Statement of Financial Accounting Concepts No. 3

Note: This Statement has been completely superseded

CON3 Status Page

Elements of Financial Statements of Business Enterprises

December 1980

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 MERRITT 7, P.O. BOX 5116, NORWALK, CONNECTICUT 06856-5116

Statement of Financial Accounting Concepts No. 3

Elements of Financial Statements of

Business Enterprises

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Paragraph Numbers

CON 3: Elements of Financial Statements of Business Enterprises

CON 3 HIGHLIGHTS

[*Best understood in context of full Statement*]

- Elements of financial statements are the building blocks with which financial statements are constructed—the classes of items that financial statements comprise. The items in financial statements represent in words and numbers certain enterprise resources, claims to those resources, and the effects of transactions and other events and circumstances that result in changes in those resources and claims.
- This Statement defines 10 interrelated elements that are directly related to measuring performance and status of an enterprise. (Other possible elements of financial statements are not addressed.)

  —Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

  —Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

  —Equity is the residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.

  —Investments by owners are increases in net assets of a particular enterprise resulting from transfers to it from other entities of something of value to obtain or increase ownership interests (or equity) in it. Assets are most commonly received as investments by owners, but that which is received may also include services or satisfaction or conversion of liabilities of the enterprise.

  —Distributions to owners are decreases in net assets of a particular enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interests (or equity) in an enterprise.

  —Comprehensive income is the change in equity (net assets) of an 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.

—Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

—Expenses are outflows or other using up of assets or incurrences of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

—Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from revenues or investments by owners.

—Losses are decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from expenses or distributions to owners.

- The Statement also defines or describes certain other concepts that underlie or are otherwise closely related to the 10 elements defined in the Statement.
- The Statement does not define the term *earnings*, which is reserved for possible use to designate a significant intermediate measure or component that is part of comprehensive income.
- The Board expects most assets and liabilities in present practice to continue to qualify as assets or liabilities under the definitions in this Statement. The Board emphasizes that the definitions neither require nor presage upheavals in present practice, although they may in due time lead to some evolutionary changes in practice or at least in the ways certain items are viewed. They should be especially helpful in understanding the content of financial statements and in analyzing and resolving new financial accounting issues as they arise.
- The appendixes are not part of the definitions but are intended for readers who may find them useful. They describe the background of the Statement and elaborate on the descriptions of the essential characteristics of the elements, including some discussions and illustrations of how to apply the definitions and what they mean.

Statements of Financial Accounting Concepts

This Statement of Financial Accounting Concepts is one of a series of publications in the Board's conceptual framework for financial accounting and reporting. Statements in the series are intended to set forth objectives and fundamentals that will be the basis for development of financial accounting and reporting standards. The objectives identify the goals and purposes of financial reporting. The fundamentals are the underlying concepts of financial accounting—concepts that guide the selection of transactions, events, and circumstances to be accounted for; their recognition and measurement; and the means of summarizing and communicating them to interested parties. Concepts of that type are fundamental in the sense that other concepts flow from them and repeated reference to them will be necessary in establishing, interpreting, and applying accounting and reporting standards.

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

Establishment of objectives and identification of fundamental concepts will not directly solve financial accounting and reporting problems. Rather, objectives give direction and concepts are tools for solving problems.

The Board itself is likely to be the most direct beneficiary of the guidance provided by the Statements in this series. They will guide the Board in developing accounting and reporting standards by providing the Board with a common foundation and basic reasoning on which to consider merits of alternatives.

However, knowledge of the objectives and concepts the Board will use in developing standards also should enable those who are affected by or interested in financial accounting standards to understand better the purposes, content, and characteristics of information provided by financial accounting and reporting. That knowledge is expected to enhance the usefulness of, and confidence in, financial accounting and reporting. The concepts also may provide some guidance in analyzing new or emerging problems of financial accounting and reporting in the absence of applicable authoritative pronouncements.

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

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

Since a Statement of Financial Accounting Concepts does not establish generally accepted accounting principles or standards for the disclosure of financial information outside of financial statements in published financial reports, it is not intended to invoke application of Rule 203 or 204 of the Rules of Conduct of the Code of Professional Ethics of the American Institute of Certified Public Accountants (or successor rules or arrangements of similar scope and intent).**

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

FASB PUBLICATIONS ON CONCEPTUAL FRAMEWORK

Statements of Financial Accounting Concepts

No. 1, *Objectives of Financial Reporting by Business Enterprises* (November 1978)

No. 2, *Qualitative Characteristics of Accounting Information* (May 1980)

No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations* (December 1980)

Discussion Memorandums and Invitations to Comment Having Issues Being (or Yet to Be) Considered by the Board

Elements of Financial Statements and Their Measurement (December 2, 1976)

Reporting Earnings (July 31, 1979)

Financial Statements and Other Means of Financial Reporting (May 12, 1980)

Reporting Funds Flows, Liquidity, and Financial Flexibility (December 15, 1980)

Other Projects in Process

Accounting Recognition Criteria

INTRODUCTION

Scope and Content of Statement

1. This Statement defines 10 elements of financial statements of business enterprises: assets, liabilities, equity, investments by owners, distributions to owners, comprehensive income,[1] revenues, expenses, gains, and losses. The Statement also defines or describes certain other concepts that underlie or are otherwise related to the 10 elements listed (see Summary Index). It contains no conclusions about matters that are intended to be decided in other phases of the Board's conceptual framework project (paragraphs 16 and 17).

2. Although this Statement is entitled *Elements of Financial Statements of Business Enterprises*, the Board has tried to word several of the definitions so that they could also apply to organizations other than business enterprises. Assets and liabilities are common to all organizations, and the Board sees no reason to define them differently for business and nonbusiness organizations. The Board also expects the definitions of equity, revenues, expenses, gains, and losses to fit both business and nonbusiness organizations. In contrast, nonbusiness organizations have no need for elements such as investments by owners, distributions to owners, and comprehensive income but may need other elements not needed by business enterprises. In the near future, the Board expects to consider and to solicit views about which, if any, of the definitions are inappropriate or may require modification for nonbusiness organizations and whether other elements are needed for financial statements of nonbusiness organizations.

Other Possible Elements of Financial Statements of Business Enterprises

3. Although the elements defined in this Statement include basic elements and are probably those most commonly identified as elements of financial statements of business enterprises, they are not the only elements of financial statements. The elements defined in this Statement are a related group with a particular focus—on assets, liabilities, equity, and other elements directly related to measuring performance and status of an enterprise. Information about an enterprise's performance and status provided by accrual accounting is the primary focus of financial reporting (FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, paragraphs 40-48). Other focuses may require other elements.[2]

4. Variations of possible statements showing the effects on assets and liabilities of transactions or other events and circumstances during a period are almost limitless, and all of them have classes of items that may be called elements of financial statements. For example, a statement showing funds flows or cash flows during a period may include categories for funds or cash provided by (a) operations, (b) borrowings, (c) issuing equity securities, (d) sale of assets, and so forth. Other phases of the conceptual framework project may define additional elements of financial statements as needed.

