Conceptual Framework for Financial Reporting

September 2024

FASB FINANCIAL ACCOUNTING STANDARDS BOARD®

Conceptual Framework for Financial Reporting

September 2024

Financial Accounting Standards Board

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Preface

This book includes Chapters 1 through 8 of FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting,* which are effective at the date of their publication. This book does not include FASB Concepts Statements No. 1 through 7, which were superseded upon completion of individual chapters within Concepts Statement 8.

Chapter 1, *The Objective of General Purpose Financial Reporting,* and Chapter 3, *Qualitative Characteristics of Useful Financial Information,* were developed jointly with the International Accounting Standards Board. This book is not an official version of Concepts Statement 8 and has been prepared primarily for those setting standards for financial reporting and those interested in researching financial reporting or standard setting. The official Concepts Statement 8 is available at www.fasb.org.

Concepts Statement 8 is not included in the *FASB Accounting Standards Codification*®. The status of FASB Concepts Statement 8 is explained in paragraph 105-10-05-3 of the Codification as follows:

> Accounting and financial reporting practices not included in the Codification are nonauthoritative. Sources of nonauthoritative accounting guidance and literature include, for example, the following:
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> a. Practices that are widely recognized and prevalent either generally or in the industry
> b. FASB Concepts Statements
> c. American Institute of Certified Public Accountants (AICPA) Issue Papers
> d. International Financial Reporting Standards of the International Accounting Standards Board
> e. Pronouncements of professional associations or regulatory agencies
> f. Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids
> g. Accounting textbooks, handbooks, and articles.
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> The appropriateness of other sources of accounting guidance depends on its relevance to particular circumstances, the specificity of the guidance, the general recognition of the issuer or author as an authority, and the extent of its use in practice.

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Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting*

The Conceptual Framework is intended to set forth fundamental concepts that will be the basis for development of financial accounting and reporting standards. The fundamentals are the underlying concepts of financial accounting—concepts that guide the selection of transactions and other 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 fundamental concepts that prescribes the nature, function, and limits of financial accounting and reporting and that is expected to lead to consistent standards. It is intended to serve the public interest by providing structure and direction to financial accounting and reporting to facilitate the provision of unbiased financial and related information. That information helps capital and other markets to function efficiently in allocating scarce resources in the economy and society. Establishment of objectives and identification of fundamental concepts will not directly solve financial accounting and reporting problems. Rather, objectives give direction, and concepts are tools for solving problems.

The Board itself is likely to be the most direct beneficiary of the guidance provided by this Concepts Statement. It 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 new standards also should enable those who are affected by or interested in generally accepted accounting principles (GAAP) to understand better the purposes, content, and characteristics of information provided by financial accounting and reporting. That knowledge is expected to enhance the usefulness of, and confidence in, financial accounting and reporting.

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

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

Because this Concepts Statement does not establish GAAP, it is not intended to invoke application of Rule 203 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).*

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

Accrual Accounting and Related Concepts

Items that qualify under the definitions of elements of financial statements and that meet criteria for recognition and, therefore would be measured, are accounted for and included in financial statements by using accrual accounting procedures. Accrual accounting and related concepts are significant for understanding and considering several aspects of the Conceptual Framework. The following paragraphs define or describe significant financial accounting and reporting concepts that are used in the Conceptual Framework.

Transactions, Events, and Circumstances

The Conceptual Framework uses the phrase *transactions and other events and circumstances affecting an entity* to describe the sources or causes of changes in assets, liabilities, and equity or net assets. An event is a happening of consequence to an entity. It may be an internal event that occurs within an entity, or it may be an external event that involves interaction between an entity and its environment, such as a transaction with another entity. A transaction is a particular

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*Rule 203 prohibits a member of the American Institute of Certified Public Accountants from expressing an opinion that financial statements conform with generally accepted accounting principles (GAAP) if those statements contain a material departure from an accounting principle promulgated by the Financial Accounting Standards Board, unless the member can demonstrate that because of unusual circumstances the financial statements otherwise would have been misleading.

kind of external event, namely, an external event involving a transfer of something of value between two (or more) entities. The transaction may be either an exchange in which each participant both receives and sacrifices value, such as purchases or sales of goods or services, or a nonreciprocal transfer in which an entity incurs a liability or transfers an asset to another entity (or receives an asset or cancellation of a liability) without directly receiving (or giving) value in exchange. Nonreciprocal transfers contrast with exchanges (which are reciprocal transfers) and include, for example, impositions of taxes, gifts, contributions given or received, and thefts.

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

Accrual Accounting

Accrual accounting attempts to record the financial effects on an entity of transactions and other events and circumstances in the periods in which those transactions, events, and circumstances occur. Accrual accounting thus provides information about an entity's assets and liabilities and changes in them that cannot be obtained by accounting for only cash receipts and outlays. Accrual accounting includes using accrual, deferral, and allocation procedures, the result of which is the recognition of revenues, expenses, gains, and losses in periods that depict an entity's performance during a period instead of merely listing its cash receipts and outlays. Thus, the recognition of revenues, expenses, gains, and losses dependent upon increments or decrements in assets and liabilities is the essence of using accrual accounting to measure the performance of entities.

Accrual, Deferral, and Allocation (Including Amortization)

Accrual is the accounting process of recognizing assets or liabilities and the related changes in revenues, expenses, gains, losses, or equity for amounts expected to be received or paid, usually in cash, in the future. Common examples of accruals include purchases and sales of goods or services on account and not-yet-paid interest, rent, wages and salaries, and taxes.

Deferral is concerned with past cash receipts and payments—and with prepayments received or paid; deferral is the accounting process of recognizing a liability resulting from a current cash receipt (or the equivalent) or an asset resulting from a current cash payment (or the equivalent) with deferred recognition of related revenues, expenses, gains, or losses. Recognition of those related elements is deferred until the obligation underlying the liability is partly or wholly satisfied or until the economic benefit underlying the asset is partly or wholly used or lost. Common examples of deferrals include prepaid expenses and customer deposits.

Allocation is the accounting process of assigning or distributing an amount according to a plan or a formula. Allocation includes amortization, which is the accounting process of reducing an amount by periodic payments or write-downs. Common examples of allocations include (a) assigning manufacturing costs to production departments or cost centers and to units of product to determine "product cost," (b) apportioning the cost of a "basket purchase" to the individual assets acquired on the basis of their relative market values, and (c) spreading the cost of an insurance policy or a building to two or more accounting periods. Expenses resulting from the use of assets are normally allocated to the periods of their estimated useful lives (the periods over which they are expected to provide benefits) by a "systematic and rational" allocation procedure. Other costs also are recognized as expenses in the period in which they are incurred because the period to which they otherwise relate is indeterminable or not worth the effort to determine.

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

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

In most entities, transactions or events occur that result in simultaneous recognition of revenue and one or more expenses that result directly and jointly from the same transactions or other events. For example, a sale of a product or merchandise involves revenues from the receipt of cash or a receivable and expense for the sacrifice of a product or merchandise sold to the customer. If all assets and liabilities are recorded from the transaction, recognition of revenues and expenses in the same period is achieved by applying the asset and liability definitions.

Many expenses, however, are not related directly to particular revenues but can be related to a period on the basis of transactions or events occurring in that period or by allocation. Some costs that cannot be related directly to particular revenues are incurred to obtain benefits that are exhausted in the period in which the costs are incurred.

Chapter 1, *The Objective of General Purpose Financial Reporting*
As Amended December 2021

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CHAPTER 1: THE OBJECTIVE OF GENERAL PURPOSE FINANCIAL REPORTING

Introduction

OB1. The objective of general purpose financial reporting forms the foundation of the Conceptual Framework. Other aspects of the Conceptual Framework—a reporting entity concept; the qualitative characteristics of, and the constraints on, useful financial information; elements of financial statements; recognition, measurement; presentation; and disclosure—flow logically from the objective.

Objective, Usefulness, and Limitations of General Purpose Financial Reporting

OB2. The objective of general purpose financial reporting[1] is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit.

OB3. Decisions by existing and potential investors about buying, selling, or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments; for example, dividends, principal and interest payments, or market price increases. Similarly, decisions by existing and potential lenders and other creditors about providing or settling loans and other forms of credit depend on the principal and interest payments or other returns that they expect. Investors', lenders', and other creditors' expectations about returns depend on their assessment of the amount, timing, and uncertainty of (the prospects for) future net cash inflows to the entity. Consequently, existing and potential investors, lenders, and other creditors need information to help them assess the prospects for future net cash inflows to an entity.

OB4. To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders, and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively

[1]Throughout this Conceptual Framework, the terms *financial reports* and *financial reporting* refer to *general purpose financial reports* and *general purpose financial reporting* unless specifically indicated otherwise.

the entity's management and governing board[2] have discharged their responsibilities to use the entity's resources. Examples of such responsibilities include protecting the entity's resources from unfavorable effects of economic factors such as price and technological changes and ensuring that the entity complies with applicable laws, regulations, and contractual provisions. Information about management's discharge of its responsibilities also is useful for decisions by existing investors, lenders, and other creditors who have the right to vote on or otherwise influence management's actions.

OB5. Many existing and potential investors, lenders, and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial reports are directed.

OB6. However, general purpose financial reports do not and cannot provide all of the information that existing and potential investors, lenders, and other creditors need. Those users need to consider pertinent information from other sources, for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks.

OB7. General purpose financial reports are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders, and other creditors to estimate the value of the reporting entity.

OB8. Individual primary users have different, and possibly conflicting, information needs and desires. The Board, in developing financial reporting standards, will seek to provide the information set that will meet the needs of the maximum number of primary users. However, focusing on common information needs does not prevent the reporting entity from including additional information that is most useful to a particular subset of primary users.

OB9. The management of a reporting entity also is interested in financial information about the entity. However, management need not rely on general purpose financial reports because it is able to obtain the financial information it needs internally.

OB10. Other parties, such as regulators and members of the public other than investors, lenders, and other creditors, also may find general purpose financial reports useful. However, those reports are not primarily directed to these other groups.

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[2]Throughout this Conceptual Framework, the term *management* refers to *management and the governing board of an entity* unless specifically indicated otherwise.

OB11. To a large extent, financial reports are based on estimates, judgments, and models rather than exact depictions. The Conceptual Framework establishes the concepts that underlie those estimates, judgments, and models. The concepts are the goal towards which the Board and preparers of financial reports strive. As with most goals, the Conceptual Framework's vision of ideal financial reporting is unlikely to be achieved in full, at least not in the short term, because it takes time to understand, accept, and implement new ways of analyzing transactions and other events. Nevertheless, establishing a goal towards which to strive is essential if financial reporting is to evolve so as to improve its usefulness.

Information about a Reporting Entity's Economic Resources, Claims, and Changes in Resources and Claims

OB12. General purpose financial reports provide information about the financial position of a reporting entity, which is information about the entity's economic resources and the claims against the reporting entity. Financial reports also provide information about the effects of transactions and other events that change a reporting entity's economic resources and claims. Both types of information provide useful input for decisions about providing resources to an entity.

Economic Resources and Claims

OB13. Information about the nature and amounts of a reporting entity's economic resources and claims can help users to identify the reporting entity's financial strengths and weaknesses. That information can help users to assess the reporting entity's liquidity and solvency, its needs for additional financing, and how successful it is likely to be in obtaining that financing. Information about priorities and payment requirements of existing claims helps users to predict how future cash flows will be distributed among those with a claim against the reporting entity.

OB14. Different types of economic resources affect a user's assessment of the reporting entity's prospects for future cash flows differently. Some future cash flows result directly from existing economic resources, such as accounts receivable. Other cash flows result from using several resources in combination to produce and market goods or services to customers. Although those cash flows cannot be identified with individual economic resources (or claims), users of financial reports need to know the nature and amount of the resources available for use in a reporting entity's operations.

Changes in Economic Resources and Claims

OB15. Changes in a reporting entity's economic resources and claims result from that entity's financial performance (see paragraphs OB17–OB20) and from other events or transactions, such as issuing debt or equity instruments (see paragraph OB21). To properly assess the prospects for future cash flows from the reporting entity, users need to be able to distinguish between both of these changes.

OB16. Information about a reporting entity's financial performance helps users to understand the return that the entity has produced on its economic resources. Information about the return the entity has produced provides an indication of how well management has discharged its responsibilities to make efficient and effective use of the reporting entity's resources. Information about the variability and components of that return also is important, especially in assessing the uncertainty of future cash flows. Information about a reporting entity's past financial performance and how its management discharged its responsibilities usually is helpful in predicting the entity's future returns on its economic resources.

Financial Performance Reflected by Accrual Accounting

OB17. Accrual accounting depicts the effects of transactions, and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. This is important because information about a reporting entity's economic resources and claims and changes in its economic resources and claims during a period provides a better basis for assessing the entity's past and future performance than information solely about cash receipts and payments during that period.

OB18. Information about a reporting entity's financial performance during a period, reflected by changes in its economic resources and claims other than by obtaining additional resources directly from investors and creditors (see paragraph OB21), is useful in assessing the entity's past and future ability to generate net cash inflows. That information indicates the extent to which the reporting entity has increased its available economic resources, and thus its capacity for generating net cash inflows through its operations rather than by obtaining additional resources directly from investors and creditors.

OB19. Information about a reporting entity's financial performance during a period also may indicate the extent to which events such as changes in market prices or interest rates have increased or decreased the entity's economic resources and claims, thereby affecting the entity's ability to generate net cash inflows.

Financial Performance Reflected by Past Cash Flows

OB20. Information about a reporting entity's cash flows during a period also helps users to assess the entity's ability to generate future net cash inflows. It indicates how the reporting entity obtains and spends cash, including information about its borrowing and repayment of debt, cash dividends or other cash distributions to investors, and other factors that may affect the entity's liquidity or solvency. Information about cash flows helps users understand a reporting entity's operations, evaluate its financing and investing activities, assess its liquidity or solvency, and interpret other information about financial performance.

Changes in Economic Resources and Claims Not Resulting from Financial Performance

OB21. A reporting entity's economic resources and claims also may change for reasons other than financial performance, such as issuing additional ownership shares. Information about this type of change is necessary to give users a complete understanding of why the reporting entity's economic resources and claims changed and the implications of those changes for its future financial performance.

Application of the Objective of General Purpose Financial Reporting to Not-for-Profit Entities[3]

OB22. The Board has concluded that it is not necessary to develop an independent conceptual framework for any particular category of nongovernmental entities (for example, not-for-profit entities or business enterprises). Rather, the Board's goal is to develop an integrated conceptual framework that has relevance to all entities and that provides appropriate consideration of any different reporting objectives and concepts that may apply to only certain types of entities. Consideration of the characteristics of not-for-profit entities set forth in paragraphs OB23–OB28 will be useful in helping to identify areas that may require unique treatment.

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[3]This guidance was incorporated into this chapter from the FASB Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*.

OB23. The major characteristics that distinguish a not-for-profit entity from a business enterprise typically include:

a. Receipts of significant amounts of resources from resource providers that do not expect to receive either repayment or economic benefits proportionate to resources provided
b. Operating purposes that are other than to provide goods or services at a profit or profit equivalent
c. Absence of defined ownership interests that can be sold, transferred, or redeemed or that convey entitlement to a share of a residual distribution of resources in the event of liquidation of the entity.

These distinguishing characteristics result in (a) certain types of transactions that are largely, although not entirely, absent in business enterprises, such as contributions and grants, and (b) the absence of transactions with owners, such as issuing and redeeming equity interests or paying dividends.

OB24. The degree to which not-for-profit entities possess the characteristics in paragraph OB23 varies significantly, ranging from entities with predominantly not-for-profit characteristics to entities with characteristics that are much closer overall to those of a business enterprise. Both not-for-profit entities and business enterprises obtain resources in exchange transactions in markets. Both obtain labor, materials, and facilities or their use by paying for them or agreeing to pay for them in the future. Both may borrow funds through bank loans, mortgages, or other direct loans or through issuing debt securities to creditors that commonly may evaluate and compare the risks and returns of securities of both not-for-profit entities and business enterprises. Financial reporting for not-for-profit entities should provide information to lenders and other creditors.

OB25. The objective of general purpose financial reporting for not-for-profit entities also includes providing useful financial information to other existing and potential resource providers, such as members, donors, and grantors, in making rational decisions about the allocation of resources to those entities. However, members, donors, and grantors that provide resources to not-for-profit entities do so for reasons different from those of owners of business enterprises. Many not-for-profit entities obtain significant resources from resource providers that either expect no economic benefits or expect benefits received not to be proportionate to the resources provided. Those resources are often provided for noneconomic reasons in furthering the purpose and goals of a not-for-profit entity, such as for charitable, cultural, educational, economic, humanitarian, political, religious, or social reasons.

OB26. Despite those different reasons, resource providers of all entities look to information about economic resources, obligations, net resources, and changes in them for information that is useful in assessing the amounts, timing, and uncertainty of the (prospects for) future net cash flows to the entity.

OB27. Resource providers focus on indicators of entity performance and information about management stewardship. For example, mandates such as restrictions imposed by donors on the use of provided resources give managers a special responsibility to ensure compliance. Information about the extent to which those mandates of a not-for-profit entity were fulfilled or departures from those mandates is important in assessing how well managers have discharged their stewardship responsibilities. In particular, members, donors, and grantors are interested in whether the activities of an entity are consistent with its stated objectives and their directives.

OB28. Existing and potential users of the information provided by financial reporting by a particular not-for-profit entity share a common interest in information about the services provided by the not-for-profit entity and its efficiency and effectiveness in providing those services as a basis for determining its ability to continue to provide those services. Resource providers, such as members, donors, and grantors, may be interested in that information as a basis for assessing how well an entity has met its objectives and whether to continue support. Information about an entity's service efforts in accomplishing its mission is useful in assessing the performance of a not-for-profit entity and in making resource allocation decisions.

This Concepts Statement was adopted by the unanimous vote of the five members of the Financial Accounting Standards Board:

Robert H. Herz, *Chairman*
Thomas J. Linsmeier
Leslie F. Seidman
Marc A. Siegel
Lawrence W. Smith

Paragraphs OB22–OB28 were incorporated from FASB Concepts Statement No. 4, which was adopted by members of the Financial Accounting Standards Board in 1980.

APPENDIX A: BASIS FOR CONCLUSIONS FOR CHAPTER 1

Introduction

BC1.1. This basis for conclusions summarizes considerations of the Financial Accounting Standards Board (the Board) in reaching the conclusions in Chapter 1, *The Objective of General Purpose Financial Reporting*. It includes reasons for accepting some alternatives and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC1.2. The Board developed this chapter jointly with the International Accounting Standards Board (IASB). Consequently, this basis for conclusions also includes some references to the IASB's literature.

Background

BC1.3. The Board began the process of developing the objective of financial reporting by reviewing its own framework and concepts as well as those of other standard setters. In July 2006, the Board published for public comment a Discussion Paper on this topic. That same paper also was published by the IASB. The Board and the IASB received 179 responses. In its redeliberations of the issues on this topic, the Board considered all of the comments received and information gained from other outreach initiatives. In May 2008, the Board and the IASB jointly published an Exposure Draft. The Boards received 142 responses. The Board reconsidered all of the issues. This document is the result of those reconsiderations.

General Purpose Financial Reporting

BC1.4. Consistent with the Board's responsibilities, the Conceptual Framework establishes an objective of financial reporting and not just of financial statements. Financial statements are a central part of financial reporting, and most of the issues that the Board addresses involve financial statements. Although the scope of FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, was financial reporting, the other FASB Concepts Statements focused on financial statements. The scope of the IASB's *Framework for the Preparation and Presentation of Financial Statements*, which was published by the IASB's predecessor body in 1989 (hereinafter called *Framework* (1989)), dealt with financial statements only. Therefore, for both Boards the scope of the Conceptual Framework is broader.

BC1.5. Some constituents suggested that advances in technology may make general purpose financial reporting obsolete. New technologies, for example the use of eXtensible Business Reporting Language (XBRL), may make it practicable in the future for reporting entities either to prepare or to make available the information necessary for different users to assemble different financial reports to meet their individual information needs.

BC1.6. To provide different reports for different users or to make available all of the information that users would need to assemble their own custom-designed reports would be expensive. Requiring users of financial information to assemble their own reports also might be unreasonable because many users would need to have a greater understanding of accounting than they have now. Therefore, the Board concluded for now that a general purpose financial report is still the most efficient and effective way to meet the information needs of a variety of users.

BC1.7. In the Discussion Paper, the Board used the term *general purpose external financial reporting*. *External* was intended to convey that internal users such as management were not the intended beneficiaries for general purpose financial reporting as established by the Board. During redeliberations, the Board concluded that this term was redundant. Therefore, this chapter uses *general purpose financial reporting*.

Financial Reporting of the Reporting Entity

BC1.8. Some respondents to the Exposure Draft said that the reporting entity is not separate from its equity investors or a subset of those equity investors. This view has its roots in the days when most businesses were sole proprietorships and partnerships that were managed by their owners who had unlimited liability for the debts incurred in the course of the business. Over time, the separation between businesses and their owners has grown. The vast majority of today's businesses have legal substance separate from their owners by virtue of their legal form of organization, numerous investors with limited legal liability, and professional managers separate from the owners. Consequently, the Board concluded that financial reports should reflect that separation by accounting for the entity (and its economic resources and claims) rather than its primary users and their interests in the reporting entity.

Primary Users

BC1.9. The objective of financial reporting set out in paragraph OB2 refers to existing and potential investors, lenders, and other creditors. The description of the primary users in paragraph OB5 refers to existing and potential investors, lenders, and other creditors who cannot require reporting entities to provide information directly to them. Paragraph OB10 states that "regulators and members of the public other than investors, lenders, and other creditors" may find information in general purpose financial reports useful but clearly states that those are not the parties to whom general purpose financial reports are primarily directed.

BC1.10. Paragraph 9 of the Framework (1989) stated that users included "present and potential investors, employees, lenders, suppliers and other trade creditors," (and later added advisers in the discussion of investors' needs) all of which are intended to be encompassed by the phrase in paragraph OB2. Paragraph 9 of the Framework (1989) also included a list of other potential users such as customers, governments and their agencies, and the public, which is similar to the list in paragraph OB10 of those who may be interested in financial reports but are not primary users.

BC1.11. Paragraph 10 of the *Framework* (1989) stated that "as investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy," which might have been read to narrow the focus to investors only. However, paragraph 12 explicitly stated that the objective of financial statements is to provide information "that is useful to a wide range of users in making economic decisions." Thus, the *Framework* (1989) focused on investors' needs as representative of the needs of a wide range of users but did not explicitly identify a group of primary users.

BC1.12. FASB Concepts Statement 1 referred to "present and potential investors and creditors and other users in making rational investment, credit, and similar decisions" (paragraph 34). It also stated that "major groups of investors are equity securityholders and debt securityholders" and "major groups of creditors are suppliers of goods and services who extend credit, customers and employees with claims, lending institutions, individual lenders, and debt securityholders" (paragraph 35). One difference in emphasis from the *Framework* (1989), which emphasized providers of risk capital, is that Concepts Statement 1 referred to "both those who desire safety of investment and those who are willing to accept risk to obtain high rates of return" (paragraph 35). However, like the *Framework* (1989), Concepts Statement 1 stated that the terms investors and creditors "also may comprehend security analysts and advisors, brokers, lawyers, regulatory agencies, and others who advise or represent the interests of investors and creditors or who otherwise are interested in how investors and creditors are faring" (paragraph 35).

BC1.13. Paragraphs OB3, OB5, and OB10 differ from the *Framework* (1989) and Concepts Statement 1 for two reasons—to eliminate differences between the

Framework (1989) and Concepts Statement 1 and to be more direct by focusing on users making decisions about providing resources (but not to exclude advisors). The reasons are discussed in paragraphs BC1.15–BC1.24.

Should There Be a Primary User Group?

BC1.14. The Discussion Paper and the Exposure Draft proposed identifying a group of primary users of financial reports. Some respondents to the Exposure Draft said that other users who have not provided and are not considering providing resources to the entity, use financial reports for a variety of reasons. The Board sympathized with their information needs but concluded that without a defined group of primary users, the Conceptual Framework would risk becoming unduly abstract or vague.

Why Are Existing and Potential Investors, Lenders, and Other Creditors Considered the Primary Users?

BC1.15. Some respondents to the Discussion Paper and the Exposure Draft suggested that the primary user group should be limited to existing shareholders or the controlling entity's majority shareholders. Others said that the primary users should be existing shareholders and creditors and that financial reports should focus on their needs.

BC1.16. The reasons why the Board concluded that the primary user group should be the existing and potential investors, lenders, and other creditors of a reporting entity are:

a. Existing and potential investors, lenders, and other creditors have the most critical and immediate need for the information in financial reports and many cannot require the entity to provide the information to them directly.
b. The Board's and the IASB's responsibilities require them to focus on the needs of participants in capital markets, which include not only existing investors, but also potential investors and existing and potential lenders and other creditors.
c. Information that meets the needs of the specified primary users is likely to meet the needs of users both in jurisdictions with a corporate governance model defined in the context of shareholders and those with a corporate governance model defined in the context of all types of stakeholders.

BC1.17. Some respondents expressed the view that the specified primary user group was too broad and that it would result in too much information in the financial reports. However, *too much* is a subjective judgment. In developing financial reporting requirements that meet the objective of financial reporting, the Boards will rely on the qualitative characteristics of, and the cost constraint on, useful financial information to provide discipline to avoid providing too much information.

Should There Be a Hierarchy of Users?

BC1.18. Some respondents to the Exposure Draft who supported the composition of the primary user group also recommended that the Board should establish a hierarchy of primary users because investors, lenders, and other creditors have different information needs. However, the Board observed that individual users may have information needs and desires that are different from, and possibly conflict with, those of other users with the same type of interest in the reporting entity. General purpose financial reports are intended to provide common information to users and cannot accommodate every request for information. The Board will seek the information set that is intended to meet the needs of the maximum number of users in cost-beneficial ways.

Information Needs of Other Users Who Are Not within the Primary User Group

Management's Information Needs

BC1.19. Some constituents questioned the interaction between general purpose financial reporting and management's needs. The Board stated that some of the information directed to the primary users is likely to meet some of management's needs but not all of them. However, management has the ability to access additional financial information, and consequently, general purpose financial reporting need not be directed explicitly to management.

