set of~~ general purpose financial ~~statements, including the notes~~reporting. Information that should be depicted in words and numbers on the face of financial statements is determined by the definitions of assets, liabilities, equity, revenues and expenses, gains and losses, and the related recognition, measurement, and presentation requirements.¹ This chapter explains what information should be considered for inclusion in notes. It first describes the purpose of notes and general limitations and then more directly addresses the nature of the content that Board members may consider.

[Footnote not shown because it is unchanged.]

C3. Amend paragraph D26 as follows:

[Reflects amendments made in Appendix B of Chapter 1.]

D26. The FASB establishes financial accounting and reporting standards for public and private companies and not-for-profit entities that follow generally accepted accounting principles (GAAP). Subsets of these entities might be required to include ~~general purpose~~ a full set of financial statements and notes in SEC filings or other regulatory reports. The Board attempts to avoid requiring information in notes that entities are otherwise required to provide, for example, in SEC filings or other regulatory reports. However, there may be valid reasons why the Board at times considers requiring disclosure of information in notes when an entity provides similar or identical information in other forms of communication. For example, some entities whose users would find the information useful may not be subject to the requirement to provide it in any other form of communication. Also, the form of communication in which the information is provided may not be required every period or may not be as timely as the financial statements and notes. Finally, the information provided in that other form of communication may not be as complete or subject to the same degree of scrutiny and verification as information in financial statements.

C4. Amend paragraph D32 as follows:

D32. The Board should consider the following potential adverse consequences when determining whether to require a particular disclosure:

- a. Legal harm. Some information, if disclosed, may subject the reporting entity to certain legal consequences. For example, disclosing certain information about the reporting entity's contract with a counterparty may cause the reporting entity to breach a confidentiality clause of the contract.
- b. Competitive harm. Various factors could cause competitive harm. For example, requiring an entity to disclose product pricing information may cause competitive harm to the reporting entity.
- c. Reputational harm. Some activities of an entity, if made known, could cause harm to the entity's reputation. For example, information about an entity's waste-disposal practice may cause users to reallocate resources away from the entity and not on the basis of the returns they expect.
- d. Other economic consequences that are not relevant to resource allocation decisions. While general purpose financial ~~statements~~ are reporting is intended for users to make resource allocation decisions, others may use certain information in notes to financial statements for purposes other than making those decisions. In some cases, the unintended use of that information may negatively affect the entity's ability to operate in its economic, legal, political, and social environments.

C5. Amend paragraph D72 as follows:

D72. The interim periods for which financial statements are prepared should be viewed primarily as an integral part of annual periods.¹² In addition, interim-period financial statements generally are not designed to be a full set ~~set~~ of ~~general purpose~~ financial statements as are annual financial statements primarily because of the increased timeliness of the information and the costs that would be incurred. Therefore, some of the information needed to understand interim-period financial statements must be obtained from the most recent set of annual financial statements.

[Footnote not shown because it is unchanged.]

C6. Amend paragraph D75 as follows:

D75. Interim-period financial statements generally are aggregated to a greater degree than a full set ~~set~~ of ~~general purpose~~ annual financial statements. Therefore, they are not necessarily as informative. If there are significant changes in financial position since the most recent annual

financial statements or significant differences in results of operations that are unclear from the line items, the changes or differences should be explained in notes.