Elements and Financial Representations

5. Elements of financial statements are the building blocks with which financial statements are constructed—the classes of items that financial statements comprise. *Elements* refers to broad classes, such as assets, liabilities, revenues, and expenses. Particular economic things and events, such as cash on hand or selling merchandise, that may meet the definitions of elements are not elements as the term is used in this Statement. Rather, they are called *items* or other descriptive names. This Statement focuses on the broad classes and their characteristics instead of defining particular assets, liabilities, or other items. Although notes to financial statements are described in some authoritative pronouncements as an integral part of financial statements, they are not elements. They serve different functions, including amplifying or complementing information about items in financial statements.

6. The items that are formally incorporated in financial statements are financial representations (depictions in words and numbers) of certain resources of an entity, claims to those resources, and the effects of transactions and other events and circumstances that result in changes in those resources and claims. 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 things and events pertaining to an entity existing and operating in what is sometimes called the "real world."

7. This Statement follows the common practice of calling by the same names both the financial representations in financial statements and the resources, claims, transactions, events, or circumstances that they represent. For example, *inventory* or *asset* may refer either to merchandise on the floor of a retail enterprise or to the words and numbers that represent that merchandise in the enterprise's financial statements; and *sale* or *revenue* may refer either to the transaction by which some of that merchandise is transferred to a customer or to the words and numbers that represent the transaction in the enterprise's financial statements.[3]

Other Scope and Content Matters

8. Appendix A to this Statement contains background information for the Statement. Appendix B contains explanations and examples pertaining to the characteristics of assets, liabilities, equity, and comprehensive income and its components.

Objectives, Qualitative Characteristics, and Elements

9. Decision usefulness in investment, credit, and similar decisions is the focus of both of the concepts Statements that precede this one: FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises,* and FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information.* Usefulness of financial reporting information for those decisions rests on the cornerstones of relevance and reliability.

10. The definitions in this Statement are of economic things and events that are relevant to investment, credit, and similar decisions and thus are relevant to financial reporting.[4] Those decisions involve committing (or continuing to commit) resources to a business enterprise. The elements defined are an enterprise's resources, the claims to or interests in those resources, and the changes therein from transactions and other events and circumstances involved in its use of resources to earn a profit. Relevance of information about those elements stems from the significance of resources and profitability in the activities of business enterprises.

11. Economic resources or assets and changes in them are central to the existence and operations of an individual business enterprise. Business enterprises are in essence resource or asset processors, and a resource's capacity to be exchanged for cash or other resources or to be combined with other resources to produce exchangeable goods or services gives it utility and value (future economic benefit) to an enterprise. Since resources or assets confer their benefits on an enterprise by being exchanged, used, or otherwise invested, changes in resources or assets are the purpose, the means, and the result of an enterprise's operations, and a business enterprise exists primarily to acquire, use, produce, and distribute resources. Through those activities it both provides goods or services to society and obtains cash and other assets with which it compensates those who provide it with resources, including its owners.

12. Although the relation between profit of an enterprise [5] and compensation received by owners is complex and often indirect, profit is the basic source of compensation to owners for providing equity or risk capital to an enterprise. Profitable operations generate resources that can be distributed to owners or reinvested in the enterprise, and investors' expectations about both distributions to owners and reinvested profit may affect market prices of the enterprise's equity securities. Expectations that owners will be adequately compensated—that they will receive returns *on* their investments commensurate with their risks—are as necessary to attract equity capital to an enterprise as are expectations of wages and salaries to attract employees' services, expectations of repayments of borrowing with interest to attract borrowed funds, or expectations of payments on account to attract raw materials or merchandise.

13. Repayment or compensation of lenders, employees, suppliers, and other nonowners for resources provided is also related to profit or loss in the sense that profitable enterprises (and those that break even) generally are able to repay borrowing with interest, pay adequate wages and salaries, and pay for other goods and services received, while unprofitable enterprises often become less and less able to pay and thus find it increasingly difficult to obtain the resources they need to continue operations. Thus, information about profit and its components is of interest to suppliers, employees, lenders, and other providers of resources as well as to owners.

Interrelation of Elements—Articulation

14. Elements of financial statements are of two different kinds or classes, which are sometimes explained as being analogous to photographs and motion pictures. The elements defined in this Statement include three of one class and seven of the other. Assets, liabilities,

and equity describe levels or amounts of resources or claims to resources at a moment of time. All other elements describe effects of transactions and other events and circumstances that affect an enterprise during intervals of time (periods). They include comprehensive income and its components—revenues, expenses, gains, and losses—as well as investments by owners and distributions to owners.[6]

15. The two classes of elements are related in such a way that (a) assets, liabilities, and equity are changed by elements of the other class and at any time are their cumulative result and (b) an increase (decrease) in an asset cannot occur without a corresponding decrease (increase) in another asset or a corresponding increase (decrease) in a liability or equity. Those relations are sometimes collectively referred to as "articulation." They result in financial statements that are fundamentally interrelated so that statements that show elements of the second class depend on statements that show elements of the first class and vice versa.[7]

Definition, Recognition, Measurement, and Display

16. All matters of recognition, measurement, and display have purposely been separated from the definitions of the elements of financial statements in the Board's conceptual framework project. The definitions in this Statement are concerned with the essential characteristics of elements of financial statements. Other phases of the conceptual framework project are concerned with questions such as which financial statements should be provided; which items that qualify under the definitions should be included in those statements; when particular items that qualify as assets, liabilities, revenues, expenses, and so forth should be formally recognized in the financial statements; which attributes of those items should be measured; which unit of measure should be used; and how the information included should be classified and otherwise displayed.

17. Definitions of elements of financial statements are a significant first screen in determining the content of financial statements. An item's having the essential characteristics of one of the elements is a necessary but not a sufficient condition for formally recognizing the item in the entity's financial statements. To be included in a particular set of financial statements, an item must not only qualify under the definition of an element but also must meet criteria for recognition and have a relevant attribute (or surrogate for it) that is capable of reasonably reliable measurement or estimate.[8] Thus, some items that meet the definitions may have to be excluded from formal incorporation in financial statements because of recognition or measurement considerations (paragraphs 37-42).