Regulators' Information Needs

BC1.20. Some constituents said that maintaining financial stability in capital markets (the stability of a country's or region's economy or financial systems) should be an objective of financial reporting. They stated that financial reporting should focus on the needs of regulators and fiscal policy decision makers who are responsible for maintaining financial stability.

BC1.21. Other constituents opposed establishing an objective to maintain financial stability. They said that financial statements should present the economic reality of the reporting entity with as little bias as possible but that such a presentation is not necessarily inconsistent with a financial stability objective. By presenting economic reality, financial statements could lead to more informed decision making and, thereby, support financial stability even if that is not the primary aim.[4]

BC1.22. However, advocates of a financial stability objective had a different outcome in mind. They did not encourage the Board to require reporting entities to provide information for use by regulators and fiscal policy decision makers. Instead, they recommended that the Board consider the consequences of new financial reporting standards for the stability of the world's economies and financial systems and, at least at times, assign greater weight to that objective than to the information needs of investors, lenders, and other creditors.

BC1.23. The Board acknowledged that the interests of investors, lenders, and other creditors often overlap with those of regulators. However, expanding the objective of financial reporting to include maintaining financial stability could at times create conflicts between the objectives that the Board is not well equipped to resolve. For example, some may take the view that the best way to maintain financial stability is to require entities not to report or to delay reporting some changes in asset or liability values. That requirement almost certainly would result in depriving investors, lenders, and other creditors of information that they need. The only way to avoid conflicts would be to eliminate or deemphasize the existing objective of providing information to investors, lenders, and other creditors. The Board concluded that eliminating that objective would be inconsistent with its basic mission, which is to serve the information needs of participants in capital markets. The Board also noted that providing relevant and faithfully represented financial information can improve users' confidence in the information and, thus, contribute to promoting financial stability.

Usefulness for Making Decisions

BC1.24. Both the Board's and the IASB's previous frameworks focused on providing information that is useful in making economic decisions as the fundamental objective of financial reporting. Those frameworks also state that

[4]One group expressing that view was the Financial Crisis Advisory Group (FCAG). The FCAG comprised approximately 20 senior leaders with broad experience in international financial markets and an interest in the transparency of financial reporting information. The FCAG was formed in 2009 to advise the Board and the IASB about the standard-setting implications of the financial crisis and potential changes in the global regulatory environment.

financial information that is useful in making economic decisions would also be helpful in assessing how management has fulfilled its stewardship responsibility.

BC1.25. The Discussion Paper that led to this chapter stated that the objective of financial reporting should focus on resource allocation decisions. Although most respondents to the Discussion Paper agreed that providing useful information for decision making was the appropriate objective, they said that investors, lenders, and other creditors make other decisions that are aided by financial reporting information in addition to resource allocation decisions. For example, shareholders who vote on whether to retain directors or replace them, and on how members of management should be remunerated for their services, need information on which to base their decisions. Shareholders' decision-making process may include evaluating how management of the entity performed against management in competing entities in similar circumstances.

BC1.26. The Board agreed with these respondents and noted that, in most cases, information designed for resource allocation decisions also would be useful for assessing management's performance. Therefore, in the Exposure Draft leading to this chapter, the Board proposed that the objective of financial reporting is to provide financial information about the reporting entity that is useful to present and potential investors, lenders, and other creditors in making decisions in their capacity as capital providers. The Exposure Draft also described the role financial statements can have in supporting decisions related to the stewardship of an entity's resources.

BC1.27. The Exposure Draft discussed the *Objective of Financial Reporting* and *Decision Usefulness* in separate sections. The Board combined those two sections in this chapter because usefulness in making decisions is the objective of financial reporting. Consequently, both sections addressed the same points and provided more detail than was necessary. Combining those two sections resulted in eliminating the separate subsections on usefulness in assessing cash flow prospects and usefulness in assessing stewardship. The Board did not intend to imply that assessing prospects for future cash flow or assessing the quality of management's stewardship is more important than the other. Both are important for making decisions about providing resources to an entity, and information about stewardship also is important for resource providers who have the ability to vote on, or otherwise influence, management's actions.

BC1.28. The Board decided not to use the term *stewardship* in this chapter because there would be difficulties in translating it into other languages. Instead, the Board described what stewardship encapsulates. Accordingly, the objective of financial reporting acknowledges that users make resource allocation decisions as well as decisions as to whether management has made efficient and effective use of the resources provided.

The Objective of Financial Reporting for Different Types of Entities

BC1.29. The Board also considered whether the objective of general purpose financial reporting should differ for different types of entities. Possibilities include the following:

a. Smaller entities versus larger entities
b. Entities with listed (publicly traded) debt or equity financial instruments versus those without such instruments
c. Closely held entities versus those with widely dispersed ownership.

BC1.30. External users of financial reporting have similar objectives, irrespective of the type of entities in which they invest. Therefore, the Board concluded that the objective of general purpose financial reports is the same for all entities. However, cost constraints and differences in activities among entities sometimes may lead the Board to permit or require differences in reporting for different types of entities.

Information about a Reporting Entity's Resources, Claims against That Entity, and Changes in Resources and Claims

The Significance of Information about Financial Performance

BC1.31. A longstanding assertion by many constituents is that a reporting entity's financial performance as represented by comprehensive income and its components is the most important information.[5] Concepts Statement 1 (paragraph 43) stated:

> The primary focus of financial reporting is information about an enterprise's performance provided by measures of comprehensive income and its components. Investors, creditors, and others who are concerned with assessing the

[5]Concepts Statement 1 referred to *earnings and its components*. However, FASB Concepts Statement No. 6, *Elements of Financial Statements*, substituted the term *comprehensive income* for the term *earnings*. The latter term is reserved for a component of comprehensive income.

prospects for enterprise net cash inflows are especially interested in that information.

In contrast, the *Framework* (1989) considered information on the reporting entity's financial position and financial performance of equal importance.

BC1.32. To be useful for decision making, financial reports must provide information about a reporting entity's economic resources and claims and the change during a period in economic resources and claims. A reporting entity cannot provide reasonably complete information about its financial performance (as represented by comprehensive income, profit or loss or other similar terms) without identifying and measuring its economic resources and the claims. Consequently, the Board concluded that to designate one type of information as the primary focus of financial reporting would be inappropriate.

BC1.33. In discussing the financial position of an entity, the Exposure Draft referred to *economic resources and claims on them*. The chapter uses the phrase *economic resources of the reporting entity and the claims against the reporting entity* (see paragraph OB12). The reason for the change is that, in many cases, claims against an entity are not claims on specific resources. In addition, many claims will be satisfied using resources that will result from future net cash inflows. Thus, while all claims are claims against the entity, not all are claims against the entity's existing resources.

Financial Position and Solvency

BC1.34. Some constituents have suggested that the main purpose of the statement of financial position should be to provide information that helps assess the reporting entity's solvency. The question is not whether information provided in the financial reports should be helpful in assessing solvency; clearly, it should. Assessing solvency is of interest to investors, lenders, and other creditors, and the objective of general purpose financial reporting is to provide information that is useful to them for making decisions.

BC1.35. However, some have suggested that the statement of financial position should be directed towards the information needs of lenders, other creditors, and regulators, possibly to the detriment of investors and other users. To do so would be inconsistent with the objective of serving the common information needs of the primary user group. Therefore, the Board rejected the notion of directing the statement of financial position (or any other particular financial statement) towards the needs of a particular subset of users.

Incorporation of Concepts Statement 4

BC1.36. FASB Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, was released in 1980 and addressed the objectives of financial reporting to nonbusiness organizations. Since Concepts Statement 4's release, the Conceptual Framework and standard setting have evolved. As a result, there were inconsistencies and redundancies in Concepts Statement 4, making it outdated and in need of reevaluation. Concepts Statement 4 used the term *nonbusiness organizations*, which the FASB has since replaced with the term *not-for-profit entities*. The scope of Concepts Statement 4 included state and local governmental units. The Governmental Accounting Standards Board (GASB) was established as the authoritative accounting standard-setting body for U.S. state and local governments in 1984 and began releasing its own Concepts Statements in 1987.

BC1.37. The Board decided to reevaluate the outdated Concepts Statement 4 and supersede it in order to improve the framework and avoid inconsistencies with the release of Chapter 4, *Elements of Financial Statements*, and Chapter 7, *Presentation*, of FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting*. The Board concluded that the integrated Conceptual Framework should be relevant to all entities and it is not necessary to retain a separate objective of financial reporting for not-for-profit entities consistent with paragraphs BC1.29 and BC1.30 of this chapter. As a result, the Board decided to incorporate language from Concepts Statement 4 discussing the areas that may require any different reporting objectives with minor editing and to add them to this chapter.

APPENDIX B: AMENDMENTS TO THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

Appendix B has been omitted from this book. The amendments that were included in this appendix have been incorporated into the text of the corresponding chapters.

Chapter 2, *The Reporting Entity* June 2023

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CHAPTER 2: THE REPORTING ENTITY

Introduction

RE1. The objective[1] of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other resource providers 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.[2]

RE2. The concept of the reporting entity was developed in the context of general purpose financial reporting. General purpose financial reporting, which is defined in Chapter 7, *Presentation,* of this Concepts Statement, provides useful financial information about a reporting entity that assists existing and potential resource providers in making resource allocation decisions. In making resource allocation decisions, resource providers form expectations about the reporting entity by evaluating (a) the entity's resources, (b) claims to the entity's resources, and (c) changes in those resources and claims during the period. A full set of financial statements, which is a component of general purpose financial reporting, is the principal way in which a reporting entity provides financial information that accomplishes the objective of general purpose financial reporting.[3]

RE3. Entities often report information, including financial information, in a variety of forms. Each of those entities could be thought of as a reporting entity. However, in the Conceptual Framework, reference to the reporting entity is in the context of an entity that produces general purpose financial reports.

Description of a Reporting Entity

RE4. A reporting entity is a circumscribed area of economic activities that can be represented by general purpose financial reports that are useful to existing and

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[1]The objective of general purpose financial reporting is described in paragraph OB2 of Chapter 1, *The Objective of General Purpose Financial Reporting*, of this Concepts Statement.

[2]Paragraphs OB22–OB28 of Chapter 1 of this Concepts Statement provide context for the application of the objective to not-for-profit entities.

[3]A full set of financial statements, as defined in paragraph PR20 of Chapter 7, *Presentation*, of this Concepts Statement, presents the elements of financial statements and the recognition and measurement related to those elements, including the information presented in paragraph PR18 of Chapter 7.

potential investors, lenders, and other resource providers in making decisions about providing resources to the entity.

RE5. A reporting entity has three features:

a. Economic activities have been conducted.
b. Those economic activities can be distinguished from those of other entities.
c. The financial information in general purpose financial reporting faithfully represents the economic activities conducted within the circumscribed area and is useful in making decisions about providing resources to the reporting entity.

RE6. Identifying the boundaries of the economic activities is necessary to faithfully present the reporting entity's financial information in general purpose financial reporting. General purpose financial reports, including a full set of financial statements, that faithfully represent the economic activities of a circumscribed area enable the reporting entity to achieve the objective of general purpose financial reporting.

RE7. Identifying the reporting entity in a specific situation requires considering the boundary of the economic activities that have been conducted. The existence of a legal entity is not necessary to identify the reporting entity. The reporting entity can include more than one entity, or it can be a portion of an entity.

Consolidated Financial Statements

RE8. If a circumscribed area of economic activities includes a parent-subsidiary relationship, a full set of consolidated financial statements that faithfully represents the circumscribed area's economic activities is necessary to meet the objective of general purpose financial reporting.

RE9. The net cash flows and other benefits to resource providers are dependent on the economic activities of both the parent entity and its subsidiaries. In assessing the prospects of net cash inflows from an investment in a parent entity, resource providers are interested in evaluating the parent entity and its subsidiaries as a single economic unit. A full set of consolidated financial statements, which includes the subsidiaries' (a) resources, (b) claims to those resources, and (c) changes in those resources and claims during the period, completely depicts the economic activities of the parent and its subsidiaries. Consequently, a full set of consolidated financial statements provides a faithful representation of the circumscribed area's economic activities. Principles of consolidation, including any exception to consolidation in circumstances in which a parent-subsidiary relationship exists, would be made at the standards level.

Parent-Only Financial Statements

RE10. Parent-only financial statements, which in certain situations may be useful or required, do not completely depict the economic activities of a reporting entity that includes a parent-subsidiary relationship and, therefore, are not sufficient to meet the objective of general purpose financial reporting. Parent-only financial statements present subsidiaries as investments and do not depict the subsidiaries' (a) resources, (b) claims to those resources, and (c) changes in those resources and claims during the period. Consequently, parent-only financial statements do not faithfully represent the operating results, financial position, and capital structure of the parent and its subsidiaries as a single economic unit.

Portion of an Entity

RE11. A portion of a larger entity, such as a subsidiary, branch, or division, can represent a circumscribed area of economic activities and, consequently, meet the description and features of a reporting entity in paragraphs RE4 and RE5. A portion of a larger entity would still need to consolidate any of its own subsidiary relationships to meet the objective of general purpose financial reporting, consistent with paragraph RE8.

RE12. For a portion of a larger entity to prepare general purpose financial reports, including a full set of financial statements, it must identify the economic activities of its circumscribed area. Decisions on which economic activities should be attributable to the portion of a larger entity should result in general purpose financial reports that provide a faithful representation of the portion of the larger entity's financial position and performance.

RE13. Based on the needs of intended users, the portion of an entity may prepare financial reports that do not include a full set of financial statements. In those circumstances, the financial reports are special purpose. Because those special-purpose financial reports do not completely depict the portion of an entity's circumscribed area of economic activities, the financial reports would not be considered general purpose financial reporting.

Combined Financial Statements

RE14. Combined financial statements can appropriately depict two or more entities that are under common control or common management, including circumstances in which a parent-subsidiary relationship does not exist. If two or more commonly controlled or commonly managed entities are combined to represent a circumscribed area of economic activities, the circumscribed area can represent a reporting entity if it can prepare general purpose financial reports. A full set of combined financial statements is consistent with the objective of general purpose financial reporting.

This chapter of Concepts Statement 8 was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

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

APPENDIX: BASIS FOR CONCLUSIONS

Introduction

BC2.1. The following basis for conclusions summarizes the Board's considerations in reaching the conclusions in this chapter. It includes reasons for accepting some alternatives and rejecting others. Individual Board members gave greater weight to some factors than others.

BC2.2. In January 2014, the FASB reactivated its Conceptual Framework project. The following are key historical documents issued on the reporting entity concept:

a. May 2008—FASB and IASB Discussion Paper, *Preliminary Views—Conceptual Framework for Financial Reporting: The Reporting Entity*
b. March 2010—FASB and IASB proposed Concepts Statement, *Conceptual Framework for Financial Reporting: The Reporting Entity*
c. October 2022—FASB proposed Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 2, The Reporting Entity*.

BC2.3. The term *reporting entity* is used multiple times in existing Concepts Statements, and paragraph OB1 in Chapter 1 of this Concepts Statement explicitly references a concept of the reporting entity. Because the Conceptual Framework is intended to be a coherent system of interrelated objectives and fundamental concepts, there is a need to develop a concept of the reporting entity.

BC2.4. To be consistent with the objective of general purpose financial reporting, the Board concluded that it was essential for the description of a reporting entity to focus on the notion of a circumscribed area of economic activities. In making resource allocation decisions, resource providers identify a circumscribed area of economic activities that they wish to evaluate for expected returns. To satisfy the informational needs of resource providers and achieve the objective of general purpose financial reporting, the circumscribed area, as a reporting entity, must provide general purpose financial reports, including a full set of financial statements, to resource providers.

Description of a Reporting Entity

BC2.5. The objective of the reporting entity concept is to describe a reporting entity. The description of a reporting entity is consistent with the objective of general purpose financial reporting. The Board concluded that a concept of the reporting entity should focus on (a) identifying a circumscribed area of economic activities and (b) faithfully representing the economic activities of that circumscribed area in general purpose financial reporting. To faithfully represent the financial information of the reporting entity, that reporting entity must identify the economic activities of its circumscribed area. To meet the objective of general purpose financial reporting, the reporting entity must faithfully represent the economic activities of its circumscribed area in general purpose financial reporting.

BC2.6. As stated in paragraph RE5(a), a reporting entity must have conducted economic activities. The Board observed that, in the absence of economic activities, there would be no financial information to report. However, the Board notes that economic activities would include initial contributions to an entity, which would consequently be financial information indicating that the feature in paragraph RE5(a) would be met.

BC2.7. The Board concluded that while a legal entity is a circumscribed area of economic activities that could represent a reporting entity, the legal form or structure of an entity should not exclusively dictate whether a circumscribed area of economic activities represents a reporting entity. For example, a sole proprietorship is not legally separate from its owner; however, a sole proprietorship may prepare general purpose financial reports for its circumscribed area of economic activities.

Consolidated Financial Statements

BC2.8. The Board decided not to define the term *control* in this chapter. The Board reasoned that the term *control* is defined at the standards level. In concepts, if a circumscribed area of economic activities represents a parent-subsidiary relationship, a full set of consolidated financial statements that faithfully represents the circumscribed area's economic activities is necessary to meet the objective of general purpose financial reporting. As noted in paragraph RE9, any exception to consolidation in circumstances in which a parent-subsidiary relationship exists would be made at the standards level.

Parent-Only Financial Statements

BC2.9. As noted in paragraph RE10, the Board concluded that parent-only financial statements do not completely depict the economic activities of a circumscribed area representing a parent-subsidiary relationship and, therefore, are not sufficient to meet the objective of general purpose financial reporting. Despite that conclusion, parent-only financial statements may provide useful information to resource providers as special-purpose financial reports. For example, parent-only financial statements may help resource providers assess the level of dividends that the controlling entity is legally able to pay without depending on transferred funds from its subsidiaries or perhaps reflecting the fair value of subsidiaries that are held as an investment if an entity elects to provide such fair value information for the investments.

Portion of an Entity

BC2.10. The Board concluded that a portion of a larger entity can qualify as a reporting entity if the portion of the entity represents a circumscribed area of economic activities whose financial information can be faithfully represented in general purpose financial reporting.

BC2.11. The Board acknowledges that in some cases there are practical complexities in identifying the assets, liabilities, and operations of a portion of an entity, specifically for items that are allocated to the portion of the entity. To achieve the objective of general purpose financial reporting, the portion of a larger entity must prepare general purpose financial reports, including a full set of financial statements, that faithfully represent the economic activities of its circumscribed area, including activities that have to be allocated to the portion of the entity, such as corporate overhead activities.

Combined Financial Statements

BC2.12. The Board concluded that combined financial statements may appropriately depict two or more entities that are under common control or common management, including circumstances in which a parent-subsidiary relationship does not exist. The Board decided to include the notion of common management to reflect structures used by various entities (for example, not-for-profit entities). The Board reasoned that two or more commonly controlled or commonly managed entities that are combined can represent a circumscribed area of economic activities and, therefore, meet the description of a reporting entity. Accordingly, general purpose financial reports, including a full set of combined financial statements, that faithfully represent the circumscribed area's economic activities achieve the objective of general purpose financial reporting.

Chapter 3, *Qualitative Characteristics of Useful Financial Information* As Amended August 2018

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CHAPTER 3: QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

Introduction

QC1. The qualitative characteristics of useful financial information discussed in this chapter identify the types of information that are likely to be most useful to the existing and potential investors, lenders, and other creditors for making decisions about the reporting entity on the basis of information in its financial report (financial information).

QC2. Financial reports provide information about the reporting entity's economic resources, claims against the reporting entity, and the effects of transactions and other events and conditions that change those resources and claims. (This information is referred to in the Conceptual Framework as information about the economic phenomena.) Some financial reports also include explanatory material about management's expectations and strategies for the reporting entity and other types of forward-looking information.

QC3. The qualitative characteristics of useful financial information[1] apply to financial information provided in financial statements, as well as to financial information provided in other ways. Cost, which is a pervasive constraint on the reporting entity's ability to provide useful financial information, applies similarly. However, the considerations in applying the qualitative characteristics and the cost constraint may be different for different types of information. For example, applying them to forward-looking information may be different from applying them to information about existing economic resources and claims and to changes in those resources and claims.

Qualitative Characteristics of Useful Financial Information

QC4. If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely, and understandable.

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[1]Throughout this Conceptual Framework, the terms *qualitative characteristics* and *constraint* refer to the qualitative characteristics of, and the constraint on, useful financial information.

Fundamental Qualitative Characteristics

QC5. The fundamental qualitative characteristics are *relevance* and *faithful representation*.

Relevance

QC6. Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or already are aware of it from other sources.

QC7. Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value, or both.

QC8. Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information need not be a prediction or forecast to have predictive value. Financial information with predictive value is employed by users in making their own predictions.

QC9. Financial information has confirmatory value if it provides feedback (confirms or changes) about previous evaluations.

QC10. The predictive value and confirmatory value of financial information are interrelated. Information that has predictive value often also has confirmatory value. For example, revenue information for the current year, which can be used as the basis for predicting revenues in future years, also can be compared with revenue predictions for the current year that were made in past years. The results of those comparisons can help a user to correct and improve the processes that were used to make those previous predictions.

Materiality

QC11. Relevance and materiality are defined by what influences or makes a difference to an investor or other decision maker; however, the two concepts can be distinguished from each other. Relevance is a general notion about what type of information is useful to investors. Materiality is entity specific. The omission or misstatement of an item in a financial report is material if, in 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.

QC11A. A decision not to disclose certain information or recognize an economic phenomenon may be made, for example, because the amounts involved are too small to make a difference to an investor or other decision maker (they are immaterial). However, magnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, generally is not a sufficient basis for a materiality judgment.

QC11B. No general standards of materiality could be formulated to take into account all the considerations that enter into judgments made by an experienced, reasonable provider of financial information. That is because materiality judgments can properly be made only by those that understand the reporting entity's pertinent facts and circumstances. Whenever an authoritative body imposes materiality rules or standards, it is substituting generalized collective judgments for specific individual judgments, and there is no reason to suppose that the collective judgments always are superior.

Faithful Representation

QC12. Financial reports represent economic phenomena in words and numbers. To be useful, financial information not only must represent relevant phenomena, but it also must faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics. It would be *complete*, *neutral*, and *free from error*. Of course, perfection is seldom, if ever, achievable. The Board's objective is to maximize those qualities to the extent possible.

QC13. A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. For example, a complete depiction of a group of assets would include, at a minimum, a description of the nature of the assets in the group, a numerical depiction of all of the assets in the group, and a description of what the numerical depiction represents (for example, original cost, adjusted cost, or fair value). For some items, a complete depiction also may entail explanations of significant facts about the quality and nature of the items, factors and circumstances that might affect their quality and nature, and the process used to determine the numerical depiction.

QC14. A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasized, deemphasized, or otherwise manipulated to increase the probability that financial information will be received favorably or unfavorably by users. Neutral information does not mean information with no purpose or no influence on behavior. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions.

QC15. Faithful representation does not mean accurate in all respects. Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. In this context, free from error does not mean perfectly accurate in all respects. For example, an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate.

QC16. A faithful representation, by itself, does not necessarily result in useful information. For example, a reporting entity may receive property, plant, and equipment through a government grant. Obviously, reporting that an entity acquired an asset at no cost would faithfully represent its cost, but that information probably would not be very useful. A slightly more subtle example is an estimate of the amount by which an asset's carrying amount should be adjusted to reflect an impairment in the asset's value. That estimate can be a faithful representation if the reporting entity has applied properly an appropriate process, described properly the estimate, and explained any uncertainties that significantly affect the estimate. However, if the level of uncertainty in such an estimate is sufficiently large, that estimate will not be particularly useful. In other words, the relevance of the asset being faithfully represented is questionable. If there is no alternative representation that is more faithful, that estimate may provide the best available information.

Applying the Fundamental Qualitative Characteristics

QC17. Information must be both relevant and faithfully represented if it is to be useful. Neither a faithful representation of an irrelevant phenomenon, nor an unfaithful representation of a relevant phenomenon, helps users make good decisions.

QC18. The most efficient and effective process for applying the fundamental qualitative characteristics usually would be as follows (subject to the effects of enhancing characteristics and the cost constraint, which are not considered in this example). First, identify an economic phenomenon that has the potential to be useful to users of the reporting entity's financial information. Second, identify the type of information about that phenomenon that would be most relevant if it is available and can be faithfully represented. Third, determine whether that information is available and can be faithfully represented. If so, the process of satisfying the fundamental qualitative characteristics ends at that point. If not, the process is repeated with the next most relevant type of information.

Enhancing Qualitative Characteristics

QC19. *Comparability, verifiability, timeliness*, and *understandability* are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented. The enhancing qualitative characteristics also may help determine which of two ways should be used to depict a phenomenon if both are considered equally relevant and faithfully represented.

Comparability

QC20. Users' decisions involve choosing between alternatives, for example, selling or holding an investment, or investing in one reporting entity or another. Consequently, information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.

QC21. Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Unlike the other qualitative characteristics, comparability does not relate to a single item. A comparison requires at least two items.

QC22. Consistency, although related to comparability, is not the same. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Comparability is the goal; consistency helps to achieve that goal.

QC23. Comparability is not uniformity. For information to be comparable, like things must look alike and different things must look different. Comparability of financial information is not enhanced by making unlike things look alike any more than it is enhanced by making like things look different.

QC24. Some degree of comparability is likely to be attained by satisfying the fundamental qualitative characteristics. A faithful representation of a relevant economic phenomenon should naturally possess some degree of comparability with a faithful representation of a similar relevant economic phenomenon by another reporting entity.

QC25. Although a single economic phenomenon can be faithfully represented in multiple ways, permitting alternative accounting methods for the same economic phenomenon diminishes comparability.

Verifiability

QC26. Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities also can be verified.

QC27. Verification can be direct or indirect. Direct verification means verifying an amount or other representation through direct observation, for example, by counting cash. Indirect verification means checking the inputs to a model, formula, or other technique and recalculating the outputs using the same methodology. An example is verifying the carrying amount of inventory by checking the inputs (quantities and costs) and recalculating the ending inventory using the same cost flow assumption (for example, using the first-in, first-out method).

QC28. It may not be possible to verify some explanations and forward-looking financial information until a future period, if at all. To help users decide whether they want to use that information, it normally would be necessary to disclose the underlying assumptions, the methods of compiling the information, and other factors and circumstances that support the information.

Timeliness

QC29. Timeliness means having information available to decision makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it is. However, some information may continue to be timely long after the end of a reporting period because, for example, some users may need to identify and assess trends.