DEFINITIONS OF ELEMENTS

18. All elements are defined in relation to a particular entity, which may be a business enterprise, an educational or charitable organization, a governmental unit, a natural person, or

the like (paragraph 2). Items that qualify under the definitions are a particular entity's asset, liability, revenue, expense, etc. An entity may comprise two or more affiliated entities and does not necessarily correspond to what is often described as a "legal entity." The definitions may also refer to "other entity," "other entities," or "entities other than the enterprise," which may include individuals, other business enterprises, nonbusiness organizations, and the like. For example, employees, suppliers, customers, lenders, stockholders, and governments are all "other entities" to a particular business enterprise. A subsidiary company that is part of the same entity as its parent company in consolidated financial statements is an "other entity" in the separate financial statements of its parent.

Assets

19. Assets are probable [9] future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

Characteristics of Assets of Business Enterprises

20. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular enterprise can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the enterprise's right to or control of the benefit has already occurred. Assets commonly have other features that help identify them—for example, assets may be acquired at a cost [10] and they may be tangible, exchangeable, or legally enforceable. However, those features are not essential characteristics of assets. Their absence, by itself, is not sufficient to preclude an item's qualifying as an asset. That is, assets may be acquired without cost, they may be intangible, and although not exchangeable they may be usable by the enterprise in producing or distributing other goods or services. Similarly, although the ability of an enterprise to obtain benefit from an asset and to control others' access to it generally rests on a foundation of legal rights, legal enforceability of a claim to the benefit is not a prerequisite for a benefit to qualify as an asset if its receipt by the enterprise is otherwise probable.

21. The kinds of items that qualify as assets under the definition in paragraph 19 are also commonly called economic resources. They are the scarce means that are useful for carrying out economic activities, such as consumption, production, and exchange.

22. The common characteristic possessed by all assets and economic resources is "service potential" or "future economic benefit," the capacity to provide services or benefits to the entities that use them. In a business enterprise, that service potential or future economic benefit eventually results in net cash inflows to the enterprise. That characteristic is the primary basis of the definition of assets in this Statement.

23. Money (cash, including deposits in banks) is valuable because of what it can buy. It can

be exchanged for virtually any good or service that is available or it can be saved and exchanged for them in the future. Money's "command over resources"—its purchasing power—is the basis of its value and future economic benefits.[11]

24. Assets other than cash benefit a business enterprise by being exchanged for cash or other goods or services, by being used to produce or otherwise increase the value of other assets, or by being used to settle liabilities. Services provided by other entities, including personal services, cannot be stored and are received and used simultaneously. They can be assets of a business enterprise only momentarily—as the enterprise receives and uses them—although their use may create or add value to other assets of the enterprise. Rights to receive services of other entities for specified or determinable future periods can be assets of particular business enterprises.

Transactions and Events That Change Assets

25. Assets of a business enterprise are changed both by its transactions and activities and by events that happen to it. A business enterprise obtains assets from other entities and adds value through operations to assets it already has. It transfers assets to other entities and uses assets in its operations. Some transactions or other events decrease one asset and increase another. An enterprise's assets or their values are also commonly increased or decreased by other events and circumstances that may be partly or entirely beyond the control of the enterprise and its management, for example, price changes, interest rate changes, technological changes, impositions of taxes and regulations, discovery, growth or accretion, shrinkage, vandalism, thefts, expropriations, wars, fires, and natural disasters.

26. Once acquired, an asset continues as an asset of the enterprise until the enterprise collects it, transfers it to another entity, or uses it, or some other event or circumstance destroys the future benefit or removes the enterprise's ability to obtain it.

Valuation Accounts

27. A separate item that reduces or increases the carrying amount of an asset is sometimes found in financial statements. For example, an estimate of uncollectible amounts reduces receivables to the amount expected to be collected, or a premium on a bond receivable increases the receivable to its cost or present value. Those "valuation accounts" are part of the related assets and are neither assets in their own right nor liabilities.[12]

Liabilities

28. Liabilities are probable [13] future sacrifices of economic benefits arising from present obligations [14] of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.

Characteristics of Liabilities of Business Enterprises

29. A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular enterprise, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the enterprise has already happened. Liabilities commonly have other features that help identify them—for example, most liabilities require the obligated enterprise to pay cash to one or more identified other entities and are legally enforceable. However, those features are not essential characteristics of liabilities. Their absence, by itself, is not sufficient to preclude an item's qualifying as a liability. That is, liabilities may not require an enterprise to pay cash but to convey other assets, to provide or stand ready to provide services, or to use assets. And as long as payment or other transfer of assets to settle an existing obligation is probable, the identity of the recipient need not be known to the obligated enterprise before the time of settlement. Similarly, although most liabilities rest generally on a foundation of legal rights and duties, existence of a legally enforceable claim is not a prerequisite for an obligation to qualify as a liability if the future payment of cash or other transfer of assets to settle the obligation is otherwise probable.

30. Most liabilities stem from human inventions—such as financial instruments, contracts, and laws—that facilitate the functioning of a highly developed economy and are commonly embodied in legal obligations and rights (or the equivalent) with no existence apart from them. Liabilities facilitate the functioning of a highly developed economy primarily by permitting delay—delay in payment, delay in delivery, and so on.[15]

31. Enterprises routinely incur most liabilities to acquire the funds, goods, and services they need to operate and just as routinely settle the liabilities they incur. For example, borrowing cash obligates an enterprise to repay the amount borrowed, usually with interest; acquiring assets on credit obligates an enterprise to pay for them, perhaps with interest to compensate for the delay in payment; using employees' knowledge, skills, time, and efforts obligates an enterprise to pay for their use, often including fringe benefits; selling products with a warranty or guarantee obligates an enterprise to pay cash or to repair or replace those that prove defective; and accepting a cash deposit or prepayment obligates an enterprise to provide goods or services or to refund the cash. In short, most liabilities are incurred in exchange transactions to obtain needed resources or their use, and most liabilities incurred in exchange transactions are contractual in nature—based on written or oral agreements to pay cash or to provide goods or services to specified or determinable entities on demand, at specified or determinable dates, or on occurrence of specified events.

32. Although most liabilities result from agreements between entities, some obligations are imposed on business enterprises by government or courts or are accepted to avoid imposition by

government or courts (or costly efforts related thereto), and some relate to other nonreciprocal transfers from a business enterprise to owners or to one or more other entities. Thus, taxes, laws, regulations, and other governmental actions commonly require business enterprises to pay cash, convey other assets, or provide services either directly to specified governmental units or to others for purposes or in ways specified by government. An enterprise may also incur liabilities for cash dividends declared but not paid or for donations pledged to educational or charitable organizations.