Understandability

QC30. Classifying, characterizing, and presenting information clearly and concisely makes it *understandable*.

QC31. Some phenomena are inherently complex and cannot be made easy to understand. Excluding information about those phenomena from financial reports might make the information in those financial reports easier to understand. However, those reports would be incomplete and therefore potentially misleading.

QC32. Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyze the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.

Applying the Enhancing Qualitative Characteristics

QC33. Enhancing qualitative characteristics should be maximized to the extent possible. However, the enhancing qualitative characteristics, either individually or as a group, cannot make information useful if that information is irrelevant or not faithfully represented.

QC34. Applying the enhancing qualitative characteristics is an iterative process that does not follow a prescribed order. Sometimes, one enhancing qualitative characteristic may have to be diminished to maximize another qualitative characteristic. For example, a temporary reduction in comparability as a result of prospectively applying a new financial reporting standard may be worthwhile to improve relevance or faithful representation in the longer term. Appropriate disclosures may partially compensate for noncomparability.

The Cost Constraint on Useful Financial Reporting

QC35. Cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information. There are several types of costs and benefits to consider.

QC36. Providers of financial information expend most of the effort involved in collecting, processing, verifying, and disseminating financial information, but users ultimately bear those costs in the form of reduced returns. Users of financial information also incur costs of analyzing and interpreting the information provided. If needed information is not provided, users incur additional costs to obtain that information elsewhere or to estimate it.

QC37. Reporting financial information that is relevant and faithfully represents what it purports to represent helps users to make decisions with more confidence.

This results in more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. An individual investor, lender, and other creditor also receive benefits by making more informed decisions. However, it is not possible for general purpose financial reports to provide all the information that every user finds relevant.

QC38. In applying the cost constraint, the Board assesses whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information. When applying the cost constraint in developing a proposed financial reporting standard, the Board seeks information from providers of financial information, users, auditors, academics, and others about the expected nature and quantity of the benefits and costs of that standard. In most situations, assessments are based on a combination of quantitative and qualitative information.

QC39. Because of the inherent subjectivity, different individuals' assessments of the costs and benefits of reporting particular items of financial information will vary. Therefore, the Board seeks to consider costs and benefits in relation to financial reporting generally, and not just in relation to individual reporting entities. That does not mean that assessments of costs and benefits always justify the same reporting requirements for all entities. Differences may be appropriate because of different sizes of entities, different ways of raising capital (publicly or privately), different users' needs, or other factors.

This Concepts Statement was adopted by the unanimous vote of the five members of the Financial Accounting Standards Board:

Robert H. Herz, *Chairman*
Thomas J. Linsmeier
Leslie F. Seidman
Marc A. Siegel
Lawrence W. Smith

The amendments in this Concepts Statement were adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Russell G. Golden, *Chairman*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Marsha L. Hunt
Harold L. Monk, Jr.
R. Harold Schroeder
Marc A. Siegel

APPENDIX: BASIS FOR CONCLUSIONS FOR CHAPTER 3

Introduction

BC3.1. This basis for conclusions summarizes considerations of the Board in reaching the conclusions in Chapter 3, *Qualitative Characteristics of Useful Financial Information*. It includes reasons for accepting some alternatives and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC3.2. The Board developed this chapter jointly with the International Accounting Standards Board (IASB). Consequently, this basis for conclusions also includes some references to the IASB's literature.

Background

BC3.3. The Board began the process of developing the qualitative characteristics of useful financial information by reviewing its own framework and concepts as well as those of other standard setters. In July 2006, the Board published for public comment a Discussion Paper on this topic. That same paper also was published by the IASB. The Board and the IASB received 179 responses. In its redeliberations of the issues on this topic, the Board considered all of the comments received and information gained from other outreach initiatives. In May 2008, the Board and the IASB jointly published an Exposure Draft. The Boards received 142 responses. The Board reconsidered all of the issues. This document is the result of those reconsiderations.

The Objective of Financial Reporting and the Qualitative Characteristics of Useful Financial Information

BC3.4. Alternatives are available for all aspects of financial reporting, including recognition, derecognition, measurement, classification, presentation, and disclosure. When developing financial reporting standards, the Board will choose the alternative that goes furthest towards achieving the objective of financial reporting. Providers of financial information also will have to choose among the alternatives if there are no applicable standards available, or if application of a particular standard requires judgments or options, to achieve the objective of financial reporting.

BC3.5. Chapter 1 specifies that the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. The decision makers on which this Conceptual Framework focuses are existing and potential investors, lenders, and other creditors.

BC3.6. That objective by itself leaves a great deal to judgment and provides little guidance on how to exercise that judgment. This chapter describes the first step in making the judgments needed to apply that objective. It identifies and describes the qualitative characteristics that financial information should have if it is to meet the objective of financial reporting. It also discusses cost, which is a pervasive constraint on financial reporting.

BC3.7. Subsequent chapters will use the qualitative characteristics to help guide choices about recognition, measurement, and the other aspects of financial reporting.

Fundamental and Enhancing Qualitative Characteristics

BC3.8. This chapter distinguishes between the fundamental qualitative characteristics that are the most critical, and the enhancing qualitative characteristics that are less critical but still highly desirable. The Discussion Paper did not explicitly distinguish between those qualitative characteristics. The Board made the distinction later because of confusion among respondents to the Discussion Paper about how the qualitative characteristics relate to each other.

BC3.9. Some respondents to the Exposure Draft stated that all of the qualitative characteristics should be considered equal and that the distinction between fundamental and enhancing qualitative characteristics was arbitrary. Others said that the most important qualitative characteristic differs depending on the circumstances; therefore, differentiating among the qualitative characteristics was not appropriate.

BC3.10. The Board does not agree that the distinction is arbitrary. Financial information without the two fundamental qualitative characteristics of relevance and faithful representation is not useful, and it cannot be made useful by being more comparable, verifiable, timely, or understandable. However, financial information that is relevant and faithfully represented may still be useful even if it does not have any of the enhancing qualitative characteristics.

Fundamental Qualitative Characteristics

Relevance

BC3.11. It is self-evident that financial information is only useful for making a decision if it is capable of making a difference in that decision. *Relevance* is the term used in the Conceptual Framework to describe that capability. It is a fundamental qualitative characteristic of useful financial information.

BC3.12. The definition of relevance in the Conceptual Framework is consistent with the definition in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*. The definition of relevance in the *Framework* (1989) was that information is relevant only if it actually makes a difference in users' decisions. However, users consider a variety of information from many sources, and the extent to which a decision is affected by a particular economic phenomenon is difficult, if not impossible, to determine, even after the fact.

BC3.13. In contrast, whether information *is capable* of making a difference in a decision (relevance as defined in the Conceptual Framework) can be determined. One of the primary purposes of publishing Exposure Drafts and other due process documents is to seek the views of users on whether information that would be required by proposed financial reporting standards is capable of making a difference in their decisions. The Board also assesses relevance by meeting with users to discuss proposed standards, potential agenda decisions, effects on reported information from applying recently implemented standards, and other matters.

Predictive and confirmatory value

BC3.14. Many decisions by investors, lenders, and other creditors are based on implicit or explicit predictions about the amount and timing of the return on an equity investment, loan, or other credit instrument. Consequently, information is capable of making a difference in one of those decisions only if it will help users to make new predictions, confirm or correct prior predictions, or both (which is the definition of predictive or confirmatory value).

BC3.15. The *Framework* (1989) identified predictive value and confirmatory value as components of relevance, and Concepts Statement 2 referred to predictive value and feedback value. The Board concluded that confirmatory value and feedback value were intended to have the same meaning. The Board and the IASB agreed that both Boards would use the same term (confirmatory value) to avoid giving the impression that the two frameworks were intended to be different.

The difference between predictive value and related statistical terms

BC3.16. Predictive value, as used in the Conceptual Framework, is not the same as predictability and persistence as used in statistics. Information has predictive value if it can be used in making predictions about the eventual outcomes of past or current events. In contrast, statisticians use predictability to refer to the accuracy with which it is possible to foretell the next number in a series and persistence to refer to the tendency of a series of numbers to continue to change as it has changed in the past.

Materiality

BC3.17. Concepts Statement 2 and the *Framework* (1989) discussed materiality and defined it similarly. Concepts Statement 2 described materiality as a constraint on financial reporting that can only be considered together with the qualitative characteristics, especially relevance and faithful representation. The *Framework* (1989), on the other hand, discussed materiality as an aspect of relevance and did not indicate that materiality has a role in relation to the other qualitative characteristics.

BC3.18. The Discussion Paper (July 6, 2006, FASB Preliminary Views, *Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information*) and the Exposure Draft (May 29, 2008, FASB Exposure Draft, *Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics and Constraints of Decision-Useful Financial Reporting Information*) proposed that materiality is a pervasive constraint in financial reporting because it is pertinent to all of the qualitative characteristics. Some respondents to the Exposure Draft agreed that any entity can consider materiality in its reporting decisions; however, it is not a constraint on a reporting entity's ability to report information because the entity can choose to report immaterial information. Furthermore, a standard setter does not consider materiality when developing standards because it is an entity-specific consideration. As a result, entity-specific assessments of materiality are not directly relevant to the Board's assessments on whether the guidance that the Board sets meets the qualitative characteristics of financial reporting. Instead, the Board evaluates the potential relevance of its guidance (and other qualitative characteristics of the reported information) in the context of a broader financial reporting environment rather than on the materiality of the information to individual entities.

BC3.18A. The Board decided to continue to include a discussion of materiality in the Concepts Statements to (a) demonstrate its understanding of the reporting environment in which the guidance it sets is applied and (b) highlight the difference between relevance and materiality.

BC3.18B. The Board observed that the definition of materiality in this chapter as originally issued is inconsistent with the definitions and discussions by the U.S. Securities and Exchange Commission (SEC), auditing standards of the Public Company Accounting Oversight Board (PCAOB) and the American Institute of Certified Public Accountants (AICPA), and the judicial system in the United States. That inconsistency does not help the Board to understand the environment in which reporting entities operate. In September 2015, the Board issued proposed Accounting Standards Update, *Notes to Financial Statements (Topic 235): Assessing Whether Disclosures Are Material*, which stated that materiality is a legal concept and that the Board observed that the U.S. Supreme Court definition of materiality is the appropriate definition. Preparers and practitioners objected to stating that materiality is a legal concept because it may imply that only legal professionals can make materiality judgments and that materiality should be considered an accounting concept. Others objected to the citing of the U.S. Supreme Court definition of materiality because of its origins in antifraud litigation. Still others stated that the meaning of the term is debatable and there is a concern that the definition may change. Some stakeholders suggested that the definition in Concepts Statement 2[1a] would be a better definition. After considering the feedback, the Board decided to replace the current definition of materiality in this chapter with the superseded definition in Concepts Statement 2. The definition of materiality that is in Concepts Statement 2 is quoted in SEC Staff Accounting Bulletin No. 99, *Materiality*. SAB 99 notes that the definition that is in Concepts Statement 2 is in substance identical to the definition of the U.S. Supreme Court, which in turn results in the definition in this chapter being in substance identical to the definition in the auditing standards of the AICPA and the PCAOB.

BC3.18C. The Board decided not to incorporate all the content of the definition of materiality from Concepts Statement 2 into this chapter. The language that was not carried forward included, in large part, examples of how one might think about a materiality assessment. In the Board's view, the examples in Concepts Statement 2 were not necessary to capture the substance of the definition.

BC3.18D. The Board is aware that the discussion of materiality as amended in this Concepts Statement is no longer identical to the definition in the International Accounting Standards Board's (IASB) *Conceptual Framework for Financial Reporting,* though both were identical when originally issued. IAS 1, *Presentation of Financial Statements,* and IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, also include definitions of materiality. It is preferable that

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[1a]Superseded.

both the FASB's and the IASB's Conceptual Frameworks converge. However, that is not possible because (a) the IASB's definitions of materiality are not consistent with the definition used in the United States and (b) the IASB is working to further amend its definitions of materiality.

Faithful Representation

BC3.19. The discussion of faithful representation in Chapter 3 differs from that in the previous frameworks in two significant ways. First, it uses the term *faithful representation* instead of the term *reliability*. Second, substance over form, prudence (conservatism), and verifiability, which were aspects of reliability in Concepts Statement 2 or the *Framework* (1989), are not considered aspects of faithful representation. Substance over form and prudence were removed for the reasons described in paragraphs BC3.26–BC3.29. Verifiability is now described as an enhancing qualitative characteristic rather than as part of this fundamental qualitative characteristic (see paragraphs BC3.34–BC3.36).

Replacement of the term *reliability*

BC3.20. Concepts Statement 2 and the *Framework* (1989) used the term *reliability* to describe what is now called faithful representation.

BC3.21. Concepts Statement 2 listed representational faithfulness, verifiability, and neutrality as aspects of reliability and discussed completeness as part of representational faithfulness.

BC3.22. The *Framework* (1989) said:

> Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

The Framework (1989) also discussed substance over form, neutrality, prudence, and completeness as aspects of faithful representation.

BC3.23. Unfortunately, neither framework conveyed the meaning of reliability clearly. The comments of respondents to numerous proposed standards indicated a lack of a common understanding of the term *reliability*. Some focused on *verifiability* or *free from material error* to the virtual exclusion of faithful representation. Others focused more on faithful representation, perhaps combined with neutrality. Some apparently think that reliability refers primarily to precision.

BC3.24. Because attempts to explain what reliability was intended to mean in this context have proven unsuccessful, the Board sought a different term that would more clearly convey the intended meaning. The term *faithful representation*, the faithful depiction in financial reports of economic phenomena, was the result of that search. That term encompasses the main characteristics that the previous frameworks included as aspects of reliability.

BC3.25. Many respondents to the Discussion Paper and the Exposure Draft opposed the Board's preliminary decision to replace *reliability* with *faithful representation*. Some said that the Board could have better explained what reliable means rather than replacing the term. However, many respondents who made those comments assigned a different meaning to reliability from what the Board meant. In particular, many respondents' descriptions of reliability more closely resembled the Board's notion of verifiability than its notion of reliability. Those comments led the Board to affirm its decision to replace the term *reliability* with *faithful representation*.

Substance over form

BC3.26. Substance over form is not considered a separate component of faithful representation because it would be redundant. Faithful representation means that financial information represents the substance of an economic phenomenon rather than merely representing its legal form. Representing a legal form that differs from the economic substance of the underlying economic phenomenon could not result in a faithful representation.

Prudence (conservatism) and neutrality

BC3.27. Chapter 3 does not include prudence or conservatism as an aspect of faithful representation because including either would be inconsistent with neutrality. Some respondents to the Discussion Paper and Exposure Draft disagreed with that view. They said that the framework should include conservatism, prudence, or both. They said that bias should not always be assumed to be undesirable, especially in circumstances when bias, in their view, produces information that is more relevant to some users.

BC3.28. Deliberately reflecting conservative estimates of assets, liabilities, income, or equity sometimes has been considered desirable to counteract the effects of some management estimates that have been perceived as excessively optimistic. However, even with the prohibitions against deliberate misstatement that appear in the existing frameworks, an admonition to be prudent is likely to lead to a bias. Understating assets or overstating liabilities in one period frequently leads to overstating financial performance in later periods—a result that cannot be described as prudent or neutral.

BC3.29. Other respondents to the Exposure Draft said that neutrality is impossible to achieve. In their view, relevant information must have purpose, and information with a purpose is not neutral. In other words, because financial reporting is a tool to influence decision making, it cannot be neutral. Obviously, reported financial information is expected to influence the actions of users of that information, and the mere fact that many users take similar actions on the basis of reported information does not demonstrate a lack of neutrality. The Board does not attempt to encourage or predict specific actions of users. If financial information is biased in a way that encourages users to take or avoid predetermined actions, that information is not neutral.

Can faithful representation be empirically measured?

BC3.30. Empirical accounting researchers have accumulated considerable evidence supporting relevant and faithfully represented financial information through correlation with changes in the market prices of entities' equity or debt instruments. However, such studies have not provided techniques for empirically measuring faithful representation apart from relevance.

BC3.31. Both previous frameworks discussed the desirability of providing statistical information about how faithfully a financial measure is represented. That would not be unprecedented. Other statistical information is sometimes reflected in financial reports. For example, some entities disclose value at risk from derivative financial instruments and similar positions. The Board expects that the use of statistical concepts for financial reporting in some situations will continue to be important. Unfortunately, the Boards have not identified any way to quantify the faithfulness of the representations in a financial report.

Enhancing Qualitative Characteristics

Comparability

BC3.32. Comparability was an important concept in both Concepts Statement 2 and the *Framework* (1989), but the two previous frameworks disagreed on its importance. Concepts Statement 2 described comparability as a quality of the relationship between two or more pieces of information that, although important, is secondary to relevance and faithful representation. The *Framework* (1989) stated that comparability is as important as relevance and faithful representation.[2]

BC3.33. Relevant and faithfully represented information is most useful if it can be readily compared with similar information reported by other entities and by the same entity in other periods. One of the most important reasons that financial reporting standards are needed is to increase the comparability of reported financial information. However, even if it is not readily comparable, relevant and faithfully represented information is still useful. Comparable information, however, is not useful if it is not relevant and may mislead if it is not faithfully represented. Therefore, *comparability* is considered an enhancing qualitative characteristic instead of a fundamental qualitative characteristic.

Verifiability

BC3.34. Verifiable information can be used with confidence. Lack of verifiability does not necessarily render information useless, but users are likely to be more cautious because there is a greater risk that the information does not faithfully represent what it purports to represent.

BC3.35. The *Framework* (1989) did not explicitly include verifiability as an aspect of reliability, but Concepts Statement 2 did. However, the two frameworks are not as different as it might appear because the definition of reliability in the *Framework* (1989) contained the phrase *and can be depended upon by users,* which implies that users need assurance on the information.

BC3.36. The Discussion Paper stated that reported financial information should be verifiable to assure users that it is free from material error and bias and can be depended on to represent what it purports to represent. Therefore, verifiability was considered an aspect of faithful representation. Some respondents pointed out that including verifiability as an aspect of faithful representation could result in excluding information that is not readily verifiable. Those respondents recognized that many forward-looking estimates that are very important in providing relevant financial information (for example, expected cash flows, useful lives, and salvage values) cannot be verified directly. However, excluding information about those estimates would make the financial reports much less useful. The Board agreed and repositioned verifiability as an enhancing qualitative characteristic, very desirable but not necessarily required.

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[2]The term *reliability* was used instead of *faithful representation*, but the meaning was intended to be similar.

Timeliness

BC3.37. Concepts Statement 2 described timeliness as an aspect of relevance. The *Framework* (1989) discussed timeliness as a constraint that could rob information of relevance. However, the substance of timeliness as discussed in the two previous frameworks was essentially the same.

BC3.38. The Discussion Paper described timeliness as an aspect of relevance. However, some respondents pointed out that timeliness is not part of relevance in the same sense that predictive and confirmatory value are. The Board was persuaded that timeliness is different from the other components of relevance.

BC3.39. Timeliness is very desirable, but it is not as critical as relevance and faithful representation. Timely information is useful only if it is relevant and faithfully represented. In contrast, relevant and faithfully represented information may still be useful (especially for confirmatory purposes) even if it is not reported in as timely a manner as would be desirable.

Understandability

BC3.40. Both Concepts Statement 2 and the *Framework* (1989) included understandability, a qualitative characteristic that enables users to comprehend the information and therefore make it useful for making decisions. Both frameworks also similarly described that for financial information to be understandable, users should have a reasonable degree of financial knowledge and a willingness to study the information with reasonable diligence.

BC3.41. Despite those discussions of understandability and users' responsibilities for understanding financial reports, misunderstanding persists. For example, some have expressed the view that a new accounting method should not be implemented because some users might not understand it, even though the new accounting method would result in reporting financial information that is useful for decision making. They imply that understandability is more important than relevance.

BC3.42. If understandability considerations were fundamental, it might be appropriate to avoid reporting information about very complicated things even if the information is relevant and faithfully represented. Classifying understandability as an enhancing qualitative characteristic is intended to indicate that information that is difficult to understand should be presented and explained as clearly as possible.

BC3.43. To clarify another frequently misunderstood point, the Conceptual Framework explains that users are responsible for *actually* studying reported financial information with reasonable diligence rather than only being *willing* to do so (which was the statement in the previous frameworks). In addition, the Conceptual Framework states that users may need to seek the aid of advisers to understand economic phenomena that particularly are complex.

Qualitative Characteristics Not Included

BC3.44. *Transparency*, *high quality*, *internal consistency*, *true and fair view* or *fair presentation*, and *credibility* have been suggested as desirable qualitative characteristics of financial information. However, transparency, high quality, internal consistency, true and fair view or fair presentation are different words to describe information that has the qualitative characteristics of relevance and representational faithfulness enhanced by comparability, verifiability, timeliness, and understandability. Credibility is similar but also implies trustworthiness of a reporting entity's management.

BC3.45. Interested parties sometimes suggested other criteria for standard-setting decisions, and the Board has at times cited some of those criteria as part of the rationale for some decisions. Those criteria include simplicity, operationality, practicability or practicality, and acceptability.

BC3.46. Those criteria are not qualitative characteristics. Instead, they are part of the overall weighing of benefits and costs of providing useful financial information. For example, a simpler method may be less costly to apply than a more complex method. In some circumstances, a simpler method may result in information that is essentially the same as, but somewhat less precise than, information produced by a more complex method. In that situation, a standard setter would include the decrease in faithful representation and the decrease in implementation cost in weighing benefits against costs.

The Cost Constraint on Useful Financial Reporting

BC3.47. Cost is a pervasive constraint that standard setters, as well as providers and users of financial information, should keep in mind when considering the benefits of a possible new financial reporting requirement. Cost is not a qualitative characteristic of information. It is a characteristic of the process used to provide the information.

BC3.48. The Board has attempted and continues to attempt to develop more structured methods of obtaining information about the cost of gathering and processing the information that proposed standards would require entities to provide. The primary method used is to request interested parties, sometimes formally (such as by field tests and questionnaires), to submit cost and benefit information for a specific proposal that is quantified to the extent feasible. Those requests have resulted in helpful information and have led directly to changes to proposed requirements to reduce the costs without significantly reducing the related benefits.

Chapter 4, *Elements of Financial Statements* As Amended July 2024

CONTENTS

Paragraph Numbers

CHAPTER 4: ELEMENTS OF FINANCIAL STATEMENTS

Introduction

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

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

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

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

E3. Matters of recognition, measurement, and display purposely have been separated from the definitions of the elements of financial statements in the Conceptual Framework. The definitions in this chapter focus on the essential characteristics of financial statement elements. Other parts of the Conceptual Framework focus on questions of when items that qualify as assets, liabilities,

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[1]Decisions about recognizing, measuring, and displaying elements of financial statements depend on evaluations such as what information is most relevant for investment, credit, and other resource allocation decisions and whether the information is reliable enough to be trusted. Other significant evaluations of that information involve its comparability with information about other periods or other entities, its materiality, and whether the benefits of providing it exceed the costs. Those matters are discussed in Chapter 3, *Qualitative Characteristics of Useful Financial Information*, and Chapter 5, *Recognition and Derecognition*, of this Concepts Statement.

revenues, expenses, and so forth, should be recognized in financial statements and how those items could be measured and displayed.

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

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

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

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

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

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

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

The Objective of Financial Reporting

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

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

E11. Economic resources or assets and changes in them are central to the existence and operations of an entity. Both business entities and not-for-profit

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

entities require and use assets to conduct their purpose and mission. A resource's capacity to be exchanged for cash or other resources or to be combined with other resources to produce needed or desired goods or services gives the resource utility and value (present and future economic benefit).

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

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

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

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

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

members, directors, officers, or others.[7] Thus, not-for-profit entities have operating purposes other than to provide goods or services at a profit or profit equivalent, and resource providers do not focus primarily on profit as an indicator of a not-for-profit entity's performance.

E15. Providers of resources to a not-for-profit entity are interested in the services that the entity provides and its ability to continue to provide those services. Because profit indicators are not the focus of their resource allocation decisions, resource providers for not-for-profit entities need other information to assess an entity's performance during a period and how its managers have discharged their stewardship responsibilities, not only for the custody and safekeeping of the entity's resources but also for their efficient and effective use. That includes information about the amounts and kinds of inflows and outflows of resources during a period and the relationship of those resources with other information about service efforts.[8]

Definition of Elements

Assets

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

Characteristics of Assets

E17. An asset has the following two essential characteristics:

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

The combination of those two characteristics allows an entity to obtain the economic benefit and control others' access to the benefit. A present right of an

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

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

entity to an economic benefit entitles the entity to the economic benefit and the ability to restrict others' access to the benefit to which the entity is entitled.

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

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

E20. An asset has the capacity to be beneficial to an entity by being exchanged for something else of value to the entity, by being used to produce something of value to the entity, or by being used to settle the entity's liabilities. Rights that give an entity no advantage beyond the common advantages of others because they are available to all do not qualify as assets. A right that is not restricted, such as a right to sue or a right to enjoy music, is not an asset of an entity. Access to a public road outside an entity's property might provide an economic benefit, but because the entity cannot restrict access to that road by others, the road is not an asset of the entity. Although proximity of the road might add value to the property, there is no right that has granted privileged access or advantage to the entity. A specific right to use a public highway from which a licensee might otherwise be excluded—for example, a license to operate a truck on the highways within a state—would create an economic benefit for the licensee, with respect to that license, even though it does not restrict access of others to the highway.

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

Present right

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

E23. Legally enforceable rights to economic benefits can be obtained without legal ownership of the underlying benefit itself as is the case, for example, when property is leased or intellectual property is licensed or when an entity has the rights to specified certain cash flows, as in the case of a contract providing rights only to interest flows from a specified debt instrument. Other legally enforceable rights that give rise to assets include the right to require other parties to make payments or render services and the right to use a patent or a trademark. Legally enforceable rights include, among other rights, contractual rights (for example, rights from options held).

E24. Rights also might be enforceable by means equivalent to legal enforcement, such as those arising within a self-regulatory structure. If enforcement by other such means is sufficiently similar to legal enforcement, rights enforceable by those alternative enforcement mechanisms may be the equivalent of legally enforceable rights. An entity also can obtain economic benefits from a right in the absence of legally enforceable rights. For example, an entity might not have legally enforceable rights to secret know-how but can otherwise obtain economic benefits from it. The entity may use or sell the knowledge and restrict or otherwise prevent or limit others' access to the benefits.[9]

E25. To qualify as an asset of an entity, that entity need not have an *exclusive* right to an economic benefit. Rights, including the ability to restrict access to a benefit, and restrictions may be single (held or imposed solely by the entity) or shared (held or imposed in conjunction with others). Two or more entities might

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

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

have different rights and share the same economic benefit at the same time or might otherwise have rights to the same economic benefits at different times. For example, lease arrangements unbundle the economic benefits of the underlying asset by giving (a) the lessee the right to hold and use the property and the lessor the right to receive lease payments for a specified interval and (b) the lessor the right to receive any residual value. Each entity has an asset based on its rights to a particular economic benefit, and the rights allow the entity to restrict access to the particular economic benefit.

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

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

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

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

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

Right to an economic benefit

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

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

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

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

E35. Many activities are undertaken with the expectation of obtaining an economic benefit in the future. Examples include research and development, advertising, training, start-up activities, and preoperating activities. While the costs incurred in those activities are not assets, the activities may result in an entity creating a right to an economic benefit and, therefore, obtaining an asset or enhancing an existing asset. For those and similar activities, assessments of when a present right exists and whether the right is to a related economic benefit may be especially uncertain. An entity (a) may have rights that are not to a discernible economic benefit or (b) may have identified future economic benefits to which it has no present rights. The practical problem is whether a right to a future economic benefit exists at a specified date.

E36. Some intangible items that do not arise from rights conveyed by contract or other legal means are nonetheless capable of being separated and exchanged for something of value. If an item is capable of being separated and exchanged for something of value, that would be evidence that a right exists and that the right is to an economic benefit. Others cannot be separated from an entity and sold or otherwise transferred, but still may represent rights to economic benefits. Generalizations about facts and circumstances that bring about internally generated intangible assets are so varied that whether an asset has been created often must be resolved at the standards level.

Liabilities

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

Characteristics of Liabilities

E38. A liability has the following two essential characteristics:

a. It is a present obligation.

b. The obligation requires an entity to transfer or otherwise provide economic benefits to others.[10]

E39. Liabilities commonly have features that help identify them. For example, many liabilities require the obligated entity to pay cash to one or more identified other entities. Liabilities may not require an entity to pay cash but may require the entity to convey other assets, provide services, or transfer other economic benefits or to be ready to do so. Liabilities are based on a foundation of legal rights and duties.

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

Present obligation

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

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

E42. Many obligations that qualify as liabilities stem from contracts and other agreements that are enforceable by courts or from governmental actions that have the force of law.[11] Agreements, contracts, or statutory requirements often will specify or imply how an obligation was incurred and when and how the obligation is to be settled. For example, borrowing and lease agreements specify the amount of charges and the dates when the payments are due. The absence of a specified maturity date or event to require settlement may cast doubt that an obligation exists.

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

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

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

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

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[11]As used in this chapter, a legal obligation is an obligation that a party is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of promissory estoppel. *Promissory estoppel* is defined in the 11th edition of *Black's Law Dictionary* (2019) as:

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

E47. Business risks result from the conduct of an entity's business activities. A business risk is not a present obligation, though at some point in the future an event may occur that creates a present obligation. Some businesses have the potential of carrying out activities and creating present obligations as a result of those activities. However, no present obligation exists even if it is virtually certain that an obligating event will occur, though at present no such event has occurred. The essence of distinguishing business risks from liabilities is determining the point in time when an entity has a present obligation.

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

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

E50. Some liabilities rest on constructive obligations, including some that arise in exchange transactions. A constructive obligation is created, inferred, or construed from the facts in a particular situation rather than contracted by agreement with another entity or imposed by government. An entity may become constructively obligated through customary business practice. In the normal course of business, an entity conducting certain activities may not create a clear contractual obligation but may nonetheless cause the entity to become presently obligated. For example, policies and practices for sales returns and those for warranties in the absence of a contract may create a present obligation because the pattern of behavior may create an enforceable claim for performance that would be upheld in the ultimate conclusion of a judiciary process.

E51. An entity's past behavior also may give rise to a present obligation. Repeated engagement in a certain behavior may obligate the entity to perform or act in a certain way on the basis of that pattern of behavior. For example, the entity may create a constructive obligation to employees for vacation pay or year-end bonuses by paying them every year even though it is not contractually bound to do so and has not announced a policy to do so.

E52. Determining whether an entity is bound by an obligation to a third party in the absence of a clear determination of legal enforceability is often extremely difficult. Thus, the concept of constructive obligations must be applied with great care. Overly narrow interpretations tend to exclude significant actual obligations of an entity, while too-broad interpretations effectively nullify the definition of liabilities.

E53. The essence of a not-for-profit entity is to provide goods or services consistent with its stated purpose or mission. The fiduciary responsibility to use assets to provide services to beneficiaries does not itself create a constructive obligation of an entity. A donor's restriction directs that fiduciary responsibility to a stipulated use for specified contributed assets but does not change the basic nature of the entity's fiduciary responsibility. Consequently, donor-imposed restrictions on an entity's use of contributed assets do not create obligations that qualify as liabilities.

Obligation to provide economic benefits

E54. A second essential characteristic of a liability is that the obligation requires an entity to transfer or provide economic benefits to others or to be ready to do so. The obligation establishes the responsibility of the entity to fulfill the requirements of the obligation or otherwise satisfy or settle the obligation. Some obligations require an entity to refrain from engaging in certain types of activities or to forgo an economic benefit to which the entity may otherwise be entitled.

E55. Many liabilities require an obligated entity to transfer cash or other assets to one or more identified other entities. An obligation also can be fulfilled, satisfied, or settled in a number of other ways, including by granting a right to use an asset, providing services, replacing that obligation with another obligation, converting the obligation to equity, or, in certain circumstances, transferring shares of the entity. Such obligations are often documented, including how the entity is required to fulfill the obligation and when—by a specified date or when specified events occur. For example, a receipt of cash results in an obligation if the entity receiving it is expected to provide a good or service on a certain day or refund the cash if the good or service is not provided. Those actions represent transfers of economic benefits.

E56. A transfer of shares sufficient in number to satisfy an obligation of determinable or defined amount is a transfer of an economic benefit. If arrangements permit or require settlement of obligations by issuance of a variable number of the entity's own shares, those shares are essentially being used in lieu of assets to settle an obligation and therefore meet the definition of a liability.

E57. In some cases, the amount and timing of settlement or performance associated with a present obligation are uncertain. Many of those situations involve what commonly have been referred to as stand-ready obligations. With such an obligation, an entity's timing of settlement or performance, the amount of economic benefits that the entity will transfer, or both are not known at the financial reporting date.

E58. Examples of certain types of contractual and legal obligations with uncertain outcomes are options, guarantees, and warranties. By writing an option, an entity formally documents that it will act in a certain way in the future if called upon by the holder of the option. Even though the external party (option holder) may never exercise the option, the entity that wrote the option is obligated to act as required by the option contract. Similarly, writing a guarantee creates a present obligation even if an outflow resulting from the guarantee is remote. The uncertainty of the payment affects measurement of the guarantee, not the existence of an obligation to honor the guarantee if called upon to do so. In the case of a product warranty, the warranty issuer has a present obligation to repair or replace the product (or to provide warranty coverage over the term of the warranty) if the product develops a fault. The issuer recognizes its liability arising from its obligation to provide warranty coverage. The amount that will be required to fulfill the conditions of the warranty depends on the product developing a fault during the warranty period, an uncertain future event. That uncertainty does not affect the existence of a present obligation to provide warranty coverage; rather, the uncertainty about whether the product will require repair or replacement is reflected in the measurement of the liability.

E59. The nature of those obligations is that the outcome of the present obligation, not the existence of the obligation itself, is determined by some future event. The consequences of the uncertain outcome may affect how the present obligation is measured. Although contractual and legal situations often provide the clearest examples of those obligations, it is possible that noncontractual situations also can give rise to present obligations. For example, an entity may implicitly warrant a product, and, as a result, that entity would be presently obligated to provide services.

E60. Sometimes present obligations with uncertain amounts and timing are referred to as contingent liabilities. The term *contingent liability* has been a source of confusion because it is often thought to refer to circumstances in which the existence of an obligation depends on the occurrence or nonoccurrence of a future event. Absent a present obligation, the occurrence or nonoccurrence of a future event does not by itself give rise to a liability. Some items commonly described as contingent liabilities satisfy the definition of a liability because the contingency does not relate to whether a present obligation exists but instead relates to one or more uncertain future events that affect the amount that will be required to settle the present obligation. For those obligations, the fact that the outcome is unknown affects the measurement but not the existence of the liability.

Equity or Net Assets

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

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

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

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

Characteristics of Equity of Business Entities

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

E65. An entity may have several classes of equity interests (for example, one or more classes each of common stock or preferred stock) with different rights to participate in distributions of entity assets or different priorities of claims on entity assets in the event of liquidation. That is, some classes of owners may bear relatively more of the risks of the entity's unprofitability or may benefit relatively more from its profitability (or both) than other classes of owners. However, all classes depend at least to some extent on entity profitability for distributions of entity assets, and no class of equity interests carries an unconditional right to receive future transfers of assets from the entity except in liquidation, and then only after liabilities have been satisfied.

E66. A major distinguishing characteristic of the equity of a business entity is that it may be increased through investments of assets by owners that also may

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

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

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

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

Characteristics of Net Assets of Not-for-Profit Entities

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

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

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

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

Investments by and Distributions to Owners

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

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

Characteristics of Investments by and Distributions to Owners

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

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

Comprehensive Income

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

Characteristics of Comprehensive Income

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

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

Elements of Comprehensive Income[16]

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

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

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

comprehensive income are significant to those attempting to use financial statements to help them with investment, credit, and similar decisions.

Revenues

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

Expenses

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

Gains

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

Losses

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

Revenues, expenses, gains, and losses

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

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

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

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

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

E86. Nonreciprocal transactions or events are generally distinguishable from revenues and expenses. Holding gains and losses can be a result of a contractual change in value of an asset or a liability from a passage of time, as is the case of interest, or a change in the value of the asset or liability. Those value changes would be distinguished between those that are classified as revenues and expenses or those that are classified as gains and losses. Distinctions between revenues and gains and expenses and losses from exchange transactions of an entity depend to a significant extent on the nature of the entity and the activity with which an item is associated. An identical item can be used by entities differently. As a result, the proceeds from the sale of an asset may be revenue for one entity and may be a factor in determining gain or loss for another. For example, the proceeds from the sale of a machine displayed as inventory would be considered revenue, and the cost of that machine would be considered an expense. However, the proceeds from the sale of a machine used by an entity in a productive capacity would not be considered revenue, and the entity would report a gain or a loss upon disposition of that machine to be consistent with the representations in the statement of financial position.

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

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

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

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

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

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

Specifically, Ms. Botosan disagrees with the following aspects:

1. Removal of the term *control* from the definition of an asset
2. Retention of the existing prescriptive definitions of equity and comprehensive income
3. The definitions of revenue, gain, expense, and loss.

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

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

resources such as public highways, air, or water from the set of economic resources that might otherwise meet the definition of an asset.[19]

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

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

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

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

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[19]Concepts Statement 6, paragraph 188.
[20]IASB's *Conceptual Framework for Financial Reporting*, paragraph 4.3.
[21]IASB's Conceptual Framework, paragraph 4.19.

of the term *control* from the definition of an asset risks complicating subsequent development of principles guiding the derecognition of an asset.

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

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

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

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

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

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

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

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

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

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

Members of the Financial Accounting Standards Board:

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

APPENDIX A: AMENDMENTS TO THE INTRODUCTION OF THE CONCEPTUAL FRAMEWORK BEFORE CHAPTER 1 OF CONCEPTS STATEMENT 8

Appendix A has been omitted from this book. The amendments that were included in this appendix have been incorporated into the text of the introduction to this book.

APPENDIX B: BASIS FOR CONCLUSIONS

Introduction

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

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

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

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

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

a. Clearly identifying the right or obligation that gives rise to an asset or a liability
b. Eliminating terminology that makes the definitions of assets and liabilities difficult to understand and apply
c. Clarifying the distinction between liabilities and equity and between revenues and gains and expenses and losses

d. Modifying the distinctions in equity for not-for-profit entities.

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

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

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

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

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

Assets and Liabilities

BC4.9. When applied as intended, the definitions of assets and liabilities in Concepts Statement 6 were not fundamentally problematic. However, those definitions were often misunderstood. As a result, the Board concluded that improving the definitions in Concepts Statement 6 by making them clearer and more precise would enhance consistent application of the definitions in developing standards.

BC4.10. Accordingly, this chapter reflects changes decided upon by the Board, many of which are common to the definitions of both assets and liabilities. Those common changes primarily address the specific terms used in the definitions of assets and liabilities that have historically been misunderstood.

BC4.11. The definitions of both an asset and a liability in Concepts Statement 6 include the term *probable* and the phrases *future economic benefit* and *past transactions or events*. The term *probable* in the definitions in Concepts Statement 6 has been misunderstood as implying that a future economic benefit or a future sacrifice of economic benefit must be probable to a certain threshold before the definition of an asset or a liability is met. In other words, if the probability of future economic benefit is low, the asset definition is not met under that interpretation. A similar interpretation could be made for liabilities. The footnotes to the Concepts Statement 6 definition of assets and liabilities also were not helpful in clarifying the application of the term *probable* as used in the definitions of assets and liabilities. Accordingly, the Board decided to eliminate that term from the definitions of both assets and liabilities.

BC4.12. The term *future* in the definitions in Concepts Statement 6 focused on identifying a future flow of economic benefits to demonstrate that an asset exists or identifying a future transfer of economic benefits to demonstrate that a liability exists. The definitions in Concepts Statement 6 were often misunderstood as meaning that the asset (liability) is the ultimate future inflow (outflow). For example, in the instance of trade receivables, the definition in Concepts Statement 6 could be misunderstood to indicate that the asset is the successful collection of the receivable in the future. When applied appropriately, however, the definition would conclude that the asset is the present right to collection. Similar misunderstandings occurred in applying the liability definition. As a result, the Board concluded that a focus on the term *present* would appropriately shift the focus from identifying a future occurrence. Therefore, the Board decided to include the term *present right* to demonstrate that an asset exists and emphasize the term *present obligation* to demonstrate that a liability exists.

BC4.13. The definitions of assets and liabilities in Concepts Statement 6 both include the phrase *past transactions or events*. The Board concluded that if an entity has a present right or a present obligation, one can reasonably assume that it was obtained from some past transaction or event. Therefore, that phrase is considered redundant and has been eliminated from the definitions.

BC4.14. In addition to addressing those specific terms used in the definitions in Concepts Statement 6, this chapter addresses other considerations for the definitions of both assets and liabilities. For assets, the considerations in this chapter do not alter the population of items that were included under the previous definition of an asset in Concepts Statement 6. For liabilities, however, this chapter fundamentally expands the population of liabilities that were included under the previous definition of a liability in Concepts Statement 6 to include certain obligations to issue or potentially issue an entity's own shares.

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

Assets

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

BC4.17. The definition of an asset in Concepts Statement 6 associated assets with a particular entity by inclusion of the term *control*. Control often refers to the ability to direct, manage, or have power over something to obtain or access benefits or to increase, maintain, or protect those benefits. Control goes beyond legal rights and includes the ability to obtain and control the benefit in other ways, including restricting, or otherwise prohibiting, the access of others to the economic benefit of the asset.

BC4.18. In applying the definition of an asset in Concepts Statement 6, however, many constituents misunderstood the notion of control. Some improperly viewed control of a probable future economic benefit in the same manner as described in business combinations or consolidation accounting. Additionally, in applying the term *control*, some failed to properly identify that which was controlled under the asset definition. For example, in the instance of trade receivables, the definition could be misunderstood to indicate that what is controlled is the successful collection of the receivable in the future. When applied appropriately, however, the definition in Concepts Statement 6 would conclude that the present right to collection is what is controlled. Similarly, if an entity has an option to acquire an asset, the present right of that entity is to the option itself, not the underlying asset that the option provides the right to acquire. Thus, control references the existing right that has the ability to generate economic benefits, or potential economic benefits, and to restrict others' access to those benefits.

BC4.19. While the Board concluded that the notion of control was an important aspect of the asset definition, it was not clear to the Board whether the explicit term *control* added anything significant to the definition of an asset. Those considerations are addressed by including the term *present right* in the definition in this chapter. If an entity has a present right to an economic benefit, that would seem to be sufficient to establish the fact that the asset is an asset of that entity. Indeed, if an entity has exclusive rights, it presumably can deny or regulate access to that benefit by others, thereby implying control.

BC4.20. An asset must give an entity rights to an economic benefit. The Board concluded that it is not the economic benefit that represents an asset. Rather, it is the existing rights that have the ability to generate economic benefits. Accordingly, the Board concluded that what is controlled is the existing right that gives rise to the economic benefits, or potential economic benefits, rather than the economic benefits themselves.

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

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

a. It eliminates redundancy. If an entity has a present right, that would seem to be sufficient to establish the fact that the asset is an asset of that entity. In fact, the Board used the phrase *of the entity* in the definition of an asset to clarify that point. Indeed, if an entity has exclusive rights, it presumably can deny or regulate access to that benefit by others.
b. It eliminates misunderstanding of the term. The term *control* has two issues in the existing definition of an asset. First, many have a different definition of the term *control*. Second, many associate the term *control*

with whether one has control of the economic benefit. The Board notes that what is controlled is the existing right that gives rise to economic benefits, or potential economic benefits, rather than the economic benefits themselves. The Board's reasoning for removing the term *control* is the same as removing other terms, such as *future* and *probable*, from the definition of an asset.

c. It avoids confusion with the IASB's Conceptual Framework use and meaning of the term. The IASB defines an asset as "a present economic resource controlled by the entity as a result of past events." In the basis for conclusions to the IASB's Conceptual Framework's discussion on control, footnote 19 references both IFRS 10, *Consolidated Financial Statements*, and IFRS 15, *Revenue from Contracts with Customers*. The Board is concerned about the references to IFRS 10 and IFRS 15 because those standards refer to control of an economic benefit, not control of the right. The Board notes that convergence with the IASB's asset definition on this point is not critical because it could perpetuate the misunderstanding discussed above.

BC4.23. The Board considered whether to use the term *economic resource* or *economic benefit* in the definition of an asset. Although either term may have been appropriate if properly applied, the Board discussed that some view *economic benefit* more broadly than *economic resource* because the latter seems to some to be limited to physical resources. Because of those views, the Board determined that the term *economic benefit* should be used in the definition to yield a more consistent application.

Liabilities

BC4.24. The definition of a liability in this chapter has been changed to (a) eliminate terms from the previous definition that were misunderstood, as described in paragraphs BC4.11–BC4.13, (b) clarify when an entity becomes presently obligated, and (c) fundamentally expand the population of liabilities to include certain present obligations settled with an entity's own shares rather than exclusively with assets.

BC4.25. The term *present obligation* is included in the definition of a liability, both in this chapter and in Concepts Statement 6. Because the application of the liability definition under Concepts Statement 6 did not give sufficient emphasis to the term *present obligation*, the definition in this chapter more appropriately emphasizes that term. Assessing whether a present obligation exists is the primary criterion in the definition of a liability in this chapter. The primacy of the term *present obligation* is made more evident through the removal of many of the problematic terms in the definition of a liability in Concepts Statement 6, as discussed in paragraphs BC4.11–BC4.13.

BC4.26. Almost always, the existence of a present obligation will be apparent. Most present obligations are legally enforceable, including obligations arising from binding contracts, agreements, statutes, or other legal or contractual means. However, situations lacking clear legal or contractual evidence of a present obligation pose particular challenges that may make it difficult to discern whether a present obligation exists.

BC4.27. Determining when a present obligation exists has caused confusion with the existence of business risks. Business risks result from the nature of the business and where, when, and how an entity conducts its business. While certain businesses pose risks of future events occurring that will cause a transfer of economic benefits, the Board decided that the risks themselves are not present obligations because exposure to a potential negative consequence does not constitute a present obligation. Rather than viewing all business risks as liabilities, the Board decided that an entity has a present obligation only after an event occurs that demonstrates that the inherent business risk has created a present obligation. Thus, distinguishing when a business risk makes an entity presently obligated requires analysis of the facts and circumstances at the standards level.

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

BC4.29. Given that constructive obligations and other noncontractual obligations are created by circumstance rather than explicit agreement, it can be unclear whether a present obligation exists. In the absence of an explicit agreement, sufficient information to distinguish a present obligation is likely only available at the specific standards level. Thus, the Board decided that specific facts and circumstances at the standards level must be assessed to determine whether an entity has created a constructive obligation.

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

BC4.31. When it is determined that a present obligation exists, some obligations have uncertain outcomes, especially related to their amount and timing. Assessing the amount and timing of those obligations is a question of measurement and, thus, is not considered in this chapter. The Board decided that determining when and why a present obligation exists is critical to identifying a liability. However, if an entity is presently obligated, it may be an obligation with an uncertain outcome. In Concepts Statement 6, obligations of this type were referred to as *stand-ready obligations*.

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

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

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

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

Similarly, when an instrument does not meet the definition of a liability (that is, it is an equity instrument), that does not imply that the instrument should not be remeasured or that a gain or a loss should not be recognized upon settlement of the arrangement.

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

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

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

Adding examples to the framework to illustrate the concept is an issue for standard setting.

Net Assets of Not-for-Profit Entities

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

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

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

Investments by and Distributions to Owners

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

Comprehensive Income

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

Revenues, Expenses, Gains, and Losses

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

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

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

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

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

Accrual Accounting and Related Concepts

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

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

APPENDIX C: AMENDMENTS TO THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

Appendix C has been omitted from this book. The amendments that were included in this appendix have been incorporated into the text of the corresponding chapters.

Chapter 5, *Recognition and Derecognition* As Amended July 2024

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CHAPTER 5: RECOGNITION AND DERECOGNITION

Introduction

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

RD2. A reporting entity achieves the objective of general purpose financial reporting by providing a full set of financial statements including financial information about the reporting entity's (a) resources, (b) claims to those resources, and (c) changes in those resources and claims during the period. The recognition and derecognition criteria provide concepts for the Board to consider when determining whether an item should be recognized or derecognized in financial statements of a reporting entity.

Recognition

RD3. Recognition is the process of incorporating an item in financial statements of a reporting entity as an asset, liability, equity, revenue, gain, expense, loss, or investment by or distribution to owners. A recognized item is depicted in both words and numbers, with the amount included in financial statement totals. For an asset or a liability, recognition involves recording the acquisition or incurrence of the item and later changes in the item (related to measurement), including changes that result in its removal from financial statements (as addressed in paragraphs RD13 and RD14). Because recognition means the depiction of an item in both words and numbers, with the amount included in the totals of financial statements, disclosure of an amount by any other means is *not* a substitution for recognition.

Recognition Criteria

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

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

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

RD6. Items recognized in accordance with the criteria in paragraph RD5 would meet the fundamental qualitative characteristic of relevance, as discussed in Chapter 3, *Qualitative Characteristics of Useful Financial Information*, of this Concepts Statement. Relevant financial information is capable of making a difference in the decisions made by users. To be relevant, financial information about an item must have predictive value, confirmatory value, or both.

RD7. All three criteria are subject to the cost constraint: the benefits from recognizing a particular item should justify the costs of providing and using the financial information. Recognition also is subject to materiality considerations. The cost constraint and materiality are discussed in Chapter 3 of this Concepts Statement.

Element Definitions

RD8. An item must meet the definition of an element in Chapter 4, *Elements of Financial Statements*, of this Concepts Statement to be recognized in financial statements. Recognizing an item that does not meet the definition of an element would be inconsistent with the fundamental qualitative characteristic of faithful representation by misrepresenting a reporting entity's (a) resources, (b) claims to those resources, or (c) changes in those resources and claims during the period.

Measurability

RD9. An item must be measurable with a relevant measurement system to be recognized in financial statements. A relevant measurement system for an item being considered for recognition cannot be determined in isolation. Relevance should be evaluated in the context of the objective of general purpose financial reporting: providing financial information about a reporting entity that is useful to existing and potential investors, lenders, and other resource providers in making decisions about providing resources to the entity.

RD10. The decision usefulness of financial information may be affected by the degree of measurement uncertainty. However, an item that has measurement uncertainty may still provide decision-useful financial information to resource providers through confirmatory value or predictive value. Furthermore, the measurement of that item can be faithfully represented if the measurement process is (a) complete, (b) neutral, and (c) free from error. Disclosures may be necessary to provide information about measurement uncertainty.

RD11. Measurement uncertainty also may relate to the existence of that item rather than its measurement. If the existence of an item is uncertain, that item would presumably fail to meet the definition of an element (the first criterion; see paragraph RD5(a)) and, therefore, would not be recognized in financial statements.

Faithful Representation

RD12. Faithful representation, as discussed in Chapter 3 of this Concepts Statement, is a fundamental qualitative characteristic. To be useful, financial information not only must represent relevant phenomena, but it also must faithfully represent the phenomena that it purports to represent. Financial information that is faithfully represented must be complete, neutral, and free from error. To achieve the objective of general purpose financial reporting, an item recognized in financial statements must be depicted and measured with faithful representation.

Derecognition

RD13. Derecognition is the process of removing an item from financial statements of a reporting entity as an asset, liability, or equity. Derecognition should occur when an item no longer meets any one of the recognition criteria in paragraph RD5. For example, an item should not continue to be recognized if it does not meet the definition of an element because continued recognition of that item would violate the definitions recognition criterion.

RD14. In certain arrangements, an entity may have continuing involvement in the asset, liability, or equity item that is being evaluated for derecognition. The nature and extent of the continuing involvement may influence the derecognition consideration at the standards level. However, that involvement also may create rights or obligations that meet the recognition requirements of paragraph RD5 and therefore should be recognized to faithfully represent the results of the arrangement.

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

Ms. Botosan does not support certain aspects of this chapter at this time for the following reasons.

This chapter includes three criteria for the FASB to consider in decisions about the recognition of items in financial statements. Ms. Botosan agrees that an item must meet the definition of an element to be recognized in the financial statements. Ms. Botosan also agrees that to be recognized, an item must have a *relevant* measurement attribute that is measurable. Ms. Botosan is concerned, therefore, that the Conceptual Framework lacks measurement concepts, such that the concept of what is a "relevant" measurement attribute remains unaddressed within the framework.