33. Similarly, although most liabilities stem from legally enforceable obligations, some liabilities rest on equitable or constructive obligations, including some that arise in exchange transactions. Liabilities stemming from equitable or constructive obligations are commonly paid in the same way as legally binding contracts, but they lack the legal sanction that characterizes most liabilities and may be binding primarily because of social or moral sanctions or custom. An equitable obligation stems from ethical or moral constraints rather than rules of common or statute law, that is, from a duty to another entity to do that which an ordinary conscience and sense of justice would deem fair, just, and right—to do what one ought to do rather than what one is legally required to do. For example, an enterprise may have an equitable obligation to complete and deliver a product to a customer that has no other source of supply even though its failure to deliver would legally require only return of the customer's deposit. 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. For example, an enterprise 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. The line between equitable or constructive obligations and obligations that are enforceable in courts of law is not always clear, and the line between equitable or constructive obligations and no obligations may often be even more troublesome because to determine whether an enterprise is actually bound by an obligation to a third party in the absence of legal enforceability is often extremely difficult. Thus, the concepts of equitable and constructive obligations must be applied with great care. To interpret equitable and constructive obligations too narrowly will tend to exclude significant actual obligations of an enterprise, while to interpret them too broadly will effectively nullify the definition by including items that lack an essential characteristic of liabilities.

Transactions and Events That Change Liabilities

34. Liabilities of a business enterprise are changed both by its transactions and activities and by events that happen to it. The preceding paragraphs note most major sources of changes in liabilities. An enterprise's liabilities are also sometimes affected by price changes, interest rate changes, or other events and circumstances that may be partly or wholly beyond the control of an enterprise and its management.

35. Once incurred, a liability continues as a liability of the enterprise until the enterprise settles it, or another event or circumstance discharges it or removes the enterprise's responsibility

to settle it.

Valuation Accounts

36. A separate item that reduces or increases the carrying amount of a liability is sometimes found in financial statements. For example, a bond premium or discount increases or decreases the face value of a bond payable to its proceeds or present value. Those "valuation accounts" are part of the related liability and are neither liabilities in their own right nor assets.

Effects of Uncertainty

37. Uncertainty about economic and business activities and results is pervasive, and it often clouds whether a particular item qualifies as an asset or a liability of a particular enterprise at the time the definitions are applied. The presence or absence of future economic benefit that can be obtained and controlled by the enterprise or of the enterprise's legal, equitable, or constructive obligation to sacrifice assets in the future can often be discerned reliably only with hindsight. As a result, some items that with hindsight actually qualified as assets or liabilities of the enterprise under the definitions may, as a practical matter, have been recognized as expenses, losses, revenues, or gains or remained unrecognized in its financial statements because of uncertainty about whether they qualified as assets or liabilities of the enterprise or because of recognition and measurement considerations stemming from uncertainty at the time of assessment. Conversely, some items that with hindsight did not qualify under the definitions may have been included as assets or liabilities because of judgments made in the face of uncertainty at the time of assessment.

38. An effect of uncertainty is to increase the costs of financial reporting in general and the costs of recognition and measurement in particular. Some items that qualify as assets or liabilities under the definitions may therefore be recognized as expenses, losses, revenues, or gains or remain unrecognized as a result of cost and benefit analyses indicating that their formal incorporation in financial statements is not useful enough to justify the time and effort needed to do it. It may be possible, for example, to make the information more reliable in the face of uncertainty by exerting greater effort or by spending more money, but it also may not be worth the added cost.

39. A highly significant practical consequence of the features described in the preceding two paragraphs is that the existence or amount (or both) of most assets and many liabilities can be probable but not certain.[16] The definitions in this Statement are not intended to require that the existence and amounts of items be certain for them to qualify as assets, liabilities, revenues, expenses, etc., and estimates and approximations will often be required unless financial statements are to be restricted to reporting only cash transactions.

40. To apply the definitions of assets and liabilities (and other elements of financial statements) thus commonly requires assessments of probabilities, but degrees of probability are

not part of the definitions. That is, the degree of probability of a future economic benefit (or of a future cash outlay or other sacrifice of future economic benefits) and the degree to which its amount can be estimated with reasonable reliability that are required to recognize an item as an asset (or a liability) are matters of recognition and measurement that are beyond the scope of this Statement. The distinction needs to be maintained between the definitions themselves and steps that may be needed to apply them. Matters involving measurement problems, effects of uncertainty, reliability, and numerous other factors may be significant in applying a definition, but they are not part of the definition. Particular items that qualify as assets or liabilities under the definitions may need to be excluded from formal incorporation in financial statements for reasons relating to measurement, uncertainty, or unreliability, but they are not excluded by the definitions. Similarly, the attitude commonly known as conservatism may be appropriate in applying the definitions under uncertain conditions, but conservatism is not part of the definitions. Definition, recognition, measurement, and display are separate in the Board's conceptual framework (paragraphs 16 and 17).[17]

Note on Uncertainty and Certain Recognition Matters

41. All practical financial accounting and reporting models have limitations. The preceding paragraphs describe one limit that may affect various models—how recognition or measurement considerations stemming from uncertainty may result in not recognizing as assets or liabilities some items that qualify as such under the definitions or may result in postponing recognition of some assets or liabilities until their existence becomes more probable or their measures become more reliable.

42. That propensity to defer recognition of or to not recognize assets and liabilities, particularly assets, may create problems in recognizing losses of future economic benefits. The situation may arise if the events or circumstances causing the losses have occurred, and the related future sacrifice of assets has become virtually inevitable, but (a) affected assets either are not recognized or separately identified in the financial statements or are recorded at amounts significantly less than the cash or other outlays needed to restore the lost future benefits and (b) the amounts to be spent in the future to restore the lost benefits are not yet owed to anyone. To recognize those kinds of losses, an enterprise may need to recognize, and display among either its assets or its liabilities, a "valuation account" (paragraph 27) that either relates to unrecorded assets or reduces recorded assets to negative amounts.[18]

Equity [19]

43. Equity is the residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.

Characteristics of Equity of Business Enterprises

44. Equity in a business enterprise stems from ownership rights (or the equivalent).[20] It involves a relation between an enterprise and its owners *as owners* rather than as employees,

suppliers, customers, lenders, or in some other nonowner role.[21] Since it ranks after liabilities as a claim to or interest in the assets of the enterprise, it is a residual interest: (a) equity is the same as net assets, the difference between the enterprise's assets and its liabilities, and (b) equity is enhanced or burdened by increases and decreases in net assets from sources other than investments by owners and distributions to owners.