Ms. Botosan believes that this omission will significantly challenge the practical application of the recognition concepts. Furthermore, Ms. Botosan is concerned that the omission undermines the ability of the Conceptual Framework to act as "a coherent system of interrelated objectives and fundamental concepts."[1] Ms. Botosan notes that in the basis for conclusions of Chapter 2, *The Reporting Entity,* the Board acknowledges the importance of coherence within the framework. Specifically, the basis for conclusions states that "because the Conceptual Framework is intended to be a coherent system of interrelated objectives and fundamental concepts, there is a need to develop a concept of the reporting entity."[2] Similarly, because recognition depends on having a relevant measurement attribute, Ms. Botosan believes that there is an equally pressing need for the Conceptual Framework to address what constitutes such an attribute.

Ms. Botosan believes that in the absence of concepts that address what constitutes a relevant measurement attribute, the existing broad relevance criterion for recognition should be retained. That criterion requires that information about an item must be capable of making a difference in user decisions, which is broader than the criterion of a relevant measurement attribute. Ms. Botosan believes that removal of the broad relevant criterion places considerably more pressure on the absent concept of a relevant measurement attribute. Consequently, Ms. Botosan would have preferred to finalize this chapter after the completion of the chapter on measurement, which is currently in initial deliberations.

Ms. Botosan notes that her concern is not new but also was expressed 39 years ago in a 1984 dissent to FASB Concepts Statement No. 5, *Recognition and*

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[1]Chapter 1, *The Objective of General Purpose Financial Reporting*, first page of "Statements of Financial Accounting Concepts."

[2]Chapter 2, *The Reporting Entity,* paragraph BC2.3.

Measurement in Financial Statements of Business Enterprises, which has been replaced by this chapter. Specifically, Board member John W. March predicted that Concepts Statement 5 would not offer sufficient guidance for the work of the Board because “to be useful, it needs to be supplemented with more specific guidance for selecting measurement attributes for specific assets, liabilities, and transactions.”

In addition, Ms. Botosan does not support the faithful representation criterion because she believes that faithful representation as it is explained in Chapter 3, *Qualitative Characteristics of Useful Financial Information*, is a vacuous concept and that a criterion based on this concept will play little, if any, role in recognition considerations. Paragraph QC12 of Chapter 3 states that “financial reports represent economic phenomena in words and numbers” and “to be useful, financial information . . . must faithfully represent the phenomena that it purports to represent.” However, faithful representation is operationalized with a focus on any measurement attribute that is “complete, neutral, and free from error.” For example, Chapter 3 states that the representation of an estimate can be faithful if “the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate” (paragraph QC15). Furthermore, an estimate “can be a faithful representation if the reporting entity has applied properly an appropriate process, described properly the estimate, and explained any uncertainties that significantly affect the estimate” (paragraph QC16). Thus, a fair value estimate is deemed to be a faithful representation of the fair value measurement attribute if the reporting entity has applied properly an appropriate process for estimating fair value, described properly the fair value estimate, and explained any uncertainties that significantly affect the fair value estimate. Similarly, a historical cost estimate of the historical cost measurement attribute or any other measurement estimate corresponding to its measurement attribute is deemed to be a faithful representation of the measurement attribute if the reporting entity has applied properly an appropriate process for estimating the measurement attribute, described properly the estimate, and explained any uncertainties that significantly affect the estimate.

Given this and consistent with the majority of comment letters received in response to the Exposure Draft on this chapter, Ms. Botosan cannot conceive of an instance in which an item could meet the definition of an element and be measurable and have a relevant measurement attribute (assuming that concept were delineated) but the item could not be depicted and measured with faithful representation as that concept is described in Chapter 3. Accordingly, Ms. Botosan does not support the inclusion of faithful representation as a standalone recognition criterion.

Members of the Financial Accounting Standards Board:

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

APPENDIX A: BASIS FOR CONCLUSIONS

Introduction

BC5.1. The following basis for conclusions summarizes the Board's considerations in reaching the conclusions in this chapter. It includes reasons for accepting some alternatives and rejecting others. Individual Board members gave greater weight to some factors than others.

BC5.2. Recognition concepts were previously set forth in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. The Board concluded that the discussion of the recognition concepts in Concepts Statement 5 could be further developed and improved with the objective of providing a foundation for future standards for business and not-for-profit entities. The decisions reflect changes to the fundamental qualitative characteristics of useful financial information since Concepts Statement 5 was originally issued in 1984.

BC5.3. Concepts Statement 5 did not explicitly address the issue of derecognition. The Board decided to develop conceptual guidance to address that issue to provide a more comprehensive framework on which to evaluate future standard-setting decisions.

Recognition Criteria and the Qualitative Characteristics

BC5.4. Some of the recognition criteria in this chapter are derived from the qualitative characteristics of useful financial information in Chapter 3 of this Concepts Statement. To be consistent with the fundamental qualitative characteristics described in Chapter 3, the following changes were made to the recognition criteria in Concepts Statement 5:

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

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

Measurability Criterion

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

BC5.6. As discussed in paragraph 76 of Concepts Statement 5 (as issued), the term *sufficient* refers to the level of uncertainty involving the measurement of an item. Certain items, such as contingencies, are susceptible to measurement uncertainty. While the passage of time in many cases reduces or resolves measurement uncertainty, waiting until the measurement of an item is *sufficiently reliable* could result in the delayed recognition of an item that meets the definition of an element and can, despite its measurement uncertainty, be faithfully represented. Consequently, that delayed recognition may reduce the usefulness of the financial information that is presented in financial statements. Therefore, the Board concluded that the phrase *sufficient reliability* may refer to the act of only recognizing items that can be measured with an unspecified degree of certainty when a reporting entity identifies an item that meets the definition of an element.

BC5.7. The Board concluded that to reduce ambiguity in the measurability criterion, the phrase *sufficient reliability* should be removed. However, an item that meets the definition of an element should be recognized in financial statements when it can be (a) measured with a relevant measurement attribute and (b) faithfully represented through depiction and measurement—although, as noted in paragraph RD10, the degree of measurement uncertainty may affect the decision usefulness of the financial information.

Faithful Representation and Relevance Criteria

BC5.8. When Concepts Statement 5 was issued, relevance and reliability were fundamental qualitative characteristics in Concepts Statement 2. Concepts Statement 2 has since been superseded by Chapter 3 of this Concepts Statement. Chapter 3 identifies relevance and faithful representation as fundamental qualitative characteristics. In the basis for conclusions of Chapter 3, the Board concluded that the term *faithful representation* "encompasses the main characteristics that the previous frameworks included as aspects of reliability." Therefore, the Board concluded that the reliability criterion, along with its explanatory paragraphs, should be updated to refer to faithful representation and its aspects of (a) completeness, (b) neutrality, and (c) freedom from error.

BC5.9. The Board also concluded that the relevance of an item, subject to materiality considerations, is inherently met when the item meets the definition of an element, can be measured using a relevant measurement attribute, and can be faithfully represented. As such, the Board decided to remove the *relevance* criterion as a standalone recognition criterion. However, because a relevant item can still be measured with an irrelevant measurement attribute, the Board decided that the fundamental qualitative characteristic of relevance would remain in the measurability criterion as discussed in paragraph BC5.7.

Derecognition

BC5.10. Concepts Statement 5 does not explicitly address the issue of derecognition. The Board decided that, conceptually, derecognition should occur when an asset, liability, or equity element no longer meets one of the recognition criteria.

BC5.11. An entity may have continuing involvement in an item that is being evaluated for derecognition (for example, an option to repurchase an item that was sold). The Board decided that when this circumstance occurs, continuing to recognize the original item would be inappropriate if the original item no longer meets the criteria in paragraph RD5. In developing standards, the Board should evaluate whether the continuing involvement results in a new item that meets the criteria in paragraph RD5. If so, that new item should be recognized (for example, recognizing an option and derecognizing the original item sold). The Board concluded that in this scenario, a failure to derecognize the original item and to recognize the new item would not be a faithful representation.

APPENDIX B: CONCEPTS STATEMENT 5 MARKED TO SHOW SUPERSEDED TEXT

Appendix B has been omitted from this book because Concepts Statement 5 has been superseded in its entirety.

APPENDIX C: AMENDMENTS TO THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

Appendix C has been omitted from this book. The amendments that were included in this appendix have been incorporated into the text of the corresponding chapters. Concepts Statement 7 has been superseded in its entirety.

Chapter 6, *Measurement*
July 2024

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CHAPTER 6: MEASUREMENT

Introduction

M1. The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Investors', lenders', and other creditors' expectations about returns depend on their assessment of the amount, timing, and uncertainty of (the prospects for) future net cash inflows to the entity.[1] To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders, and other creditors need 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 to use the entity's resources. Accrual basis earnings are useful in assessing the effectiveness and efficiency of management.

M2. The qualitative characteristics of useful financial information describe the characteristics of financial information needed to best meet that objective.[2] Useful financial information must possess two fundamental qualitative characteristics—relevance and faithful representation. To be relevant, financial information must be capable of making a difference in the decisions made by users. Financial information is capable of making a difference in users' decisions if it has predictive value, confirmatory value, or both. To be a faithful representation, financial information must be complete, neutral, and free from error to the greatest extent possible.

M3. Other aspects of the Conceptual Framework, including measurement, flow logically from the objective. This chapter discusses measurement in financial statements, which is the process of determining relevant numerical depictions of items recognized in financial statements, which result in faithful representation.

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[1]The objective is described and explained in paragraphs OB2–OB4 of Chapter 1, *The Objective of General Purpose Financial Reporting*, of this Concepts Statement.

[2]The fundamental qualitative characteristics of useful financial information are described and explained in paragraphs QC5–QC18 of Chapter 3, *Qualitative Characteristics of Useful Financial Information*, of this Concepts Statement.

Measurement

M4. Measurement is the process of determining relevant numerical depictions of items recognized[3] in financial statements. An important conceptual premise in any measurement system is that the reported amounts of assets should not be more than what is recoverable, by disposition or use, and the reported amounts of liabilities should not be less than what is settleable, by transfer or satisfaction over an expected benefit or obligation period. A measurement amount that does not meet the recoverability or settleability premise provides less predictive or confirmatory value and, consequently, yields less relevant financial information. The measurement process results in assigning a value to a recognized item in financial statements. Consideration of measurement occurs at (a) the initial recognition of an asset or a liability[4] and (b) each subsequent reporting date. The measurement amount at a subsequent reporting date may be the initial measurement amount, or that initial measurement amount may be remeasured or adjusted. Both the initial measurement or any change to the initial measurement amount may result in the recognition of revenue, expense, gain or loss, or investment by or distribution to owners; therefore, measurement may have consequences on the statement of financial position and the statement of comprehensive income.[5]

M5. Measurement is anchored in prices—both entry prices and exit prices. Both business entities and not-for-profit entities engage in activities with other parties to acquire and provide goods and services and transact with providers of financial capital. Those activities and transactions often have observable entry and exit prices because an exchange has occurred at a known or contracted amount. When an exchange occurs, that price is an entry price to one party and an exit price to the counterparty. Prices objectively measure the financial effects of transactions and other events and circumstances on the reporting entity and, consequently, are fundamental in depicting recognized items in general purpose financial reporting. An agreed-upon price is considered an exchange at fair value absent evidence to the contrary. Circumstances in which there may be evidence to the contrary are discussed in paragraphs M24–M29.

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[3]The recognition criteria for an item and its financial information to be recognized in financial statements are described and explained in paragraphs RD4–RD7 of Chapter 5, *Recognition and Derecognition*, of this Concepts Statement.

[4]Consideration of measurement also is necessary for equity instruments in certain equity transactions, as described in paragraph M27.

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

M6. In many exchange transactions, an entry price and an exit price are easily observed.[6] In the absence of an observable exchange transaction (see paragraphs M24–M29), when consideration in an exchange transaction depends on an uncertain outcome, or in nonmonetary transactions, exit prices can be estimated[7] rather than observed. If a price for an asset or liability or a similar asset or liability can be observed in the marketplace, that price represents a basis for estimation. When the price of that or a similar asset or liability is not observable, estimates of future cash flows that are expected from transactions and other events and circumstances should be calculated with the objective of replicating prices. Therefore, measurement is anchored in prices, even when the price is not directly observable.

Measurement Systems

M7. There are two relevant and representationally faithful measurement systems: the entry price system and the exit price system. A measurement system encompasses both the initial measurement and the subsequent measurement of an item.[8] The prices in those measurement systems are defined as follows:

a. Entry price: The price paid (the value[9] of what was given up) to acquire an asset or received to assume a liability in an exchange transaction
b. Exit price: The price received (the value[10] of what was received) to sell an asset or paid to transfer or settle a liability in an exchange transaction.

M8. More than one measurement system is necessary to meet the objective of general purpose financial reporting. The acceptance of multiple measurement systems is predicated on the assumption that the selection between alternative measurement systems will be based on which measurement system best meets the objective of general purpose financial reporting and best possesses the qualitative characteristics of decision-useful information for the asset or liability

[6]Certain transactions in which there may be multiple elements bundled together, such as a revenue contract or a business combination, may have an entry price or an exit price that is easily observed for the total transaction but not for the separate elements of the transaction.

[7]If the risks of performance and other risks are included in an entity's cash flow estimate, the entity should not incorporate those risks when determining the discount rate. Otherwise, the effect of some assumptions will be double-counted.

[8]When a price is used as a measurement, there are consequences that affect subsequent measurement and allocation decisions. This chapter refers to the initial measurement as a price and the corresponding consequences of that choice as a measurement system.

[9]Value refers to the amount of the cash or equivalent value of the asset given up or received, or the liability incurred or settled, in an exchange transaction.

[10]See footnote 9.

being measured. In addition, selection between alternative measurement systems will be subject to the cost constraint as described in paragraph M49.

M9. Under both systems, an entity would initially record entry prices when assets and liabilities are acquired. In addition, under both systems, an entity would record exit prices at the point that assets are sold or liabilities are transferred or settled. However, prior to sale, transfer, or settlement the subsequent measurement under the systems is different, and the choice between the systems is for the measurement at each subsequent reporting date. The entry price system requires costs to be accumulated and allocated over a benefit period or accrued over an obligation period subject to the recoverability and settleability premise described in paragraphs M4 and M12. The exit price system requires remeasurement at each reporting date under the recoverability and settleability premise.

Entry Price System

M10. To provide useful financial information, the entry price measurement system[11] requires that the asset acquired be initially recorded at entry price (cost) and that the cost be subsequently allocated over its benefit period, resulting in an adjusted entry price. The allocation of costs over an item's benefit period can provide relevant information about an entity's use of an asset. Cost allocation recognizes that an asset is being used and that a corresponding expense has been incurred. Similarly, the costs associated with the incurrence of a liability are allocated to each reporting period until the liability is settled. The allocation of costs to an expected benefit period should be done in a systematic manner, often through amortization or accretion.

M11. Systematic amortization or accretion of an asset or liability is not intended to approximate an entry price or an exit price. Rather, systematic amortization and accretion are adjustments intended to allocate a portion of the entry price to revenue or to an expense each reporting period. Systematic amortization or accretion may be the result of a contractual arrangement, such as interest accretion on a loan, or the result of arithmetically allocating the carrying value of a recognized item over its expected benefit period, such as depreciation. Decisions about specific allocation requirements should be determined at the standards level.

M12. The entry price system assumes that the reported amounts of assets should not be more than what is recoverable, by disposition or use, and the reported amount of liabilities should not be less than what is settleable, by transfer

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[11]The entry price measurement system often is referred to as the *historical cost system*.

or satisfaction over an expected benefit or obligation period. For example, the settleability premise is met through the systematic accretion of a contractual liability to the contracted settlement amount over the obligation period. This premise may not always be met by applying a systematic amortization or accretion cost allocation process. As a result, there are circumstances that require an entity to consider whether the adjusted entry price of an asset or a liability should be remeasured. The adjusted entry price of an asset or a liability is remeasured to reflect the impairment of the asset's value or the modification of the liability's settlement value. In those circumstances, the new measurement assigned to the asset or liability should be an exit price to meet the recoverability and settleability conceptual premise. Once remeasured, the asset or liability should continue to be allocated over its expected benefit period.

M13. In the acquisition of some assets, certain actions must be taken to get the asset to the location and condition necessary to function as intended. Prices related to those actions—such as taxes and shipping and handling costs—should be included within the initial entry price of an asset to be consistent with the premise of the entry price system. Although each of those costs may not meet the definition of an asset individually, each would be allocated over the underlying asset's expected benefit period to be consistent with the premise of the entry price system. Decisions about which actions are necessary and thus have a related price that would be included within the initial entry price should be determined at the standards level.

M14. Similarly, transaction costs, such as legal and underwriting costs, that are necessary to incur an obligation should be netted against the proceeds to adjust the entry price of the liability to be consistent with the entry price measurement system's premise of allocating costs over their benefit period. These items are not assets but are expenses. Under the entry price measurement system, those costs should be allocated over the periods that the liability is outstanding by accreting the liability to the contracted or estimated settlement amount. Decisions about which costs are necessary to incur an obligation should be determined at the standards level.

Exit Price System

M15. To provide useful financial information, the exit price measurement system requires that an asset or a liability be recorded at the market participant value or entity-specific value that an entity would receive from selling an asset or would pay to transfer or settle a liability.

M16. An exit price determined or estimated (using cash flows or otherwise) from a market participant perspective is most commonly referred to as fair value, which is a price a market participant would expect to receive to sell an asset or expect to pay to settle or transfer a liability in an orderly transaction. An entity-specific exit price reflects the price that a specific entity would expect to receive to sell an asset or expect to pay to settle or transfer a liability, which may be different from fair value.

M17. In the exit price measurement system, assets and liabilities at the first reporting date after acquisition are measured at the estimated exit price (either from a market participant perspective or an entity-specific perspective) and remeasured at each subsequent reporting date to reflect the estimated exit price at that reporting date. The subsequent remeasurement of an asset or liability at each reporting date ensures that an asset is not reported at more than what is recoverable, through disposition or use, or that a liability is not reported at less than what is settleable, through transfer or satisfaction. Any difference between the estimated exit price at the first reporting date and the transacted entry price, as well as the impact of any remeasurements in subsequent reporting dates, should be reported in comprehensive income.

M18. An exit price is not observable until a transaction occurs. In some circumstances, exit prices may be determinable by a contracted amount. If exit prices cannot be determined, they should be estimated, whether from a market participant perspective or from an entity-specific perspective. Exit prices of assets and liabilities from a market participant perspective can be readily estimated when an active market exists for identical assets and liabilities. For other assets and liabilities, exit prices from a market participant perspective must be estimated by (a) comparing them with similar assets or liabilities or (b) calculating an exit price from assumptions that market participants would make. Entity-specific exit prices must be estimated by calculating an exit price from assumptions that an entity itself would make. As a result, market-participant value and entity specific value will not always be the same.

M19. In the exit price system, the costs to acquire an asset or assume a liability, as described in paragraphs M13 and M14 (excluding the cost of the asset or liability), should be expensed as incurred. Unlike the entry price measurement system, the exit price measurement system does not allocate costs to each reporting period. A change in the exit price from the beginning of the reporting period to the end of the reporting period should be reported in comprehensive income. Consequently, the exit price measurement system does not necessitate considering either impaired assets or onerous liabilities because the conceptual premise that the reported amounts of assets and liabilities will be recovered or settled, respectively, should be met at each reporting date under the exit price system.

M20. The exit price of a liability at a given date may not equal the contractual amount that the counterparty requires to settle the liability. For example, a change in interest rates over the contract period of a liability may change the fair value of that liability to an amount different from the amount required to settle that liability with the counterparty. Similarly, some assets may require significant disposition expenses; consequently, the ultimate proceeds realized from the sale of an asset will not be the same as the exit price of that asset.

Cash Flows as an Estimate of Exit Prices

M21. Cash flow estimates can be made from a market participant perspective (which would estimate fair value) or from an entity-specific perspective. Cash flow estimates must consider the amount, timing, and uncertainty of the future cash flows expected from transactions and other events and circumstances. Consideration of the amount, timing, and uncertainty of the estimated cash flows determines the value of those cash flows. Therefore, there is no conceptual justification for not considering the time value of money in a cash flow estimate of a price.

M22. The objective of estimating exit prices with cash flows is to determine the price that would be received from selling an asset or that would be paid to transfer or settle a liability. If an estimation is made from a market participant perspective, the price should be calculated using assumptions that a market participant would make. If an estimation is made from an entity-specific perspective, the measurement process would consider unique advantages or disadvantages of the entity to determine the value of the cash flows. Both estimations would represent exit prices to the entity, but the value of the cash flows may not be the same, and only the estimates from the market participant perspective would represent fair value.

M23. Exit price measurements based on estimated cash flows raise issues for subsequent measurement when the amount, timing, or uncertainty of the expected cash flows changes. Each of those changes would cause a change in the value of the expected cash flows and should result in considering remeasurement from either a market participant perspective or an entity-specific perspective. Changes in interest rates also modify the value of the cash flows and should result in considering remeasurement from either a market participant perspective or an entity-specific perspective. However, the original discount rate assumption may be retained in an exit price from an entity-specific perspective if that discount rate would better incorporate the unique advantages or disadvantages of the entity.

Specific Measurement Circumstances

M24. Entry and exit prices in transactions are considered to represent exchanges at fair value, absent evidence to the contrary. That conclusion rests on the presumption that transactions have been consummated on an arm's-length basis between independent parties. As such, circumstances in which there is evidence that the exchange was not at fair value or circumstances in which the fair value of the transaction involving multiple items is only available for the transaction as a whole necessitate special consideration.

M25. Transactions between related parties occur at amounts that are not determined by a price that resulted from negotiations between independent unrelated parties. The price specified in the arrangement is used to record that arrangement with disclosures required to alert financial statement readers of the nature of the arrangements. Consequently, the stipulated value cannot be assumed to be an amount that would represent an exchange at fair value. Resolution of the complexities of accounting for related party transactions should be determined at the standards level.

M26. Charitable contributions are transactions in which the recipient of a contribution did not actively participate in establishing the amount to be received as a basis for the transaction. Contributions are typically measured at the fair value of what was contributed by the donor. Resource providers for both parties to this nonreciprocal transaction are interested in the fair value of what was exchanged. Exceptions to this practice should be determined at the standards level.

M27. Ownership interests often are exchanged between owners of equity interests in transactions that do not involve participation by the issuing entity. These market-based transactions typically result in establishing values of ownership interests absent the participation of the issuing entity. Issuance or acquisition of equity interests by the issuing entity at a price other than the value established in the independent market suggests that the arrangement may have created rights and obligations that should be identified and considered for recognition.

M28. Some transactions, such as a purchase of a group of assets or liabilities, require allocating the entry price value to distinct assets acquired and liabilities assumed. The entry price should be allocated at the relative fair values of what was acquired if that is the best approximation of an entry price of the individual assets or liabilities. Exceptions to that practice should be determined at the standards level.

M29. There may be circumstances when a liability may not have an entry price, such as liabilities accrued related to litigation. In that case, the exit price system (either an entity-specific value or a market participant value) may be used.

Choosing between the Relevant Measurement Systems

M30. Choosing between the entry price system and the exit price system should be guided by whichever system best meets the objective of general purpose financial reporting for a particular asset or liability being measured. Chapter 3 of this Concepts Statement identifies and describes the qualitative characteristics that financial information should have if it is to meet the objective of financial reporting. Information must be both relevant and faithfully represented if it is to be useful. Neither a faithful representation of an irrelevant measure nor an unfaithful representation of a relevant measure helps resource providers make informed decisions.

Relevance

M31. Information is relevant if it is capable of making a difference in the decisions made by resource providers. Information is capable of making a difference in decisions if it has predictive value or confirmatory value (or both). These decisions include buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit. These decisions depend on the returns that existing and potential investors or lenders expect from their investments. Expectations about returns often depend on an assessment of the amount, timing, and uncertainty of the prospects for future net cash inflows to the entity. Whichever measurement system best helps resource providers assess the amount, timing, and uncertainty of future net cash flows to the entity will be more relevant.

M32. Determining which measurement system is more relevant depends on the asset or liability itself (see paragraph M36) and how that asset or liability is used or settled. How assets and liabilities are used should be considered when making measurement decisions at the standards level. In some circumstances, two entities could realize a different price if provided with the same asset (for example, inventory) and could settle the same liability (for example, warranty accrual) with a different price. In contrast, in other circumstances, other market participants could realize the same price if provided with the same asset (for example, investment in an equity security) and could settle the same liability (for example, a cash-settled derivative) with the same price. Whether an asset or a liability is used in combination with other assets and liabilities or is used on a standalone basis may be an indicator of whether two different entities could realize a different price for that same asset or liability. Assets or liabilities used in combination with other assets or liabilities are more likely to result in a unique price, while assets or liabilities used on a standalone basis are more likely to result in a nonunique price.

M33. The entry price system would likely result in more relevant measurements when entities have unique exit prices for the same asset or liability. That is because for assets and liabilities with unique exit prices, the entry price system better maintains the historical relationship between revenues and the costs incurred and the assets employed to generate those revenues. These historical relationships are an important starting point in the process of predicting future unique net cash flows. Information about the return that the entity has produced from its entry price provides an indication of how well management has discharged its responsibilities to make efficient and effective use of the reporting entity's resources. The exit price system (specifically, an exit price that incorporates market participant cash flows) (a) does not maintain those historical relationships and (b) reflects nonunique prices that are different from and, therefore, may not necessarily be confirmatory or predictive of the unique cash flows.

M34. However, the exit price system (specifically, an exit price that incorporates market participant cash flows) would likely result in more relevant measurements when entities have the same exit price for the same asset or liability. That is because the prices associated with the asset or liability are often more exposed to fluctuations in market conditions. Exit prices that incorporate market participant cash flows provide more useful information to users because these prices help users better understand the risks and uncertainties inherent in those potential cash flows. Because an estimated exit price is intended to represent the amount of an exchange transaction, this information is predictive of the market participant cash flows and can be used to confirm or revise earlier expectations. The exit price system (specifically, an exit price that incorporates market participant cash flows) also allows for assessment of how well management has discharged its responsibilities to make efficient and effective use of the reporting entity's resources related to the opportunity to dispose of the asset or settle the liability in an exchange transaction on the measurement date. When assessing the solvency and liquidity of an entity, exit prices from a market participant perspective are particularly useful (for example, for use in determining collateral that may be available to help provide funding).