45. Equity represents the source of distributions by an enterprise to its owners, whether in the form of cash dividends or other distributions of assets. Owners' and others' expectations about distributions to owners may affect the market prices of an enterprise's equity securities, thereby indirectly affecting owners' compensation for providing equity or risk capital to the enterprise (paragraph 12). Thus, the essential characteristics of equity center on the conditions for transferring enterprise assets to owners. Equity—an excess of assets over liabilities—is a necessary but not sufficient condition; distributions to owners are at the discretion and volition of the owners or their representatives after satisfying restrictions imposed by law, regulation, or agreements with other entities. Generally, an enterprise is not obligated to transfer assets to owners except in the event of the enterprise's liquidation unless the enterprise formally acts to distribute assets to owners, for example, by declaring a dividend.[22] Owners may sell their interests in an enterprise to others and thus may be able to obtain a return *of* part or all of their investments and perhaps a return on investments through a securities market, but those transactions do not normally affect the equity of an enterprise or its assets or liabilities.

46. An enterprise may have several classes of equity (for example, one or more classes each of common stock or preferred stock) with different degrees of risk stemming from different rights to participate in distributions of enterprise assets or different priorities of claims on enterprise assets in the event of liquidation. That is, some classes of owners may bear relatively more of the risks of an enterprise'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 enterprise profitability for distributions of enterprise assets, and no class of equity carries an unconditional right to receive future transfers of assets from the enterprise except in liquidation, and then only after liabilities have been satisfied.

47. Equity is originally created by owners' investments in an enterprise and may from time to time be augmented by additional investments by owners. Equity is reduced by distributions by the enterprise to owners. However, the distinguishing characteristic of equity is that it inevitably is affected by the enterprise's operations and other events and circumstances affecting the enterprise (which together constitute comprehensive income—paragraph 56).

Equity and Liabilities

48. An enterprise's assets, liabilities, and equity all pertain to the same set of probable future economic benefits. Assets are probable future economic benefits owned or controlled by the enterprise. Its liabilities and equity are mutually exclusive claims to or interests in the enterprise's assets by entities other than the enterprise. In a business enterprise, equity or the

ownership interest is a residual interest, remaining after liabilities are deducted from assets and depending significantly on the profitability of the enterprise. Distributions to owners are discretionary, depending on the volition of owners or their representatives after considering the needs of the enterprise and restrictions imposed by law, regulations, or agreement. An enterprise is generally not obligated to transfer assets to owners except in the event of the enterprise's liquidation. In contrast, liabilities, once incurred, involve nondiscretionary future sacrifices of assets that must be satisfied on demand, at a specified or determinable date, or on occurrence of a specified event, and they take precedence over ownership interests.

49. Although the line between equity and liabilities is clear in concept, it may be obscured in practice. Applying the definitions to particular situations may involve practical problems because several kinds of securities issued by business enterprises seem to have characteristics of both liabilities and equity in varying degrees or because the names given some securities may not accurately describe their essential characteristics. For example, convertible debt instruments have both liability and residual interest characteristics, which may create problems in accounting for them. (APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*, and APB Opinion No. 15, *Earnings per Share*, both discuss problems of that kind.) Preferred stock also often has both debt and equity characteristics, and some preferred stocks may effectively have maturity amounts and dates at which they must be redeemed for cash. To determine whether specific securities of the kinds illustrated are liabilities or equity presents practical problems of applying definitions rather than problems of determining the essential characteristics of those definitions. Adequate definitions are the starting point. They provide a basis for assessing, for example, the extent to which a particular application meets the qualitative characteristic of representational faithfulness, which includes the notion of reporting economic substance rather than legal form (Concepts Statement 2, paragraphs 63-80 and 160).

Transactions and Events That Change Equity

50. The following diagram [The diagram has been deleted in the electronic version of *Original Pronouncements*. If there is a need to reference this diagram, please refer to the printed version of *Original Pronouncements*.] shows the sources of changes in equity (class B) and distinguishes them from each other and from other transactions, events, and circumstances affecting an enterprise during a period (classes A and C). Specifically, the diagram shows that (a) class B (changes in equity) comprises two mutually exclusive classes of transactions and other events and circumstances, B1 and B2, each of which also comprises two (or perhaps more) significant subclasses, and (b) classes B1, B2, and A are the sources of all increases and decreases in assets and liabilities of an enterprise; class C includes no changes in assets or liabilities. Shaded bands rather than clear boundary lines separate classes B1(a) and B1(b) and fall within class B1(b) in the diagram because of display considerations that are beyond the scope of this Statement. First, paragraphs 63-73 of this Statement define and discuss revenues, expenses, gains, and losses as elements of financial statements but do not precisely distinguish between revenues and gains on the one hand or between expenses and losses on the other.

Second, the definitions of gains and losses include the possibility of other descriptions for some items in that class (paragraphs 57 and 58). Fine distinctions between revenues and gains and between expenses and losses as well as other distinctions *within* comprehensive income are more appropriately considered as part of display or reporting.

51. The full width of the diagram, represented by the two-pointed arrow labeled "All transactions and other events and circumstances that affect an enterprise during a period," encompasses all potentially recordable events and circumstances affecting an enterprise. Moving from top to bottom of the diagram, each level divides the preceding level into classes that are significant for the definitions and related concepts in this Statement. (Size of classes does not indicate their relative volume or significance.)

A. All changes in assets and liabilities not accompanied by changes in equity. This class comprises four kinds of exchange transactions that are common in most business enterprises (exchanges that affect equity belong in class B rather than class A).[23]
    1. Exchanges of assets for assets, for example, purchases of assets for cash or barter exchanges
    2. Exchanges of liabilities for liabilities, for example, issues of notes payable to settle accounts payable or refundings of bonds payable by issuing new bonds to holders that surrender outstanding bonds
    3. Acquisitions of assets by incurring liabilities, for example, purchases of assets on account, borrowings, or receipts of cash advances for goods or services to be provided in the future
    4. Settlements of liabilities by transferring assets, for example, repayments of borrowings, payments to suppliers on account, payments of accrued wages or salaries, or repairs (or payments for repairs) required by warranties.

B. All changes in assets or liabilities accompanied by changes in equity. This class is the subject of this section and comprises:
    1. Comprehensive income (defined in paragraph 56) whose components are:
        a. Revenues and expenses (broadly defined and discussed in paragraphs 63-66)
        b. Gains and losses (broadly defined and discussed in paragraphs 67-73)
    2. All changes in equity from transfers between the enterprise and its owners (defined in paragraphs 52 and 53)
        a. Investments by owners in the enterprise
        b. Distributions by the enterprise to owners

C. Changes within equity that do not affect assets or liabilities (for example, stock dividends, conversions of preferred stock into common stock, and some stock recapitalizations). This class contains only changes *within* equity and does not affect the definition of equity or its amount.

The definitions in paragraphs 56, 63, 65, 67, and 68 are those in class B1 and its subclasses (a) and (b): comprehensive income, revenues, expenses, gains, and losses.

Investments by and Distributions to Owners [24]

52. Investments by owners are increases in net assets of a particular enterprise resulting from transfers to it from other entities of something valuable to obtain or increase ownership interests (or equity) in it. Assets are most commonly received as investments by owners, but that which is received may also include services or satisfaction or conversion of liabilities of the enterprise.

53. Distributions to owners are decreases in net assets of a particular enterprise resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners. Distributions to owners decrease ownership interest (or equity) in an enterprise.

Characteristics of Investments by and Distributions to Owners

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

55. Distributions by an enterprise to its owners decrease its net assets and decrease or terminate ownership interests of those that receive them. Reacquisition by an entity of its own equity securities by transferring assets or incurring liabilities to owners is a distribution to owners as that concept is defined in this Statement. Since owners become creditors for a dividend declared until it is paid, an enterprise's incurrence of a liability to transfer assets to owners in the future converts a part of the equity or ownership interest of the enterprise into a creditors' claim; settlement of the liability by transfer of the assets is a transaction in class A4 in the diagram in paragraph 50 rather than in class B2(b). That is, equity is reduced by the incurrence of the liability to owners, not by its settlement.

Comprehensive Income

56. Comprehensive income is the change in equity (net assets) of an 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.

Concepts of Capital Maintenance

57. 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 in excess of 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 enterprise to provide a constant supply of goods or services). The major difference between them involves the effects of price changes on assets held and liabilities owed during a period. Under the financial capital concept, if the effects of those price changes are recognized, they are called *holding gains and losses* and are included in return on capital. Under the physical capital concept, those changes are recognized but are called *capital maintenance adjustments* and are included directly in equity and are *not* included in return on capital. Under that concept, capital maintenance adjustments are a separate element rather than being gains and losses.

58. The financial capital concept is the traditional view and is generally the capital maintenance concept in present primary financial statements. Comprehensive income as defined in paragraph 56 is a return *on* financial capital. However, the reason for using *comprehensive income* rather than *earnings* in this Statement is that the Board has decided to reserve *earnings* for possible use to designate a different concept that is a component part of—that is, is narrower than or less than—comprehensive income,[25] and *earnings,* when defined, may be a return *on* physical capital or may be a return *on* financial capital. The Board emphasizes that capital maintenance concepts are the subject of another project and that the Board has not chosen between the financial and physical capital maintenance concepts for deciding the meaning and appropriate display of *earnings* and thus has not decided whether *capital maintenance adjustments* should be considered to be a separate element of financial statements.[26] For that reason, gains and losses in the diagram in paragraph 50 (class B1(b)) and in the discussions in the remainder of this Statement explicitly or implicitly include the possibility that some items included in that class may more appropriately be described by other terms, including perhaps *capital maintenance adjustments*.

Characteristics, Sources, and Components of Comprehensive Income of Business Enterprises

59. Over the life of a business enterprise, its comprehensive income equals the net of its cash receipts and cash outlays, excluding cash investments by owners and cash distributions to owners (Concepts Statement 1, paragraph 46). That characteristic holds whether the amounts of cash and comprehensive income are measured in nominal dollars or constant dollars. Although the amounts in constant dollars may differ from those in nominal dollars, the basic relationship is not changed because both nominal and constant dollars express the same thing using different measuring units. Matters such as recognition criteria and choice of attributes to be measured [27] also do not affect the amounts of comprehensive income and net cash receipts over the life of an

enterprise but do affect the time and way parts of the total are identified with the periods that constitute the entire life. Timing of recognition of revenues, expenses, gains, and losses is also a major difference between accounting based on cash receipts and outlays and accrual accounting. Accrual accounting may encompass various timing possibilities—for example, when goods or services are provided, when cash is received, or when prices change—that are being considered in the project on accounting recognition criteria.

60. Comprehensive income results from (a) exchange transactions and other transfers between the enterprise and other entities that are not its owners, (b) the enterprise's productive efforts,[28] and (c) price changes, casualties, and other effects of interactions between the enterprise and the economic, legal, social, political, and physical environment of which it is part. An enterprise's productive efforts and most of its exchange transactions with other entities are ongoing major activities that constitute the enterprise's central operations by which it attempts to fulfill its basic function in the economy of producing and distributing goods or services at prices that are sufficient to enable it to pay for the goods and services it uses and to provide a satisfactory return to its owners. Although those ongoing major or central operations are generally intended to be the primary source of comprehensive income, they are not the only source. Most enterprises occasionally engage in activities that are peripheral or incidental to their central activities. Moreover, all enterprises are affected by the economic, legal, social, political, and physical environment of which they are part, and comprehensive income of each enterprise is affected by events and circumstances that may be partly or wholly beyond the control of individual enterprises and their managements.[29]

61. Although cash resulting from various sources of comprehensive income is the same, receipts from various sources 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, between various kinds of gains and losses, and between measures found in present practice such as income from continuing operations and income after extraordinary items and cumulative effect of change in accounting principle.

62. Comprehensive income comprises two related but distinguishable types of components. Comprehensive income consists of not only its basic components—revenues, expenses, gains, and losses—but also various intermediate components or measures that result from combining the basic components. Revenues, expenses, gains, and losses can be combined in various ways to obtain several measures of enterprise performance with varying degrees of inclusiveness. Examples of intermediate components or measures are gross margin, contribution margin, income from continuing operations before taxes, income from continuing operations, and operating income. Those intermediate components or measures are, in effect, subtotals of comprehensive income and often of one another in the sense that they can be combined with each other or with the basic components to obtain other intermediate measures of comprehensive income.

Revenues

63. Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.[30]

Characteristics of Revenues of Business Enterprises

64. Revenues represent actual or expected cash inflows (or the equivalent) that have occurred or will eventuate as a result of the enterprise's ongoing major or central operations during the period. The assets increased by revenues [31] may be of various kinds—for example, cash, claims against customers or clients, other goods or services received, or increased value of a product resulting from production. Similarly, the transactions and events from which revenues arise and the revenues themselves are in many forms and are called by various names—for example, output, deliveries, sales, fees, interest, dividends, royalties, and rent—depending on the kinds of operations involved and the way revenues are recognized.

Expenses

65. Expenses are outflows or other using up of assets or incurrences of liabilities (or a combination of both) during a period from delivering or producing goods,[32] rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

Characteristics of Expenses of Business Enterprises

66. Expenses represent actual or expected cash outflows (or the equivalent) that have occurred or will eventuate as a result of the enterprise's ongoing major or central operations during the period. The assets that flow out or are used or the liabilities that are incurred [33] may be of various kinds—for example, units of product delivered or produced, kilowatt hours of electricity used to light an office building, or taxes on current income. Similarly, the transactions and events from which expenses arise and the expenses themselves are in many forms and are called by various names—for example, cost of goods sold, cost of services provided, depreciation, interest, rent, and salaries and wages—depending on the kinds of operations involved and the way expenses are recognized.[34]

Gains and Losses [35]

67. Gains are increases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from revenues or investments by owners.

68. Losses are decreases in equity (net assets) from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity during a period except those that result from expenses or distributions to owners.