Measurement Uncertainty

M35. Measurement uncertainty also should be considered when analyzing the relevance of the measurement systems. If the level of uncertainty in an estimate under one of the measurement systems is of concern, that estimate may not be particularly useful, and the other measurement system should be considered. However, if only one measurement system would result in decision-useful information for a particular asset or liability, that measurement system may still provide relevant information even if highly uncertain.

M36. Determining the relevant measurement system can be illustrated by considering a warranty liability with a highly uncertain outcome. Upon initial assessment, an entity may expect that the entry price system would provide the most relevant measurement because the entity could satisfy the warranty for a unique price and use the liability in combination with other assets or liabilities. However, depending on the level of the uncertainty about the outcome and settlement of the warranty, the entry price system may not provide the most relevant measurement and the exit price system should be considered. An entity-specific exit price may provide the most relevant measurement because it reflects the specific entity's circumstances that will affect the price at which the entity can settle the warranty. If an exit price system is used, the liability would be remeasured at each subsequent reporting period, and the subsequent remeasurement of an asset or liability at each reporting date ensures that an asset is not reported at more than what is recoverable, through disposition or use, or that a liability is not reported at less than what is settleable, through transfer or satisfaction.

Price and Cash Flows

M37. Transactions associated with different activities may have significantly different prices, and those activities may help indicate whether an entity could receive a unique price or a nonunique price for the transaction. 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. Those different activities may have significantly different effects on profitability and cash flows.

M38. Commercial activity of both business entities and not-for-profit entities involves buying goods or services necessary to produce the goods or services they provide to generate cash flows. The net cash flows from those transactions often are recurring and helpful in predicting future cash flows to an entity. Distinction between assets that directly provide cash flows and assets that only provide cash flows when used with other assets or resources may be an indicator when choosing between measurement systems.

M39. The type of activity does not necessarily indicate conclusively whether an entity could receive a unique price or a nonunique price. For example, the same activity of a sale could result in receiving a unique price for the asset (for example, inventory) or could result in receiving a nonunique price for the asset (for example, a commodity). Two different retailers could sell the same inventory for a different price, indicating that distinguishing characteristics of each entity could affect the price that could be realized from the sale. On the other hand, such characteristics would have no impact on the price of gold as a commodity.

M40. The entry price system retains the historical cost structure for items like inventory. Resource providers would be able to evaluate the relationship of the cost structure with current and future revenues or earnings. The exit price system (specifically, an exit price that incorporates market participant cash flows) depicts the sensitivity of changing economic conditions for items like commodities. Correspondingly, resource providers may better understand the risks and uncertainties inherent in these potential cash flows. Furthermore, an exit price that incorporates market participant cash flows may offer more predictive value because it would represent the price that would be expected to be received for the commodity.

M41. As with assets, the type of activity for a liability does not necessarily indicate conclusively whether an entity could settle or transfer the liability at a unique or nonunique price. For example, the same activity—performance according to terms of an arrangement—could result in settling at a unique price (for example, warranties) or could result in settling at a nonunique price (for example, a trading-account liability). Distinguishing characteristics of each entity could affect the price at which the entity settles or transfers its warranties, while such characteristics would have no impact on the settlement price of a trading-account liability.

Faithful Representation

M42. To be useful, financial information must represent relevant phenomena and must faithfully represent the phenomena that it purports to represent. A perfectly faithful representation is complete, neutral, and free from error. In this context, free from error does not mean perfectly accurate in all respects. For example, an estimate of an unobservable price cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate. Application of either the entry price or the exit price measurement system provides measurements that can be faithfully represented.

Enhancing Qualitative Characteristics

M43. Comparability, verifiability, timeliness, and understandability are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented. The enhancing qualitative characteristics also may help determine which of the two measurement systems should be used to depict a phenomenon if both are considered equally relevant and faithfully represented.

M44. Enhancing qualitative characteristics should be maximized to the extent possible. However, the enhancing qualitative characteristics, either individually or as a group, cannot make information useful if that information is irrelevant or not faithfully represented. Applying the enhancing qualitative characteristics is an iterative process that does not follow a prescribed order. Sometimes one enhancing qualitative characteristic may have to be diminished to maximize another qualitative characteristic.

Comparability

M45. Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date. Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences between, items. Likewise, using the same measurement system from period to period can help make financial statements more consistent, which is an aspect of comparability. Comparability is not uniformity. For information to be comparable, like things must look alike and different things must look different.

Verifiability

M46. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Using a measurement system that can be independently corroborated, for example, by observable prices or inputs, will enhance verifiability.

Timeliness

M47. Timeliness means having information available to decision makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it is. However, some information may continue to be timely long after the end of the reporting period because, for example, resource providers use financial information to identify and assess trends.

Understandability

M48. Classifying, characterizing, and presenting information clearly and concisely makes it understandable. Using multiple measurement systems for unique prices and using multiple measurement systems for nonunique prices may decrease understandability.

Cost Constraint

M49. Cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information. Paragraphs QC35–QC39 of Chapter 3 discuss several types of costs and benefits to consider. Dependent on these considerations and the item being measured, the benefits of one measurement system may not justify the costs.

This chapter of Concepts Statement 8 was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Richard R. Jones, *Chair*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Frederick L. Cannon
Susan M. Cosper
Marsha L. Hunt
Dr. Joyce T. Joseph

APPENDIX A: BASIS FOR CONCLUSIONS

Introduction

BC6.1. The following basis for conclusions summarizes the Board's considerations in reaching the conclusions in this chapter. It includes reasons for accepting some alternatives and rejecting others. Individual Board members gave greater weight to some factors than others.

BC6.2. FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, was originally issued in 1984. That Concepts Statement addressed recognition, measurement, and certain concepts for presentation. With regard to measurement, Concepts Statement 5 was criticized as being a description of practice rather than providing a conceptual basis for standard-setting decisions. The Board concluded that the discussion of measurement should be further developed with the objective of providing a framework for analyzing measurement issues more consistently.

BC6.3. The Board began the process of developing measurement concepts by reviewing its existing Concepts Statements as well as the frameworks of other standard setters. The Board then reviewed and considered various publications of the International Accounting Standards Board (IASB) and the work of researchers associated with other standards boards. The Board also considered the partial results of the work done on measurement before the Board and the IASB discontinued their joint project on the Conceptual Framework.

BC6.4. In December 2023, the Board issued proposed Chapter 6, *Measurement*, of this Concepts Statement for public comment and received 25 comment letters. Additional outreach included individual stakeholder meetings and meetings with the FASB's various advisory groups.

BC6.5. This chapter describes:

a. Two relevant and representationally faithful measurement systems: the entry price system and the exit price system
b. Considerations necessary to choose between those measurement systems.

BC6.6. In the Board's view, this chapter provides sufficient guidance for the Board to consider in developing measurement requirements at the standards level. Concepts Statement 5 stated that items reported in financial statements are measured by different measurement attributes. This chapter replaces that discussion with a framework in which items recognized in financial statements should be measured by measurement systems. This chapter does not conclude which measurement system should be used for any particular asset or liability. This chapter also does not provide specific guidance on how to calculate an exit price.

BC6.7. The Board observed that recognition, measurement, presentation, and disclosure all work together to achieve the objective of financial reporting. Predicting an entity's future cash flows and, consequently, its earnings, is enhanced by presenting line items in comprehensive income consistent with the objectives of presentation concepts in Chapter 7, *Presentation*, of this Concepts Statement.

Measurement Concepts and the Objective of Financial Reporting

BC6.8. This chapter provides concepts for the Board to consider when choosing a measurement system for an asset or a liability recognized in general purpose financial statements. This choice is necessary to carry out the objective of general purpose financial reporting as described in Chapter 1.

BC6.9. In developing this chapter, the Board considered whether one single measurement system could meet the objective of financial reporting. A majority of the Board identified the following potential advantages of using a single measurement system:

a. The amounts recorded in financial statements could be easily compared across entities.
b. The financial statements would be less complex and more understandable.

BC6.10. However, the Board concluded that more than one measurement system is necessary to meet the objective of general purpose financial reporting. The Board recognized that in different circumstances different measurement bases provide information relevant to the users of financial statements. In addition, the Board reasoned that, the qualitative characteristics of useful information and the cost constraint are likely to result in selection of different measurement systems for different types of assets and liabilities. Financial reporting serves a variety of financial resource providers whose various needs also led the Board to conclude that more than one measurement system is necessary to meet the objective of general purpose financial reporting.

BC6.11. This chapter has the following three foundational premises:

a. Measurement should be anchored in prices, and transactions and other events and circumstances affecting the entity should ultimately be measured in prices (entry and exit prices).
b. Entry and exit prices are the only relevant measures.
c. An asset should not be reported at more than what is recoverable, and a liability should not be recorded at less than what is settleable.

BC6.12. The Board decided that measurement should be anchored in prices because commercial activity is largely carried out through exchange transactions of goods and services. The prices in these exchange transactions represent an objective measure of the initial recognition of an asset or liability and are typically easily observed. In circumstances in which the exchange price of the asset or liability cannot be observed, the Board concluded that the objective of the measurement should still be to consistently anchor the measurements of assets and liabilities in amounts that estimate prices.

BC6.13. Both the entry price system and the exit price system are subject to the assumption that reported amounts of assets and liabilities should not be more than what is recoverable, by disposition or use, or less than what is settleable, by transfer or satisfaction. The Board concluded that a failure to meet this premise would result in measurements with less predictive and confirmatory value.

BC6.14. The majority of respondents agreed with the underlying concepts in the proposed chapter. However, some respondents suggested that there could be other relevant and faithfully representational measurement systems. For example, other standard setters have described or highlighted other measurement systems. In developing this chapter, the Board decided to describe two measurement systems. The Board acknowledges that there may be different techniques used to determine a specific measure, such as current replacement cost, that could be considered an exit price.

Measurement Systems

Entry Price

BC6.15. This chapter describes the entry price system as a relevant and representationally faithful measurement system. Generally, respondents to the proposed chapter agreed with the description and features of the entry price system. Some respondents questioned the application of the underlying recoverability and settleability premise under the entry price system. This feedback was specific to liabilities; respondents generally acknowledged that the premise is easily applied to assets through impairment. The Board decided to describe how the premise is applied differently to assets and liabilities under the entry price system. The Board also decided to add a discussion emphasizing that the underlying premise is met over the expected benefit period of an asset or liability, rather than at a specific point in time.

BC6.16. Respondents to the proposed chapter expressed concern that some liabilities, such as contingencies and asset retirement obligations, do not have initial entry prices. The Board observed that those liabilities have uncertain outcomes and noted that those liabilities may be measured under the exit price system.

Exit Price

BC6.17. This chapter states that the exit price measurement system requires that an asset or a liability be recorded at the exit price from a market participant perspective or at the exit price from an entity-specific perspective. Exit prices from a market participant perspective are most commonly referred to as fair value.

BC6.18. Respondents to the proposed chapter asked that the Board clarify the definition of an entity-specific exit price and when an entity-specific exit price would be used. The Board decided to add a discussion to describe the differences between an entity-specific exit price and a market participant exit price. The Board also added a discussion of liabilities with uncertain outcomes and included an analysis of why an entity-specific exit price may provide a more relevant measure for these types of liabilities.

Transaction Costs

BC6.19. The entry price system includes transaction costs in the initial measurement of an asset or liability. Under the exit price system, transaction costs are expensed upon initial measurement. Some respondents expressed confusion about how the treatment of transaction costs interacts with the underlying recoverability and settleability premise under the entry price system. The Board emphasized that the premise is met over an asset or liability's expected benefit period.

Choosing between Relevant Measurement Systems

BC6.20. The objective of both the entry price system and the exit price system is to provide information useful to resource providers about the factors described in paragraph M1. The Board concluded that both systems provide that information and that selection between the two systems should be based on the asset or liability itself and how that asset or liability is used or settled. Fundamental to meeting that assumption is an expectation of future cash flows to the entity. Resource providers often make resource allocation decisions on the basis of an expectation of future cash flows to the entity; therefore, information that is useful would help a resource provider make that assessment.

BC6.21. Throughout the development of this chapter, the Board considered various approaches to selecting a measurement for a particular asset or liability. First, the Board considered basing measurement on the characteristics of assets and liabilities alone. Next, the Board considered basing measurement on how an asset or liability is used or settled alone. Neither of those approaches was successful in developing a framework to select a measurement system that best meets the objective of financial reporting. Because of the variety of assets and liabilities and different ways that assets and liabilities are capable of being used or settled, an approach that focuses only on one of those factors is insufficient in selecting between alternative measures.

BC6.22. As such, the Board concluded that selection between measurement systems should be based on both the asset or the liability that is being measured and how it is used or settled. Combining the two previous approaches results in evaluating whether other market participants would realize the same price if provided with the same asset or settle the same liability at the same price. The Board concluded that basing measurement on the distinction between unique prices and nonunique prices would best meet the objective of financial reporting, as discussed in paragraphs M32–M34.

BC6.23. As discussed in paragraph M21, estimates of an exit price can be from either a market participant perspective or an entity-specific perspective. Paragraphs M30–M34 describe considerations when choosing between the entry price system and the exit price system for an asset or a liability. Paragraphs M37–M41 provide examples of items that may be recognized under each system to aid the Board in its understanding of the measurement system's applicability. The description and examples provided for the exit price system primarily reflect scenarios that use exit prices from a market participant perspective. The Board decided that both the market participant perspective and the entity-specific perspective are critical to the exit price system.

Concepts Statement 7

BC6.24. The Board considered whether portions of FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, should be retained as an appendix to this chapter. Concepts Statement 7, which was originally issued in February 2000, addressed the use of probability-weighted cash flows to estimate market participant exit prices (fair value). The Board observed that the standard-setting environment, as well as practice, has evolved since the issuance of Concepts Statement 7. Therefore, the Board decided to supersede Concepts Statement 7 in its entirety. The Board noted that Concepts Statement 7 relates to a narrow aspect of this chapter and it is more illustrative than conceptual in nature.

BC6.25. Some respondents suggested that the Board retain portions of Concepts Statement 7 that discuss elements of cash flow estimates and changes in the original timing or amount of an estimated cash flow estimate. The Board affirmed its decision to supersede Concepts Statement 7 in its entirety. The Board reasoned that Concepts Statement 7 would not provide useful information to users of this chapter.

APPENDIX B: AMENDMENTS TO THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

Appendix B has been omitted from this book. The amendments that were included in this appendix have been incorporated into the text of the corresponding chapters.

Chapter 7, *Presentation*
As Amended July 2024

CONTENTS

Paragraph Numbers

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 objective[1] 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

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[1]The 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.

[2]The 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.

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[3]Some 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 this Concepts Statement.

[4]*Recognition criteria* are in Chapter 5, *Recognition and Derecognition*, of this Concepts Statement, while measurement concepts are in Chapter 6, *Measurement*, of this Concepts Statement.

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.

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

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[5]Paragraphs 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.
[6]The introduction to this Concepts Statement explains the use of the terms *transaction*, *events*, and *circumstances*.
[7]Paragraphs QC6–QC10 of Chapter 3 of this Concepts Statement explain the concept of predictive value in providing useful financial information.

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
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, 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

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[8]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.

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 and 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

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

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.

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

Appendix B has been omitted from this book because Concept Statement 5 has been superseded in its entirety.

APPENDIX C: AMENDMENTS TO THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

Appendix C has been omitted from this book. The amendments that were included in this appendix have been incorporated into the text of the corresponding chapters.

Chapter 8, *Notes to Financial Statements* As Amended August 2023

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CHAPTER 8: NOTES TO FINANCIAL STATEMENTS

Introduction

D1. This chapter discusses the information that should be considered for inclusion in notes to financial statements. It also addresses considerations specific to notes to interim-period financial statements.

D2. There are limits to the information that can and should be provided in general purpose financial 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.

D3. As with other aspects of the Conceptual Framework, the concepts and questions in this chapter may evolve. Additionally, none of the concepts can be considered in isolation. They are affected by the economic, legal, political, technological, and social environment in which financial reporting takes place and they also may change as new insights and new research results are obtained and understood. The concepts ought to change if new knowledge shows present judgments to be outdated. As this happens, the concepts and the decision questions in this chapter may need to be updated.

This Chapter's Ties to Other FASB Concepts Statement Chapters

Businesses

D4. The primary purpose of notes to financial statements is to supplement or further explain the information on the face of financial statements by providing financial information relevant to existing and potential investors, lenders, and other creditors for making decisions about providing resources to an entity.

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[1]Definitions of elements and recognition criteria are in Chapter 4, *Elements of Financial Statements*, and Chapter 5, *Recognition and Derecognition*, of this Concepts Statement, respectively.

D5. 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. Information disclosed in notes or parenthetically on the face of financial statements amplifies or explains information recognized in financial statements.

D6. According to paragraph RD3 of Chapter 5, *Recognition and Derecognition*, of this Concepts Statement, recognition is defined as:

> . . . the process of incorporating an item in financial statements of a reporting entity as an asset, liability, equity, revenue, gain, expense, loss, or investment by or distribution to owners. A recognized item is depicted in both words and numbers, with the amount included in financial statement totals.

D7. Thus, one of the purposes of notes to financial statements[2] is to supplement or explain information depicted in words and numbers on the face of, and included in totals of, financial statements. (This chapter refers to that information as financial statement line items or, simply, line items.)[3]

D8. The objective of financial reporting is the starting point for identifying what information is needed to supplement or explain information in line items. That objective, as discussed in paragraph OB2 of Chapter 1, *The Objective of General Purpose Financial Reporting*, of FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting*, is:

> . . . to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about . . . buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit.

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[2]In some cases, as indicated in paragraph D5, an entity has a choice of providing information in notes or parenthetically on the face of financial statements. For convenience and ease of reading, this chapter specifically refers only to notes, but the concepts discussed also apply to information disclosed parenthetically.

[3]Line items are discussed in this chapter as if each represents only one phenomenon. That ignores the fact that nearly every financial statement line item represents an aggregation of items, but it simplifies sentence structures in this chapter while still conveying the intended meaning.

D9. As indicated in paragraph OB3 of Chapter 1, investors and creditors allocate resources on the basis of their expectations about returns from their investments, loans, or other forms of credit. The parties noted in paragraph OB2 (along with contributors to not-for-profit entities) are referred to throughout this chapter as users of financial statements (or users).

D10. Ultimately, expectations about returns from investments, loans, and other forms of credit depend directly or indirectly on the following factors:

a. An assessment of prospects for cash flows to the reporting entity. To make those assessments, a user 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.
b. The nature of the specific investment or credit instrument issued by the reporting entity—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. The assessments of those factors lead investors or creditors to an assessment of prospects for cash flows to themselves.

D11. While financial statements provide information that can assist users in making resource allocation decisions, financial statements are not the only source of information upon which users rely. Additionally, financial statements are not designed to show the value of an entity.

D12. To help achieve the objective of financial reporting set forth in paragraph D8, the notes should contain information about the following matters:

a. Financial statement line items
b. The reporting entity
c. Past events and current conditions and circumstances that have not been recognized that can affect an entity's cash flows.

D13. The following information might be suitable for the purposes described in paragraph D4, but generally should not be required by the Board in the notes:

a. Assumptions and expectations about uncertain future events that are not reflected in financial statements
b. Information about matters that are not specific to the entity and are common knowledge or attainable at little cost from other sources and readily available from other sources as long as a knowledgeable user should be aware of the need for the information and its availability.

Not-for-Profit Entities

D14. Paragraph OB28 of Chapter 1, *The Objective of General Purpose Financial Reporting*, of this Concepts Statement, states:

> Existing and potential users of the information provided by financial reporting by a particular not-for-profit entity share a common interest in information about the services provided by the not-for-profit entity and its efficiency and effectiveness in providing those services as a basis for determining its ability to continue to provide those services.

The users noted above are different from current and potential lenders or other creditors because lenders and other creditors are generally most interested in assessing cash flows to themselves.

D15. A contributor can use information about an entity's use of its resources to assess the services that have been provided and the entity's ability to provide services in the future. Because the assessments of the services that have been provided and the entity's ability to provide services can be aided, at least in part, through assessing past and future cash flows of the entity, this chapter can be used to identify information that would be useful to users of not-for-profit entities' financial statements.

D16. However, some disclosures that are relevant to investors, lenders, and other creditors may not be beneficial to contributors. Thus, the Board should consider contributors separately from the other types of users when using the concepts within this chapter and the decision questions in Appendix A. Considering contributors separately from other users may lead to a different assessment of the costs and benefits of disclosures. Said differently, a disclosure that is useful for assessing the prospects for cash inflows to a business entity may not be useful for assessing how efficiently and effectively a not-for-profit entity has provided services and the not-for-profit's ability to provide services in the future. Therefore, consideration of the differences may result in a different cost-and-benefit consideration.

Employee Benefit Plans

D17. Currently, there is no explicit mention in this Concepts Statement of matters specific to employee benefit plan financial statements. An employee benefit plan's financial statements and their users are sufficiently different from financial statements of business entities and not-for-profit entities and their respective users and warrant potentially different considerations in reporting. Therefore, this chapter is not designed to be used by the Board when making disclosure decisions relative to employee benefit plans.

Types of Information in Notes to Financial Statements

D18. The information provided by the recognized amounts and related descriptions in the financial statements is fundamental to a user's decision making, but the information that can be provided in that form is inherently limited. Information not discernable from line items or from readily available sources other than the entity could significantly affect a user's decisions. Consequently, notes to financial statements provide types of relevant information that is not provided on the face of the financial statements. The resulting disclosures can be categorized as information about (a) financial statement line items, (b) the reporting entity, and (c) past events and current conditions and circumstances that have not been recognized that can affect an entity's cash flows.

D19. Notes provide information that explains specific line items on the face of the financial statements. The information conveyed by the amount and description of a line item does not always give users enough information to assist in their decisions about whether to provide resources to an entity. The nature, terms, or quality of an asset, whether based on physical conditions, contractual terms, the ability of the counterparty to perform, or other factors, often will not be apparent from the amount and description of a line item or related line items. Similarly, important information about the nature, terms, or other features of a liability or equity instrument may not be discernable simply from the amount and description of a line item. Also, the nature of revenues, expenses, gains and losses, and the reasons why they occurred may not be readily apparent from line items but may be important in assisting the user, including assessing the probability that similar or related phenomena will occur in the future.

D20. Notes also provide general information about the nature of an entity, its activities, any special restrictions or privileges that apply to it, and its advantages and disadvantages relative to other entities. That might include unusual or unique regulatory or legal factors that apply to the entity or it might be the nature of the entity's activities.[4] Users require appropriate context or background to assess the potential effect of financial statement line items on prospective future cash flows to and from the entity because an identical asset held or a liability owed by two

[4]As discussed in paragraph D13(b), it is not necessary for the Board to require disclosure of unique regulatory or legal factors if users can be presumed to be aware of the information because such information is readily available from sources other than the entity at little or no cost.

different entities can have very different implications on a user's decisions as could similar exposures and circumstances of the entity. For example, one entity acquires subsidiaries to hold for a period of time and sell versus another entity that acquires subsidiaries and integrates them into its operations. As another example, two entities may have identical performance obligations, but one may be required by law to hire licensed contractors to fulfill the obligation and the other may not operate under that restriction. In both of these examples, additional context would be relevant for a user's assessment of prospects for future cash flows.

D21. Additionally, notes provide information about past events and current circumstances and conditions that have not been recognized but will or may affect an entity's future cash flows. The effects of those types of events, circumstances, or conditions may not be recognized because they have not (or the entity cannot determine whether they have) created resources for the entity or claims against the entity or caused changes to the entity's existing resources or claims. They also may not be recognized because the creation of, or changes in, resources or claims have not met the criteria for recognition or the Board has decided to prohibit or not to require recognition.

Limitations on Information in Notes to Financial Statements

D22. Requirements to provide information in notes to financial statements are limited in at least four ways:

a. The Board should only require information that is relevant to existing and potential users of the financial statements of a broad range of entities (or to a broad range of entities within an identified subset of entities).
b. The cost constraint applies; that is, the benefits of providing the information should justify the costs of providing and consuming it, as described in paragraphs QC35–QC39 in Chapter 3, *Qualitative Characteristics of Useful Financial Information*, of this Concepts Statement.
c. The Board considers potential unintended adverse consequences that may arise from requiring certain information in notes.
d. Including some types of future-oriented information in notes may have negative effects on the cash flow prospects of the reporting entity and its investors, lenders, and other creditors.

Relevance

D23. The Board's judgments about whether to establish disclosure requirements are based on broad general considerations of relevance rather than on entity-specific judgments about materiality. Ideally, disclosure requirements would be made applicable only to the specific entities to which they are most important. However, disclosures should have the potential to apply to a broad range of entities (or to a broad range of entities within an identified subset of entities). For example, disclosures may be relevant to a broad range of not-for-profit entities while not being relevant to for profit entities, although that range may not stay constant. While disclosures have relevance to a broad range of entities, they may not be material to all entities to which they may apply. Materiality decisions must be made by each individual entity. As such, the Board should establish requirements that are not so prescriptive that they preclude reporting entities from making materiality judgments.

The Cost Constraint

D24. Notes to financial statements are subject to the same cost constraint that applies to financial reporting. Entities generally should not be required to provide in notes information about general economic, political, and social conditions, events, and circumstances that are common knowledge and not specific to the entity, even if that information can be provided at a low cost.[5]

D25. Users would be expected to be aware of and have access to information about things such as the *FASB Accounting Standards Codification*® and common accounting practices, frequently used pricing models, or other regulations, and for public entities the U.S. Securities and Exchange Commission's (SEC) rules and regulations. Disclosure of accounting methods is important if (a) alternatives are permitted, (b) the methods are not otherwise apparent, or (c) the methods have changed. Disclosure of the details of frequently used mathematical models is seldom if ever important. However, certain key assumptions within those models may be important.

D26. The FASB establishes financial accounting and reporting standards for public and private companies and not-for-profit entities that follow generally

[5]That does not mean that economic, social, or political information should never be required. For example, economic, social, or political matters specific to lesser-known foreign jurisdictions in which an entity operates may not be generally available. Also, in times of significant economic, social, or political change, an entity may need to inform users about matters affecting the entity because the entity is in a better position to evaluate those effects.

accepted accounting principles (GAAP). Subsets of these entities might be required to include 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.

D27. Technology's effect on the cost constraint is twofold. First, technology increases the ability of a user to consume data. That increased ability translates to increased demand for more data. Second, as technology becomes more advanced, the cost to preparers to provide disclosures may be reduced over time. Therefore, the Board's analysis of cost will change over time.