Characteristics of Gains and Losses of Business Enterprises

69. Gains and losses result from enterprises' peripheral or incidental transactions and from other events and circumstances stemming from the environment that may be largely beyond the control of individual enterprises and their managements. Thus, gains and losses are not all alike. There are several kinds, even in a single enterprise, and they may be described or classified in a variety of ways that are not necessarily mutually exclusive.

70. Gains and losses may be described or classified according to sources. Some gains or losses are net results of comparing the proceeds and sacrifices (costs) in peripheral or incidental transactions with other entities—for example, from sales of investments in marketable securities, from dispositions of used equipment, or from settlements of liabilities at other than their carrying amounts. Other gains or losses result from nonreciprocal transfers between an enterprise and other entities that are not its owners—for example, from gifts or donations, from winning a lawsuit, from thefts, and from assessments of fines or damages by courts. Still other gains or losses result from holding assets or liabilities while their values change—for example, from price changes that cause inventory items to be written down from cost to market, from changes in market prices of investments in marketable equity securities accounted for at market values or at the lower of cost and market, and from changes in foreign exchange rates. And still other gains or losses result from other environmental factors, such as natural catastrophes—for example, damage to or destruction of property by earthquake or flood.

71. Gains and losses may also be described or classified as "operating" or "nonoperating," depending on their relation to an enterprise's major ongoing or central operations. For example, losses on writing down inventory from cost to market are usually considered to be operating losses, while major casualty losses are usually considered nonoperating losses.

Revenues, Expenses, Gains, and Losses

72. Revenues and gains are similar, and expenses and losses are similar, but some differences are significant in conveying information about an enterprise's performance. Revenues and expenses result from an enterprise's ongoing major or central operations and activities—that is, from activities such as producing or delivering goods, rendering services, lending, insuring, investing, and financing. In contrast, gains and losses result from incidental or peripheral transactions of an enterprise with other entities and from other events and circumstances affecting it. Some gains and losses may be considered "operating" gains and losses and may be closely related to revenues and expenses. Revenues and expenses are commonly displayed as gross inflows or outflows of net assets, while gains and losses are usually displayed as net inflows or outflows.

73. The definitions and discussion of revenues, expenses, gains, and losses in this Statement give broad guidance but do not distinguish precisely between revenues and gains or between expenses and losses. Distinctions between revenues and gains and between expenses and losses in a particular enterprise depend to a significant extent on the nature of the enterprise, its operations, and its other activities. Items that are revenues for one kind of enterprise are gains for another, and items that are expenses for one kind of enterprise are losses for another. For example, investments in securities that may be sources of revenues and expenses for insurance or investment companies may be sources of gains and losses in manufacturing or merchandising companies. Technological changes may be sources of gains or losses to most kinds of enterprises but may be characteristic of the operations of high-technology or research-oriented enterprises. Events such as commodity price changes and foreign exchange rate changes that occur while assets are being used or produced or liabilities are owed may directly or indirectly affect the *amounts* of revenues or expenses for most enterprises, but they are *sources* of revenues or expenses only for enterprises for which trading in foreign exchange or commodities is a major or central activity. Since a primary purpose of distinguishing gains and losses from revenues and expenses is to make displays of information about an enterprise's sources of comprehensive income as useful as possible, fine distinctions between revenues and gains and between expenses and losses are principally matters of display or reporting (paragraphs 50, 151, and 152).

Accrual Accounting and Related Concepts

74. Items that qualify under the definitions of elements of financial statements and that meet criteria for recognition and measurement (paragraph 17) are accounted for and included in financial statements by the use of accrual accounting procedures. Accrual accounting and related concepts are therefore significant not only for defining elements of financial statements but also for understanding and considering other aspects of the conceptual framework for financial accounting and reporting. Paragraphs 75-89 define or describe several significant financial accounting and reporting concepts that are used in this Statement or will be needed in related projects.

Transactions, Events, and Circumstances

75. This Statement commonly uses "transactions and other events and circumstances affecting an entity" to describe the sources or causes of the components of comprehensive income and other changes in assets, liabilities, and equity. An event is a happening of consequence to an entity. It may be an internal event that occurs within an entity, such as using raw materials or equipment in production, or it may be an external event that involves interaction between an entity and its environment, such as a transaction with another entity, a change in price of a good or service that an entity buys or sells, a flood or earthquake, or an improvement in technology by a competitor.[36] Many events are combinations. For example, acquiring services of employees or others involves exchange transactions, which are external events; using those services, often simultaneously with their acquisition, is part of production, which involves a series of internal events (paragraph 64, footnote 31). An event may be initiated by an entity, such as a purchase of

merchandise or use of a building, or it may be partly or wholly beyond the control of an entity and its management, such as an interest rate change, an act of vandalism or theft, or the imposition of taxes.

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

77. A transaction is a particular kind of external event, namely, an external event involving transfer of something of value (future economic benefit) between two (or more) entities. The transaction may be an exchange in which each participant both receives and sacrifices value, such as purchases or sales of goods or services; or the transaction may be a nonreciprocal transfer in which an entity incurs a liability or transfers an asset to another entity (or receives an asset or cancellation of a liability) without directly receiving (or giving) value in exchange. Nonreciprocal transfers contrast with exchanges, which are reciprocal transfers, and include, for example, investments by owners, distributions to owners, impositions of taxes, gifts, charitable contributions, and thefts.[37]

78. This Statement does not use the term *internal transaction* (which is essentially contradictory). Transferring materials to production processes, using plant and equipment whose wear and tear is represented by depreciation, and other events that happen within an entity are internal events, not internal transactions.

Accrual Accounting

79. "Accrual accounting attempts to record the financial effects on an enterprise of transactions and other events and circumstances that have cash consequences for the enterprise in the periods in which those transactions, events, and circumstances occur rather than only in the periods in which cash is received or paid by the enterprise. Accrual accounting is concerned with the process by which cash expended on resources and activities is returned as more (or perhaps less) cash to the enterprise, not just with the beginning and end of that process. It recognizes that the buying, producing, selling, and other operations of an enterprise during a period, as well as other events that affect enterprise performance, often do not coincide with the cash receipts and payments of the period" (FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises,* paragraph 44).