Potential Adverse Consequences

D28. The assessment of potential adverse consequences of disclosure is separate and distinct from the cost-constraint assessment. Although adverse consequences might have adverse financial effects on an entity, they are not costs as described in paragraphs QC35–QC39 of Chapter 3 of this Concepts Statement, which include the costs to collect, process, verify, and disseminate information to users.

D29. Accounting standards are intended to neutrally reflect economic activity so that users of financial statements can make resource allocation decisions. That being said, accurate financial reporting can have economic consequences, both beneficial and adverse.

D30. Beneficial consequences include fostering economic growth by promoting more efficient capital allocation, greater market liquidity, and a lower cost of capital.

D31. However, certain information might result in adverse economic consequences for some organizations, especially if that reporting sheds light on an area that was not previously transparent. For example, a potential disclosure may require an entity to reveal liabilities that it previously had not been required to provide information about in its financial statements. This new information could result in reduced capital flow or an increased cost of capital for that business. It also could result in some businesses having difficulty attracting and retaining talented employees or, in some extreme cases, in the failure of a business. The Board should not consider this form of potential adverse consequences a reason to not require a disclosure. Those consequences are results of relevant and representationally faithful financial reporting.

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 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.

Future-Oriented Information

D33. Making decisions about providing resources involves, in part, assessing prospects for the entity's future cash flows. Users make estimates and assumptions about future events and conditions and might benefit from receiving such future-oriented information in notes to financial statements, at least for use in comparison with their own predictions or assessments. The cost constraint would not always preclude requiring entities to provide that kind of information. Some entities prepare forecasts or budgets or both or set detailed numerical goals and objectives, and, in those cases, the incremental direct costs of preparing future-oriented information may not be particularly significant.[6]

D34. However, sometimes there are potentially significant negative consequences to issuers of financial statements (and ultimately to their investors and creditors) of providing some future-oriented information. Predictions, projections, forecasts, or similar assertions about uncertain or unknown future events that are beyond management's control cause the most concern because some of that information may turn out to be materially different from the actual future events or conditions when they occur. Some potential consequences are litigation or threat of litigation and loss of credibility.

D35. SEC registrants are required to provide "forward-looking"[7] information with respect to certain disclosures in portions of certain registrants' regulatory filings that are outside audited financial statements, and they are encouraged to provide forward-looking information where doing so is useful to investors.[8] Federal securities laws and SEC rules provide a "safe harbor" for some forward-looking information.[9] The safe harbor does not extend to audited financial statements, whether or not the reporting entity is an SEC registrant.

D36. The objective of financial reporting does not require a reporting entity's management to assess the entity's prospects for future cash flows but to provide

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[6]The cost and difficulty of auditing that information might, at least in some cases, change the judgment about whether expected costs are justified by expected benefits.

[7]SEC rules provide a safe harbor for "forward-looking" information, as defined in those rules, which is provided outside audited financial statements. To avoid any confusion over possible differences in definition or scope, the term *forward looking* is not used anywhere else in this chapter.

[8]See, for example, SEC Securities Act of 1933 Release No. 33-8350, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations* (effective date: December 29, 2003):

> In addressing prospective financial condition and operating performance, there are circumstances, particularly regarding known material trends and uncertainties, where forward-looking information is required to be disclosed. We also encourage companies to discuss prospective matters and include forward-looking information in circumstances where that information may not be required, but will provide useful material information for investors that promotes understanding.

[9]See, for example, Section 27A(c) of the Securities Act of 1933, *Application of Safe Harbor for Forward-Looking Statements*; Section 21E of the Securities Exchange Act of 1934, *Application of Safe Harbor for Forward-Looking Statements*; Securities Act Rule No. 175, *Liability for Certain Statements by Issuers*; and Exchange Act Rule 3b-6, *Liability for Certain Statements by Issuers*.

information to assist users in making their own assessments. Therefore, it is not necessary for the Board to require that entities disclose in notes to financial statements predictions of future outcomes, which could have significant potential for negative consequences to a reporting entity.

D37. However, there are at least two other types of future-oriented information that may be useful disclosures for the Board to consider in some cases and that are not expected to have the same type of adverse consequences as those discussed in paragraph D32.

D38. The first is information about estimates and assumptions used as inputs to measurements, many of which are future oriented and internally developed. Information about those inputs often is an important part of a faithful representation of a line item and may not create the same degree of risk of negative consequences as do projections or predictions about future events that are not within a line item in the financial statements. Many such inputs relate to fair value measurements (which are estimates of current market prices). Those inputs reflect a market perspective instead of the entity's own perspective and are required specifically to be based on existing conditions and currently available information. In addition, they are either probability weighted and/or discounted at a rate that reflects risk and uncertainty. Furthermore, the results of entity-specific measurement inputs are purported to represent the way an entity views an item at the reporting date on the basis of existing conditions and are not purported to be predictions. However, some entity-specific measurements also include projections or predictions about future events (for example, salvage value, useful lives, and expected credit losses) that are important to faithful representation of the line item. Because that information explains amounts included in financial statement line items, it is appropriate for the Board to consider requiring disclosure of these inputs. In contrast, estimates of future revenues related to future sales transactions or the timing of those revenues would not be related to past events or current conditions or circumstances. Therefore, that information would be inappropriate for the notes unless it is an input to a current measure of an asset or a liability.

D39. The second is information about management's existing plans and strategies related to matters under management's control. This type of future-oriented information may be appropriate if management's existing plans and strategies affect the presentation, recognition, or measurement of line items. However, disclosures of management's existing plans and strategies are rarely required for the following reasons:

a. Disclosing some types of plans and strategies may render them less effective and, therefore, adversely affect the reporting entity.

b. Disclosing plans and strategies seldom explains information on the face of the financial statements.

D40. In summary, the Board generally does not require disclosures of expectations and assumptions about the future that are not inputs to current measures in financial statements or notes.

Information Content of Notes to Financial Statements

D41. As previously discussed, the general types of information to be included in notes to financial statements are:

a. Additional information about line items
b. Information about the reporting entity
c. Information about other past events and current conditions and circumstances that can affect an entity's cash flows.

D42. Those descriptions are very general and might include a wide range of information. However, because of the limitations discussed in paragraphs D22–D40, it is not necessary that notes include all the information that might fit those descriptions.

Additional Information about Line Items

D43. Users can adequately understand some line items with little to no explanation or additional information in notes, for example, a non-interest-bearing-demand deposit in an entity's local currency that is not subject to any restrictions and that does not result in a concentration of risk. However, there are many line items that users might need more information about. That information is not conveyed by the amount and description of the line item and cannot be gathered by users in a cost-effective manner from other sources.

D44. The volume of information required to adequately understand different line items varies greatly depending on many factors. Some assets and liabilities are easy to understand. In many cases, understanding trade accounts payable and receivable or plant and equipment would require only marginally more information than what is conveyed by the amounts and descriptions of the line items. Similarly, some revenues and expenses result from routine transactions, and nearly all the information users need may be conveyed by the amounts and descriptions of the line item. In contrast, complex financial instruments or gains or losses arising from complex transactions may require significantly more explanation and elaboration.

D45. The nature of additional information about line items that is relevant for a user's decision making depends on what the line item represents. For example, assets may be physical, contractual or statutory, or intangible. Similarly, liabilities may result from contracts, statutes, or court actions, and revenues, expenses, and gains and losses may be routine or unusual and may result from cash transactions, accruals, or estimation processes. In each case, the set of information that should be provided is potentially different.

D46. Ultimately, each line item should be explained in enough detail for a user to understand the nature of the underlying phenomenon and significant uncertainties, if any, about ownership, obligation, or other matters that the entity considered in determining whether to recognize the item. Some other information that is useful for almost any kind of line item includes how the amounts were determined if that is not specified by GAAP, for example, measurement methods, measurement uncertainties, amortization or accretion methods, and any other relevant information about the accounting and, if applicable, why the amounts or descriptions changed from previous reporting periods or dates. If that information is not otherwise available or apparent, providing that information in notes would be appropriate.

D47. The following additional types of information would be useful for some line items in some circumstances:

a. Information about the nature, quality, location, and other factors affecting the utility of an asset, how the asset can or will generate future cash flows, how the asset relates to other line items (hedging relationships, liens, contractual restrictions on use, sale, and settlement), and any significant contractual, statutory, regulatory, or judicial restrictions on the asset's use or disposition
b. For assets or liabilities resulting from financial instruments or other contracts or legal documents:
    (1) Contractual or legal terms, such as the amount and timing of receipts or disbursements and the form of settlement (for example, by delivering cash or other assets, issuing equity or debt instruments, or performing services)
    (2) Degree of credit or nonperformance risk
    (3) Potential effect of the counterparty's or the entity's inability to pay or perform
    (4) Some indication of the method of determining the amounts and timing of uncertain future cash flows (such as probability-weighted estimates, ranges of possibilities, or most positive outcomes or most negative outcomes) that are either one of the following:

(i) Contractually required, but whose amounts and timing are not contractually specified
(ii) Not contractually specified, but that are anticipated or otherwise probable.

c. The terms or conditions of equity instruments issued by the entity
d. Potential effects of changes in accounting methods
e. Breakdowns of line items that are aggregations of phenomena with significantly different descriptions; effects on cash flow prospects of the entity; risks; or accounting methods
f. Alternative measurements and information to support those measurements
g. How the line item relates to other line items in the financial statements.

Decision Questions to Be Considered in Establishing Disclosure Requirements

D48. Each time the Board sets new accounting standards or updates existing standards that affect specific line items or that require new line items, it considers information that should be provided about those particular line items. Appendix A aids that process by expanding on the types of information discussed in paragraphs D46 and D47. Appendix A is organized as a series of questions about the nature of line items being considered that, if answered positively, indicate that the Board should consider requiring disclosures. It also provides a list of types of disclosures to consider. Obviously, because line items differ, a "yes" answer to a question does not automatically mean the Board should require disclosures. Board judgments will be necessary in each circumstance.

D49. Consistent with decisions about other accounting issues (recognition, measurement, and presentation), Board judgments should include a robust consideration of the objective of general purpose financial reporting, qualitative characteristics of useful financial information, differences in activities among entities, and stakeholder feedback (as well as the limitations described in paragraphs D22–D40). Therefore, not all decision questions in Appendix A should be utilized for each Topic of the Codification. Furthermore, additional information that is not derived directly from the decision questions may be necessary for the Board to meet the objective of general purpose financial reporting.

D50. Two matters about line items are not included in Appendix A because they do not arise when establishing or updating standards about particular line items.

D51. First, although the Codification addresses most phenomena that an entity needs to account for, there are or may still be gaps or new phenomena that may arise or be created. If an entity must determine on its own, by analogy or otherwise, how to account for a significant phenomenon not addressed in the Codification, users almost certainly would need information about the method of accounting that the entity has used and possibly even why the entity decided to use that method.

D52. Second, disclosure about the correction of an error is a more detailed explanation of a change in a line item. Users most likely would be interested in understanding that an apparent change in the reported financial position of an entity occurred because of the correction of an error rather than normal and routine transactions.

Information about the Reporting Entity

D53. There is a variety of general information about an entity that if unknown to users could impair their ability to make informed resource allocation decisions. The general information that different entities should provide in notes to financial statements can vary greatly in both type and volume depending on the nature of the entity and its activities and the availability of information from other sources.

Information about the Entity and Its Activities

D54. The nature of many entities' primary activities is readily apparent or otherwise well known to the average person and need not be detailed in notes to financial statements. However, some entities are not very well known, even to investors or creditors that are well informed about the types of activities in which those entities engage. Also, some well-known entities' routine and recurring activities are more complex or varied than observers can be presumed to be aware of, and other entities engage in ancillary or occasional activities that would have a potentially significant effect on resource allocation decisions.

Restrictions, Privileges, Advantages, and Disadvantages

D55. Some entities operate with relatively few restrictions or privileges other than statutes that apply to every entity (for example, taxes and land use restrictions). Others are subject to restrictions or are granted privileges (or both) because of regulations. Others have significant contractual, statutory, or judicial restrictions or advantages. Still others have a business that depends heavily on government subsidies or on one or very few customers, suppliers, or financing sources. Information about any of those matters that have had, will have, or can have significant effects on resource allocation decisions is a candidate for disclosure.

Information about Related Parties and Related Party Transactions

D56. Most entities have interrelationships with their owners, managers, parents, subsidiaries, entities under common control, or other entities in which they have significant investments. Information about those matters can significantly affect resource allocation decisions if the interrelationships result in conditions, circumstances, transactions, or events that are different from what otherwise informed observers would have expected if they were uninformed about those interrelationships. Therefore, such interrelationships and their effects on conditions, circumstances, transactions, or events are candidates for disclosure.

Disaggregation of Legal Entities and Segments

D57. Disaggregation at the entity level (as opposed to the line item level) is a possible reason for providing information in notes. That information may be about disaggregation of consolidated entities or disaggregation of different activities, geographical areas, or other units managed separately.

D58. Consolidated financial statements tend to make a group of entities appear to an outside observer to be a single entity. Even though the observer may be aware (and, in most cases, should be aware) that a more complex structure exists, the potential effect on cash flows to users may not be discernable unless the entity provides additional information in notes about its structure. In some cases, an entity may include a subsidiary or a variable interest entity in consolidated financial statements under conditions of uncertainty. Information about such decisions and the related uncertainties is a candidate for disclosure.

D59. Many business entities provide significantly different products or services, otherwise engage in varied activities such as operating in different geographical areas with different effects on prospects for cash flows to users, or may manage different portions of the consolidated entity separately or differently. Similarly, some not-for-profit entities provide more than one type of service or otherwise engage in more than one type of activity. Information such as a description of each of those portions (for example, segments) and some indication of assets, liabilities, and results of operations is a candidate for disclosure.

D60. Providing these types of information may be accomplished by disaggregating line items. However, the objective of providing such disclosures is for users to understand the nature of the reporting entity, not to identify items of different natures within a line item.

Decision Questions to Be Considered in Establishing Disclosure Requirements

D61. Disclosures of additional information about the reporting entity typically are not considered when the Board sets standards about individual line items. In the past they have been, and may be in the future, the subjects of separate standards (separate Topics in the Codification). For example, the requirements for disclosures about segments, related party transactions, and consolidation were all established as separate standards. Therefore, there are no questions addressing those matters in Appendix A. However, the concepts contained in this chapter would be used when the Board updates related requirements or undertakes any such projects.

Information about Other Past Events and Current Conditions and Circumstances That Can Affect an Entity's Cash Flows

D62. There are a number of types of events, conditions, and circumstances that can affect the amounts or timings of an entity's future cash flows but that have not yet affected a line item. The Board should consider requiring information about such events, conditions, and circumstances subject to the cost constraint and other limitations on information to be provided in notes. (See paragraphs D22–D40 for a discussion of the limitations of disclosures.)

Events

D63. Some types of events that are candidates for disclosure are:

a. Existing or potential litigation (because of specific matters instead of general business risk) against the entity or by the entity against another entity or entities
b. Suspected or known violations by the entity of statutes, judicial requirements, regulations, or contractual terms and violations by other entities of the reporting entity's rights under statutes, judicial requirements, regulations, or contracts
c. Existing commitments that have not been recognized but that are expected to be recognized in future periods (for example, contracts to deliver goods, provide services, permit use of assets, or extend credit that are not yet required by standards to be recognized)
d. Events that have not created recognizable assets, liabilities, equity, revenues, expenses, gains, or losses but about which there was

significant uncertainty in the entity's decision not to recognize (for example, disputed rights and obligations)
e. Events that have occurred after the reporting date but before the financial statements are issued.

D64. In most cases, users are likely to want as much information as possible about the potential effects of those events on the entity. Some of the information users may want is obvious and is not likely to be difficult to provide. However, some events may require an entity to make difficult estimates or judgments or may subject the entity to a potential disadvantage (or a loss of advantage) to competitors, litigants, or others. The Board's decisions about such matters are made on a case-by-case basis. This chapter identifies the possible types of information but does not imply that all types identified always should be disclosed.

D65. The information about those events that is relevant for resource allocation decisions begins with the fact that an event has occurred, then a description of the event, and possibly which other entities or groups are involved; for example, (a) a lawsuit was filed against the entity by a group of customers to recover $1 billion in claimed overcharges and punitive damages or (b) the entity signed a contract to provide services to a customer for $500 million.

D66. Other factors users likely would consider important are whether an event is unique, infrequent, unusual, or routine and whether it could have a continuing effect on routine and frequent business activities. Users also are likely to be interested in the entity's judgment about the probability that an event such as threatened litigation or a claimed statutory violation ultimately will significantly affect that entity and, if there is an effect, a current measure of that possible effect.

D67. Finally, if the entity assessed uncertainties in concluding that the effects of an event should not be recognized under existing standards, users may need at least a general indication of what those uncertainties were to facilitate comparisons with other entities that have experienced similar events.

Conditions and Circumstances

D68. Some current conditions and circumstances that do not necessarily affect line items but that are candidates for disclosure are:

a. Dependency of the entity for its continued profitability (or existence) on one or a few customers or suppliers
b. Volatility or other uncertainty in volumes or prices in the markets for the entity's inputs or outputs that would have a significant effect on the entity's future cash flows

c. Uncertainty in the entity's access to the markets for its inputs or outputs (whether resolution of the uncertainty would result in increased or decreased access)
d. Uncertainty about the entity's ability to maintain a qualified work force and suitable physical facilities
e. Other uncertainties specific to the entity (that is, outside of ordinary business risks) that create significant risk that the entity will not be able to continue to operate (that is, that call into question the "going concern" presumption).

D69. The following are the types of information about the conditions and circumstances in paragraph D68 that might be decision useful (not all apply in every case):[10]

a. The existence and description including, if applicable, the causes and the nature of the effects of any uncertainties
b. If possible, the probabilities that the conditions or circumstances will affect future cash flows of the entity and at least a general indication of the amount and timing of the effects (for example, the worst-case scenario or the best-case scenario or some other general indication of potential significance of the potential effect) and the factors that affect the occurrence or nonoccurrence and the amount and timing
c. An explanation of actions that the entity has taken to mitigate potential effects of the conditions or circumstances.

Decision Questions to Be Considered in Establishing Disclosure Requirements

D70. Appendix A includes three questions about events and circumstances that will or may affect the amount or timing of an entity's future cash flows but that have not yet affected a line item. Such events are sometimes associated with line items that are addressed in standard-setting projects, and requiring disclosures of information about those events may be judged to be appropriate. Two examples are potential litigation or suspected violation of laws.

[10]The considerations of potential disadvantage or loss of advantage to the entity discussed in paragraph D64 as well as the limitations discussed in paragraphs D22–D40 will apply when considering these disclosures.

Considerations Specific to Financial Statements for Interim Periods

D71. Interim-period financial statements generally are provided for reasons that are different from those provided for annual financial statements and, therefore, have unique characteristics and limitations. Those characteristics and limitations affect the nature and volume of information to be provided in notes.

D72. The interim periods for which financial statements are prepared should be viewed primarily as an integral part of annual periods.[11] In addition, interim-period financial statements generally are not designed to be a full set of 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.

D73. Because interim-period financial statements are essentially an update of the information in the most recent annual statements, notes are intended to convey new information or information about significant changes to matters discussed in notes to the most recent annual financial statements.

Information Specific to Interim Reporting

D74. Because interim-period financial statements are not discrete, the notes should provide two specific types of information that would not be relevant in notes to annual financial statements. First, they should describe differences from the most recent annual financial statements in recognition, measurement, or presentation of line items. Some examples are accounting policies that differ from those applied in the most recent annual financial statements and methods of determining the amounts and expenses that are deferred or accelerated to reflect a portion of the anticipated annual amount. Second, they should explain how the financial position and results of operations for the interim period relate to the entire year, for example, the effect of seasonal variations in revenues.

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[11]As of the issuance of this chapter, paragraph 270-10-45-1 of the Codification stated:

> Interim financial information is essential to provide investors and others with timely information as to the progress of the entity. The usefulness of such information rests on the relationship that it has to the annual results of operations. Accordingly, each interim period should be viewed primarily as an integral part of an annual period.

D75. Interim-period financial statements generally are aggregated to a greater degree than a full set of 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.

Information to Be Provided in both Interim-Period Financial Statements and Annual Financial Statements

D76. Interim-period financial statements are not designed to be as complete as a set of annual financial statements. Normally, relevant information that can be obtained from the most recent annual financial statements and that has not changed is not provided in interim-period financial statements. That applies to most descriptions in notes and much of the explanatory information, such as accounting policies.

D77. Numerical information in notes to financial statements tends to change at least slightly from period to period, but that does not automatically mean that all notes—including numerical information—should be included in interim-period financial statements. For example, notes to annual financial statements include disaggregated information about some line items. Interim-period financial statements generally are designed to be more highly aggregated than annual financial statements and emphasize information about changes from the most recent annual financial statements. Providing all of the same disaggregated information in interim-period financial statements that is provided in annual financial statements is inconsistent with that design. However, disaggregated information about line items is not inconsistent with that design if the composition changed significantly in ways that users would have no reason to expect.

D78. If the direction and amount of the change during an interim period cannot be readily estimated or are otherwise not discernable from other information in the interim period and most recent annual financial statements, the new information should be included in notes. Fair values change in inherently less predictable ways and information about fair values of material items may be necessary at interim periods. Contingent liabilities or potential liabilities may have highly uncertain outcomes or otherwise may be so unpredictable that the most recent available information should be provided.

D79. In contrast, some annual disclosures relate to matters that are peripheral to the activities of most entities to whom they apply and are not likely to give important information for interim-period financial statements. For example, annual disclosure of capitalized costs may be relevant but peripheral to most businesses.

D80. Information may need to be included in notes to interim-period financial statements even if it can be estimated or is discernable from other information if it is especially important to the assessment of cash flow prospects. A notable example is detailed information about revenues such as disaggregation, contract terms, and related balances.

D81. Some notes to annual financial statements provide information about changes since the end of the previous annual period. Similar information may be important to notes to interim-period financial statements. One example is a financial instrument measured at fair value for which there was an observed market price at the end of one period but no observable market price at the end of the next period.

D82. Finally, notes to interim-period financial statements tend to be more highly aggregated than similar notes to annual financial statements.

APPENDIX A: DECISION QUESTIONS TO BE CONSIDERED IN ESTABLISHING DISCLOSURE REQUIREMENTS

Introduction

DQ1. The Board and stakeholders that use this appendix will be guided and aided by the concepts in this chapter, but judgments based on the particular circumstances of each case will continue to play a major role in improving disclosure. The questions in this appendix are developed as educational guidance for the Board to be used as a tool to identify possible considerations for setting standards for disclosures in Topics in the Codification. Consistent with decisions about recognition, measurement, and presentation, the consideration by the Board should include a robust consideration of the objective of general purpose financial reporting, relevance of the information, cost constraints, and differences in activities among entities. Therefore, not all questions in this appendix will be utilized for each Topic of the Codification. Furthermore, disclosure requirements not derived directly from the decision questions may be considered relevant in advancing the objective of general purpose financial reporting at a standards level.

DQ2. A “yes” answer to a question indicates that the Board should consider requiring that information in notes. However, a “yes” answer does not necessarily mean that the Board should require note disclosure. It also does not indicate the extent of disclosure that would be necessary. Those decisions can be reached only by considering the particular Topic and are subject to all of the constraints listed in paragraphs D22–D40.

DQ3. When the decision questions reference cash flows, and because the decision questions will be used by the Board and staff as a tool in standard-setting projects, the cash flows being referred to relate to the cash flows of the entity from the particular line item, transaction, phenomenon, event, circumstance, or condition being addressed. Ultimately, the prospects of cash flows to the entity can affect the cash flows to the resource providers.

Information about Line Items

DQ4. The following group of questions relates to information about line items in financial statements that can affect a user’s decisions.

Question L1

Is there information about the nature or quality of the phenomenon or phenomena represented by the line item (for example, the underlying rights, obligations, or transactions) that can affect assessments of cash flow prospects and that is not adequately conveyed by the line item's description?

Information to Be Considered for Disclosure

a. Enough information (normally qualitative instead of quantitative) about the phenomenon or phenomena so that a user may access reference materials or other sources of information to understand the phenomenon or phenomena
b. If a user could not reasonably be expected to find adequate information from other sources, an explanation of the nature of the phenomenon or phenomena in enough detail to provide an understanding of how the item might affect prospects for cash flows.

Question L2

Does the line item represent any of the following:

a. Financial instruments issued or held by the entity
b. Other contracts or legally binding documents
c. Other binding arrangements?

Information to Be Considered for Disclosure

a. Terms (obligations and rights) needed for assessing prospects for cash flows. Some examples are amounts and timing of payments and receipts, interest rates, and the nature and timing of other required performance, call or put options, and penalty or bonus clauses.
b. If the item is an asset, the risk of counterparty nonperformance (credit risk or failure to deliver other assets or services) at the date of the financial statements.
c. The potential effect on the financial statements of the reporting entity of counterparty nonperformance.
d. The potential effect on the financial statements of the reporting entity of the entity's nonperformance.

e. The estimated amounts and timing of future cash flows that are contractually required, but whose amounts and/or timing are not contractually specified.
f. The estimated amounts and timing of future cash flows that are not contractually specified but that are anticipated or otherwise probable (for example, on the basis of past history or economic incentives).
g. Terms needed for assessing prospects for cash flows of claims against the entity related to equity instruments issued by the entity. Some examples are the number of shares outstanding, the number of share options outstanding, dividend and liquidation preferences, conversion or exercise prices, participation rights, and unusual voting rights.
h. For claims against the entity, information about the priority of those claims.

Question L3

Could the existence or ownership of the rights and obligations underlying the line item be uncertain?

This question is different from the uncertainty question related to measurement (see Question L12) in that it does not relate to uncertainty about measurement, but to uncertainty about whether an asset or liability exists or is owned or owed by the entity.

Information to Be Considered for Disclosure

a. A description of the uncertainty or uncertainties about the existence and ownership of the item
b. An explanation of how future cash flows would change if the uncertainty is resolved in a manner that is different from what the entity expects.

Question L4

Does the line item include components of different natures that could affect prospects for net cash flows differently?

There are many examples of line items that contain different components, and some of those components may affect prospects for cash flows in a different manner. Some examples include the following:

a. A portfolio of financial instruments of different types

b. Inventories of different types of products or raw materials, work in process, or finished goods
c. Revenues from different products or services whose sales are not correlated
d. Real estate that includes apartment buildings, malls, and office buildings
e. Revenue related to a business acquired through a business combination
f. Property, plant, and equipment acquired in exchange for debt.

The following are examples of indications that components affect prospects for cash flows differently:

a. Different frequency or timing of occurrence
b. Different probabilities of repeating
c. Responses to different variables or different responses to the same variables
d. Different rates of return expected.

Information to Be Considered for Disclosure

a. The amounts and natures of the different components of the line item
b. Unusual or infrequent items.

Question L5

Are the causes of the changes in an entity's line item of an asset, liability, or equity instrument not readily assessable because there are numerous causes or because the line item is subject to nonroutine changes?

Information to Be Considered for Disclosure

a. A detailed rollforward, major inflows and outflows, or particular changes in a line item.

It may be important to separate routine changes from nonroutine changes and changes in reported amounts caused by changes in accounting, changes in economic conditions, changes in the composition of the entity, and changes in contractual obligations or rights.

Question L6

Could the quality or utility of a nonfinancial asset have changed?

That disclosure is related to measurement but is not strictly a measurement issue. Some productive assets are carried at amounts that are not closely related to their current values, and they do not change in relation to those values. For example, a building with a carrying amount that is being depreciated may actually be appreciating in value, and its cash-flow generating potential may be increasing.

Information to Be Considered for Disclosure

a. A description of the nature of the change and how that change could affect prospects for cash flows of the entity. The objective of this disclosure would be to provide information not signaled or indicated by accounting and reporting. For example, the carrying amounts of depreciable assets may systematically decline in a way that masks a change in utility or value. The asset may have been depreciated at a rate that exceeds the rate at which its economic value has declined. Therefore, a technological change that causes it to become significantly less valuable in a single year may not require an impairment write-down. That change in economic value is the kind of information to be provided by this disclosure.

Question L7

Does the line item include individual items (or groups) that are measured differently?

Information to Be Considered for Disclosure

a. Descriptions, carrying amounts, and measurement methods of the items or groups that are measured differently.

Question L8

Are there acceptable alternative accounting policies or methods provided under GAAP that might have been applied to this line item?

Information to Be Considered for Disclosure

a. The accounting policy or method applied
b. The magnitude of the effect if the accounting method is unusual, if results produced are counter to what a reader might otherwise expect (for

example, last-in, first-out [LIFO] inventory costing), or if the method otherwise dramatically affects the financial statements (full cost versus successful efforts).

Question L9

Has the accounting policy or method used for this line item changed because of adoption of or transition to newly issued guidance or because the previous method was determined to no longer be proper?

Information to Be Considered for Disclosure

a. The fact that a change has occurred
b. The reason(s) for the change
c. How the change would have affected previous years or, if that is not feasible, how the previous method would have produced different information this year.

Question L10

Will this line item be affected in future years by transition to an accounting standard that has been issued but that is not yet effective or not fully effective?

Information to Be Considered for Disclosure

a. When the transition will occur
b. A description of the anticipated effect on future financial statements[12]
c. If readily available, the pro forma effect on current-year financial statements.

Question L11

Is the method for determining the amount of the line item uncommon, not apparent from the description, or otherwise hard to discern?

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[12]If the data are available without undue effort.

Information to Be Considered for Disclosure

a. An explanation of how the amount of the line item was determined (for example, an option pricing model, a matrix pricing technique, or an internally developed technique). However, if the computation is unique or unusual but prescribed in an accounting standard (such as the way of determining deferred taxes or uncertain tax positions), disclosure might be unnecessary if the line-item description is adequate to indicate the accounting requirement that is applied.

Question L12

Is the carrying amount of the line item an estimate that requires assumptions, judgments, or other internal inputs that could reasonably have been different?

This question is not limited to fair value or other estimates of current value. At times, accumulations of costs involve uncertainties (about which costs to include, for example), and impairment allowances not based on quoted market prices are nearly always subject to significant uncertainties. Information about how changes between periods for significant estimates, assumptions, judgments, or other internal inputs that have affected a line item also could be relevant.

Information to Be Considered for Disclosure

a. Disclosure of enough detail about the significant estimates, assumptions, judgments, or other internal inputs to provide a general understanding of (1) how the carrying amount was determined, (2) the level of uncertainty inherent in the amount, and (3) how significantly the number might have changed if the inputs had been different.

Question L13

Is there an alternative measure or way of applying a measurement that clearly would be useful in assessing prospects for cash flows?

An alternative measure might be considered for an asset or a liability. One example is the fair value of a financial instrument reported at a cost-based amount. Another example is disclosing inventory using the first-in, first-out (FIFO) inventory costing method for inventory carried using the LIFO inventory costing method.

Information to Be Considered for Disclosure

a. Identification of the alternative measurement or method of application
b. An indication of the magnitude of the difference between the reported measurement and the alternative measurement (or the amount of the alternative measurement).

Question L14

Does a line item have a direct relationship not otherwise apparent to another line item or items in another statement?

Information to Be Considered for Disclosure

a. A description of the relationship(s) between line items when the relationship or relationships are otherwise not apparent
b. The effects that a change in a particular item has on another item
c. A reconciliation of the relationship(s) between line items on various statements.

Information about Other Past Events and Current Conditions and Circumstances That Can Affect an Entity's Cash Flows

DQ5. The following group of questions relates to information about other past events and current conditions and circumstances (the effects of which have not yet been reflected in financial statements) that can affect a user's decisions.

Question O1

Can any of the following events or conditions create a possibility that a user's assessment of an entity's future cash flows would be significantly different (lower or higher):

a. Potential litigation against the entity or by the entity against another entity or entities (because of specific matters instead of general business risk)
b. Existing litigation against the entity or by the entity against another entity or entities, the outcome of which is still uncertain

c. Suspected or known violations by the entity of laws, regulations, or contractual terms or violations of the entity's rights under statutes, regulations, or contracts
d. Other uncertain conditions (such as the entity's inability to continue as a going concern)?

Information to Be Considered for Disclosure

a. The existence and description of the event or condition
b. Whether the effect of the event or condition would involve the entity's routine and frequent business activities or would have an infrequent or one-time effect on the entity's cash flows
c. Whether the event or condition itself is unique or infrequent or is routine or frequent
d. A current measure of the possible effect of the event or condition on the entity's future cash flows
e. The entity's judgment about the probability that the event or condition will affect the entity's future cash flows.

Question O2

Are there other events or circumstances that are not represented by an asset or a liability and a gain or loss (or income or expense) in an entity's financial statements but for which there is uncertainty in the decision about whether it should be recognized (that would include items other than the contingencies discussed in Question O1(a) and (b))?

Information to Be Considered for Disclosure

a. The existence and description of the event or condition
b. Uncertainties that were assessed in deciding not to recognize an asset or a liability and a gain or a loss (income or expense) and the reason for that decision
c. Whether events or conditions of the same type are routine and frequent or would have an infrequent or one-time effect on cash flows
d. Whether the event or condition itself is unique or infrequent or is routine or frequent
e. A current measurement of the possible effect of the event or condition on future cash flows

f. The entity's judgment of the probability that the event or condition will affect future cash flows.

Question O3

Are there contractual rights or obligations arising from past transactions and events or current conditions and circumstances that are expected to meet the criteria for recognition by the entity in the future?

Information to Be Considered for Disclosure

a. Unrecognized obligations
b. Future payments related to unrecognized obligations
c. Potential issuances of an entity's own shares resulting from existing contractual agreements.

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

Ms. Botosan dissents from the issuance of this chapter of Concepts Statement 8 because she believes that excluding one type of entity—an employee benefit plan—from a single chapter of the Conceptual Framework creates inconsistencies within the entire Conceptual Framework. Ms. Botosan believes that choosing to exclude employee benefit plans from this chapter has broader implications for the Conceptual Framework as a whole, which the Board has yet to consider. In Ms. Botosan's view, the applicability of the Conceptual Framework to employee benefit plans should be considered more holistically to ensure that the Conceptual Framework remains "a coherent system of interrelated objectives and fundamental concepts," as described in the introduction of this Concepts Statement.

Chapter 1, *The Objective of General Purpose Financial Reporting*, of this Concepts Statement defines the objective of general purpose financial statements. The existing and future "principles" chapters (including Chapter 3, *Qualitative Characteristics of Useful Financial Information*, of this Concepts Statement and possible forthcoming chapters on element definitions, measurement, and presentation) are intended to offer an internally consistent set of principles that operate as a system to support the achievement of the stated objective. Excluding employee benefit plans from this chapter alone raises a host of questions about the applicability to employee benefit plans of the principles contained in the other chapters of the Conceptual Framework.

Paragraph BC12 of this chapter states that "the Board decided that because users generally *do not use plan financial statements to make resource allocation decisions*, this chapter does not apply to employee benefit plans" (emphasis added). Ms. Botosan believes that this conclusion calls into substantial doubt the applicability of the stated objective of financial reporting to employee benefit plans, which is "to provide financial information about the reporting entity that is *useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources* to the entity" (emphasis added).[13]

Moreover, Ms. Botosan believes that this same justification might imply that employee benefit plans are appropriately excluded from proposed Chapter 7, *Presentation*, or other parts of the Conceptual Framework. Nonetheless, the Board has decided not to address applicability to employee benefit plans in its redeliberations of proposed Chapter 7 (which is silent on the issue) or in its possible forthcoming deliberations of other parts of the Conceptual Framework (for example, measurement principles). In Ms. Botosan's opinion, failing to more holistically address the applicability of the Conceptual Framework to employee benefit plans impairs the overall coherence of the system and the interrelatedness of the stated objective and the fundamental principles.

Ms. Botosan would have preferred that the Board pursue one of five possible alternative paths to more comprehensively resolve the question of the applicability of the Conceptual Framework to employee benefit plans:

1. Adhere to the conclusion in paragraph BC1.30 of Chapter 1 that the objective of general purpose financial reporting is the same for *all* entities but that cost constraints and differences in activities among entities may lead the Board to permit or require differences in reporting for different types of entities.
2. Clarify in Chapter 1 that employee benefit plan financial statements are not "general purpose" in nature so that the objective of general purpose financial reporting and, consequently, the Conceptual Framework do not apply.
3. Clarify in Chapter 1 that the objective of employee benefit plan financial statements is fundamentally different from the objective of financial reporting specified in Chapter 1.
4. Acknowledge in the basis for conclusions in this chapter that although the question of the applicability of the principles to employee benefit plans first appears in the context of this chapter, through its due process

[13]Paragraph OB2 of Chapter 1, *The Objective of General Purpose Financial Reporting*, of this Concepts Statement.

procedures, the Board came to realize that the answer to that question has implications for the Conceptual Framework that extend well beyond this chapter.

5. Include employee benefit plans within the scope of this chapter but clarify that the decision questions, which were drafted with other types of entities in mind, do not apply to employee benefit plans.

Ms. Botosan dissents from the issuance of this chapter because she believes that a piecemeal exclusion of employee benefit plans from this chapter of the Conceptual Framework raises numerous essential questions that have not been answered.

Mr. Schroeder dissents from the issuance of this chapter of Concepts Statement 8. In developing this chapter, the Board followed an iterative approach of applying its then-tentative concepts to several existing sets of disclosure requirements. Overall, this approach led to some disclosure improvements by adding new decision-useful information while eliminating disclosures that users found less useful or redundant. However, in Mr. Schroeder's view, this approach also highlighted a substantive weakness in the interplay between (1) the Board's process for assessing information that should be considered for inclusion in notes to financial statements and (2) each entity's process for assessing whether that information is in fact decision useful to its financial statement users and, therefore, must be included in the notes.

Specifically, Mr. Schroeder's concerns with this chapter center on the "limitations on information" articulated in paragraph D22 (particularly item (a)) that hand the Board too blunt an instrument for guiding its decisions. Mr. Schroeder asserts that the results can be, and have been, biased toward only requiring disclosures of information when "relevant to existing and potential users of the financial statements of a *broad range* of entities" (emphasis added). To confirm this bias, he believes that one only need look at the contemporaneous efforts to apply this chapter's guidance to standard-setting projects related to inventory and fair value disclosures. In both projects, the notion of *broad range* led the Board to not require certain disclosures even though stakeholder feedback indicated such information would have been clearly decision useful to users focused on certain entities or on specific industries.

Mr. Schroeder notes that paragraph D23 of this chapter effectively acknowledges that the limitation is too restrictive by suggesting disclosure requirements could be narrowed to a "broad range of entities *within an identified subset* of entities" (emphasis added). However, he agrees with the Board's conclusions in those standard-setting projects that requiring industry-specific disclosures is fraught with complications and generally does not support such an approach. Therefore, Mr. Schroeder believes that the most effective approach to addressing the “limitations on information” articulated in paragraph D22 is twofold.

First, deleting the word *broad* in both paragraphs D22 and D23 would lower the threshold for when the Board should consider requirements to provide information in notes. Second, while outside the scope of this chapter, is the notion of materiality. Mr. Schroeder believes that this chapter will not achieve the broader objective of improving the effectiveness of note disclosures until the notion of materiality becomes more operable in practice.

The notion of materiality is discussed in Chapter 3 of this Concepts Statement, which was amended at the same time this chapter was issued. Specifically, paragraph QC11 of the amended Chapter 3 states:

> Relevance and materiality are defined by what influences or makes a difference to an investor or other decision maker; however, the two concepts can be distinguished from each other. Relevance is a general notion about what type of information is useful to investors. *Materiality is entity specific*. [Emphasis added.]

Furthermore, paragraph 105-10-05-6 of the Codification reinforces this notion by clearly stating that its provisions “need not be applied to immaterial items.” Therefore, in Mr. Schroeder’s view, each entity can most cost effectively communicate with existing and potential investors only by applying the notion of materiality. In doing so, each entity could mitigate disclosure costs, when justified, by concluding which information not to disclose because it is immaterial.

Mr. Schroeder acknowledges that there are real barriers to applying a materiality notion in the current financial reporting ecosystem that includes auditors and regulators. Those barriers make it costlier for an entity to exclude specific immaterial disclosures, even though that information would not prove decision useful. Mr. Schroeder also accepts that certain of those barriers are outside the Board’s authority to unilaterally address. However, he believes that using the *broad range* limitation in paragraph D22 of this chapter is not the best long-term path for achieving the Board’s mission of improving financial reporting. He believes that the financial reporting ecosystem will be more effective and efficient only when entities are able to use greater discretion in providing disclosures that best fit the needs of each entity’s existing and potential investors. Therefore, in Mr. Schroeder’s view, the Board should make every effort to work with others within the ecosystem to remove both real barriers and perceived barriers.

Mr. Schroeder notes that without contemplating each entity's ability to apply a reasonable and rational assessment of materiality, the generic-questions approach used in this chapter too often can result in financial statement users being provided with collectively less information. More important, because most analysis is performed by industry specialists, user needs are not being met. This is particularly true for investors focused on specific industries or on conglomerates operating in a diverse set of industries (often including both financial activities and nonfinancial activities). Therefore, Mr. Schroeder has more broad concerns about the way future Boards may evaluate those generic questions in making cost-benefit assessments at a standard-setting level.

Members of the Financial Accounting Standards Board:

Russell G. Golden, *Chairman*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Marsha L. Hunt
Harold L. Monk, Jr.
R. Harold Schroeder
Marc A. Siegel

APPENDIX B: BASIS FOR CONCLUSIONS

Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this chapter. It includes reasons for accepting some alternatives and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC2. In July 2012, the Board issued for public comment an Invitation to Comment, *Disclosure Framework*, and received 84 comment letters on that document. In March 2014, the Board issued the proposed Concepts Statement of this chapter for public comment and received 54 comment letters on it. Additional outreach included public roundtables, individual stakeholder meetings, forums with individuals from all parts of the financial reporting system, and meetings with the FASB's various advisory groups.

BC3. After issuing the 2014 proposed Concepts Statement, the Board tested the concepts and decision questions in this chapter by applying them in standard-setting projects on the following Codification Subtopic and Topics:

a. Topic 820, Fair Value Measurement
b. Subtopic 715-20, Compensation—Retirement Benefits—Defined Benefit Plans—General
c. Topic 740, Income Taxes
d. Topic 330, Inventory.

The purpose of the Topic-level testing was to assess the effectiveness of the proposed disclosure concepts in aiding the Board to develop decision-useful disclosures. Stakeholder feedback from that Topic-level testing was used to fine-tune and improve the disclosure concepts as proposed.

BC4. This chapter sets out the FASB's views after considering all the above outreach efforts and Topic-level testing.

Notes to Financial Statements

Purpose and Boundary of the Notes

BC5. The 2012 Invitation to Comment stated that the decision questions created a de facto boundary for the notes. Many respondents to that Invitation to Comment said that the decision questions alone are not adequate to describe the purpose or create a boundary for notes to financial statements. Therefore, paragraphs D4–D13 have been added to this chapter to describe, at a high level, the purpose of notes to financial statements and the types of information that would be considered appropriate and not appropriate for inclusion in the notes.

Collaboration with the SEC and Disclosure Overlap

BC6. Many respondents commented that the disclosure framework should be developed in coordination with the SEC and that the coordinated effort should address issues such as overlapping disclosure requirements.

BC7. The SEC staff and the FASB have been in contact throughout the course of the project. Additionally, forums cosponsored by the FASB and the Center for Audit Quality[14] were held. The forums were attended by various stakeholders within the financial reporting system, including an SEC staff member. The Board acknowledges that there are ways in which it and the SEC could work together to improve existing or potential disclosure requirements and intends to pursue every reasonable opportunity to eliminate duplication or overlap.

BC8. Some of the duplication or overlap in SEC rules and FASB standards exists because FASB standards apply to reporting entities that are not SEC registrants. In addition, there are situations in which the Board concludes that information may not be as complete or subject to the same degree of scrutiny unless the information is required in the financial statements.

Not-for-Profit Entities

BC9. Initially, the decision questions in the 2012 Invitation to Comment and the 2014 proposed Concepts Statement were developed with business enterprises in mind. Investors and creditors of those entities' financial statements are interested in disclosures that assist in the assessment of future cash flows to the investors and creditors. Creditors of not-for-profit entities also are interested in assessing cash flows to themselves; therefore, the decision questions are useful in identifying relevant disclosures in not-for-profit financial statements.

BC10. The 2012 Invitation to Comment and the 2014 proposed Concepts Statement asked whether the decision questions and the indicated disclosures could be used to identify disclosures relevant to contributors to not-for-profit entities even though contributors do not expect cash flows to themselves.

[14]The Center for Audit Quality is affiliated with the American Institute of Certified Public Accountants (AICPA).

Respondents said that the questions could be used as long as the Board considers the contributor's purpose for using the financial statements when assessing the relevance of potential disclosures. That purpose is to assess how an entity used its resources to provide services and the entity's efficiency and effectiveness in providing those services as well as the entity's ability to continue to provide those services.

Employee Benefit Plans

BC11. Respondents to the 2012 Invitation to Comment stated that there are issues unique to disclosures in financial statements of employee benefit plans that are not addressed by the decision questions in that document. After additional research and analysis, the Board agreed with those respondents. The Board considered modifying the decision questions in that Invitation to Comment or adding questions to address employee benefit plan issues but decided not to do so. Many of the disclosures unique to employee benefit plans (some of which are the result of legal or regulatory requirements) are included in a single Topic in the Codification. The concerns expressed by stakeholders did not relate to those specific disclosures. Therefore, modifying the decision questions to address those disclosures would not have addressed stakeholders' concerns.

BC12. Respondents to the 2014 proposed Concepts Statement were asked whether employee benefit plans should be included within the scope of this chapter. The Board decided that because users generally do not use plan financial statements to make resource allocation decisions, this chapter does not apply to employee benefit plans.

Private Company Considerations

BC13. This chapter applies to all business as well as not-for-profit entities, whether they are public or private. If there are factors unique to private companies that affect disclosure requirements, they are addressed separately by the *Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies*. Procedurally, the Private Company Decision-Making Framework is applied after the Board has established general applicability of disclosure requirements to all entities.

Future-Oriented Information

BC14. Some respondents to the 2012 Invitation to Comment and the 2014 proposed Concepts Statement said that the notes should include only information of a historical nature because the financial statements themselves represent the accounting for the entity's current financial position and past financial results.

BC15. Currently, a number of disclosures discuss matters related to the future (such as maturity schedules), but that information is based on existing circumstances and conditions. That information relates to the entity's current financial position and is not highly subjective.

BC16. The Board concluded that although some information may be subjective and oriented toward the future, that information is appropriate if it affects the presentation, recognition, or measurement of an item.

Decision Questions

BC17. The decision questions in Appendix A exclude some of those included in the 2012 Invitation to Comment and the 2014 proposed Concepts Statement because of stakeholder feedback, experience in performing the Topic-level reviews, and additional consideration by the Board. The Board also evaluated certain feedback specific to particular decision questions and elected to retain those questions as proposed or with some modification.

Changes in Line Items

BC18. Many stakeholders noted that Decision Question L5 could lead the Board to require disclosure of changes in opening and closing balances for every line item. Through the Topic-level review of Topic 330, Inventory, the Board noted that an appropriate level of useful information could be provided to users by requiring particular changes within the inventory balance (instead of a comprehensive analysis of all of the changes in the balance). Furthermore, the Board concluded that disclosures about changes in line items are most relevant when the causes of the changes are difficult to understand because the causes of the changes are numerous or because the line item is subject to nonroutine changes. The Board modified the decision question to emphasize that view.

Information about General Economic, Market, or Entity-Specific Factors That May Affect a Line Item

BC19. The Board concluded that information about how particular line items are sensitive to potential changes in the future because of general economic, market, or entity-specific factors is more appropriate for inclusion by public companies in management's discussion and analysis. The Board is not likely to require these types of disclosures for private companies because users of private company financial statements have greater access to management (according to the Private Company Decision-Making Framework). Therefore, the Board decided to remove those concepts and the related decision questions.[15] This means that the Board will not systematically consider these types of disclosures when evaluating what sort of information is relevant to certain line items.

Alternative Measures

BC20. The 2012 Invitation to Comment and 2014 proposed Concepts Statement stated that the Board should consider requiring disclosure in certain circumstances of alternative measures of line items. Many respondents stated that disclosure of alternative measures should never be required. They added that alternative measures can challenge the measurement used in the financial statements as well as confuse the user.

BC21. The Board decided that alternative measures are useful and appropriate for the notes in certain circumstances. Users have different needs and different ways of analyzing the financial position and performance of an entity. Therefore, at times, users may differ on which measure is best suited to their needs. Furthermore, alternative measures can provide additional information that complements reported amounts (for example, the fair value of a financial instrument measured at historical cost).

BC22. As stated in the 2014 proposed Concepts Statement, alternative measures should be considered for disclosure only if they are clearly useful in assessing the prospects for cash flows.[16] Topic-level testing indicated that the notion of "clearly useful" may not be necessary because, as with all potential disclosures, expected costs and expected benefits must be assessed for this type of disclosure. However, there could be many alternative measures of a particular item for the Board to consider. To be more efficient, the "clearly useful" notion helps the Board to focus on alternative measures that are most important to users of financial statements.

Potential Adverse Consequences

BC23. In Topic-level testing (particularly in the area of income tax disclosures), some stakeholders noted that certain information, if disclosed, could adversely affect the reporting entity. While the 2014 proposed Concepts Statement did not

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[15]Designated as Decision Questions L5 and L6 in the 2014 proposed Concepts Statement.

[16]Designated as Decision Question L4 in the 2014 proposed Concepts Statement.

discuss potential adverse consequences of disclosures in detail, the Board already had considered some of those consequences as possible reasons not to require a disclosure. However, the Board decided to include a discussion about potential adverse consequences of disclosures in this chapter to help the Board be more consistent in its consideration of those consequences.

Evaluating Costs

BC24. Some stakeholders noted that additional decision questions or concepts should be added to this chapter to explain how costs should be evaluated when the Board is considering disclosures. The Board indicated that other aspects of the Conceptual Framework already describe (a) the types of costs that should be considered when setting standards, including disclosures (for example, the cost to collect, process, verify, and disseminate information), and (b) that cost and benefit assessments are subjective (paragraph QC39 of Chapter 3 of this Concepts Statement). Therefore, the Board decided not to provide any additional detail on the application of the cost constraints in this chapter.

Notes to Financial Statements at Interim Periods

BC25. A number of respondents suggested that the Board should not have a role in setting disclosure requirements for interim reporting but, rather, should include within GAAP a principle that places the burden on preparers to determine where changes have occurred and whether updates of disclosures are needed. That principle would be similar to SEC Regulation S-X, Rule 10-01, *Interim Financial Statements*, which states that ". . . disclosure shall be provided where events subsequent to the end of the most recent fiscal year have occurred which have a material impact on the registrant."

BC26. However, users expressed concern about allowing decisions about what to disclose at interim periods to rest solely with the reporting entity. The Board concluded that it is appropriate for the Board to require at least some level of disclosure for interim financial reporting.

BC27. The Board concluded that some disclosure requirements should be considered for interim periods because of the differences in the accounting methods that exist at those periods and because the interim-period results may not achieve a fair measure of the results of the annual period or the financial position at the end of the annual period for which they are a part.

BC28. The Board decided that there are some types of disclosures required in annual periods that also might be suitable for requirement at interim periods.

However, there has been an expansion of this subset of disclosures in recent years, which has placed a strain on the ability of preparers to provide the information within tighter reporting deadlines. Therefore, this chapter contains a number of indicators that will assist the Board in evaluating whether an annual disclosure is both useful and appropriate for disclosure at interim periods.

BC29. The use of those indicators is intended to limit the number of disclosures required for interim periods while still requiring information that is necessary for users to receive a meaningful and timely update of the financial results of the reporting entity.

BC30. It also is possible that the Codification could incorporate something similar to (or exactly like) the guidance in SEC Regulation S-X, Rule 10-01 (see paragraph BC25). However, such a modification would be most appropriately considered as part of the reporting entity's decision process within the disclosure framework rather than the development of this chapter.

BC31. Stakeholders suggested and the Board considered whether the Board's decision process should include the targeting of disclosures in interim reports on the basis of size, ratios, types of business in which a company engages, or other factors. During deliberations, the Board expressed mixed views on that issue. Some Board members noted that the entity's decision process could provide entities with sufficient tools to exercise further discretion at the entity-specific level and alleviate the need for such targeted interim disclosures at the standard-setting level. Some Board members also were concerned about the Board's ability to set appropriate thresholds for disclosure on the basis of the previously mentioned factors, such as size.