80. Thus, accrual accounting is based not only on cash transactions but also on credit transactions, barter exchanges, changes in prices, changes in form of assets or liabilities, and

other transactions, events, and circumstances that have cash consequences for an enterprise but involve no concurrent cash movement. By accounting for noncash assets, liabilities, revenues, expenses, gains, and losses, accrual accounting links an enterprise's operations and other transactions, events, and circumstances that affect it with its cash receipts and outlays whose assessment looms large in the objectives of financial reporting by business enterprises (Concepts Statement 1, paragraphs 37 and 45).

Accrual and Deferral (Including Allocation and Amortization)

81. Accrual accounting attempts to recognize noncash events and circumstances as they occur and involves not only accruals but also deferrals, including allocations and amortizations. Accrual is concerned with expected future cash receipts and payments: it is the accounting process of recognizing assets, liabilities, or components of comprehensive income for amounts expected to be received or paid, usually cash, in the future. Deferral is concerned with past cash receipts and payments—with prepayments received (often described as collected in advance) or paid: it is the accounting process of recognizing a liability resulting from a current cash receipt or an asset resulting from a current cash payment with deferred recognition of components of comprehensive income. Common examples of accruals include purchases and sales of goods or services on account, interest, rent (not yet paid), wages and salaries, taxes, and decreases and increases in marketable securities accounted for at lower of cost and market. Common examples of deferrals include prepaid insurance and unearned subscriptions.[38]

82. Allocation is the accounting process of assigning or distributing an amount according to a plan or a formula. It is broader than and includes amortization, which is the accounting process of reducing an amount by periodic payments or write-downs. Specifically, amortization is the process of reducing a liability recorded as a result of a cash receipt by recognizing revenues or reducing an asset recorded as a result of a cash payment by recognizing expenses or costs of production. That is, amortization is an allocation process for accounting for prepayments and deferrals. Common examples of allocations include assigning manufacturing costs to production departments or cost centers and thence to units of product to determine "product cost," apportioning the cost of a "basket purchase" to the individual assets acquired on the basis of their relative market values, and spreading the cost of an insurance policy or a building to two or more accounting periods. Common examples of amortizations include recognizing expenses for depreciation, depletion, and insurance and recognizing earned subscription revenues.

Realization and Recognition

83. Realization in the most precise sense means the process of converting noncash resources and rights into money and is most precisely used in accounting and financial reporting to refer to sales of assets for cash or claims to cash. The related terms *realized* and *unrealized* therefore identify revenues or gains or losses on assets sold and unsold, respectively. Those are the meanings of realization and related terms in the Board's conceptual framework. Recognition is the process of formally recording or incorporating an item in the financial statements of an entity. Thus, an asset, liability, revenue, expense, gain, or loss may be recognized (recorded) or

unrecognized (unrecorded). *Realization* and *recognition* are not used as synonyms, as they sometimes are in accounting and financial literature.

Recognition, Matching, and Allocation for Business Enterprises

84. A major difference between accrual accounting and accounting based on cash receipts and outlays is timing of recognition of revenues, expenses, gains, and losses. Investments by an enterprise in goods and services for its operations or other activities commonly do not all occur in the same period as revenues or other proceeds from selling the resulting products or providing the resulting services. Several periods may elapse between the time cash is invested in raw materials or plant, for example, and the time cash is returned by collecting the sales price of products from customers. A report showing cash receipts and cash outlays of an enterprise for a short period 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. Cash receipts in a particular period may largely reflect the effects of activities of the enterprise in earlier periods, while many of the cash outlays may relate to activities and efforts expected in future periods.

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

86. Matching of costs and revenues is combined or simultaneous recognition of the revenues and expenses that result directly and jointly from the same transactions or other events. In most business enterprises, some transactions or events result simultaneously in both a revenue and one or more expenses. The revenue and expense(s) are directly related to each other and require recognition at the same time. In present practice, for example, a sale of product or merchandise involves both revenue (sales revenue) for receipt of cash or a receivable and expense (cost of goods sold) for sacrifice of the product or merchandise sold to customers. Other examples of expenses that may result from the same transaction and be directly related to sales revenues are transportation to customers, sales commissions, and perhaps certain other selling costs.

87. Many expenses, however, are not related directly to particular revenues but can be related to a period on the basis of transactions or events occurring in that period or by allocation. Recognition of those expenses is largely independent of recognition of particular revenues, but they are deducted from particular revenues by being recognized in the same period.[39]

88. Some costs that cannot be directly related to particular revenues are incurred to obtain benefits that are exhausted in the period in which the costs are incurred. For example, salesmen's monthly salaries and electricity used to light an office building usually fit that description and are usually recognized as expenses in the period in which they are incurred. Other costs are also recognized as expenses in the period in which they are incurred because the period to which they otherwise relate is indeterminable or not worth the effort to determine.

89. However, many assets yield their benefits to an enterprise over several periods, for example, prepaid insurance, buildings, and various kinds of equipment. Expenses resulting from their use are normally allocated to the periods of their estimated useful lives (the periods over which they are expected to provide benefits) by a "systematic and rational" allocation procedure, for example, by recognizing depreciation or other amortization. Although the purpose of expense allocation is the same as that of other expense recognition—to reflect the using up of assets as a result of transactions or other events or circumstances affecting an enterprise—allocation is applied if causal relations are generally, but not specifically, identified. For example, wear and tear from use is known to be a major cause of the expense called depreciation, but the amount of depreciation caused by wear and tear in a period normally cannot be measured. Those expenses are not related directly to either specific revenues or particular periods. Usually no traceable relationship exists, and they are recognized by allocating costs to periods in which assets are expected to be used and are related only indirectly to the revenues that are recognized in the same period.

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

Donald J. Kirk, *Chairman*
Frank E. Block
John W. March
Robert A. Morgan
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix A: BACKGROUND INFORMATION

90. The need for a conceptual framework for financial accounting and reporting, beginning with consideration of the objectives of financial reporting, is generally recognized. The Accounting Principles Board issued APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, in 1970. When the Financial Accounting Standards Board came into existence, the Study Group on the Objectives of Financial Statements was at work, and its report, *Objectives of Financial Statements*, was

published in October 1973 by the American Institute of Certified Public Accountants.

91. The Financial Accounting Standards Board issued a Discussion Memorandum, *Conceptual Framework for Accounting and Reporting: Consideration of the Report of the Study Group on the Objectives of Financial Statements*, dated June 6, 1974, and held a public hearing on September 23 and 24, 1974 on the objectives of financial statements. On December 2, 1976, the Board issued three documents:

Tentative Conclusions on Objectives of Financial Statements of Business Enterprises,

FASB Discussion Memorandum, *Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement*, and

Scope and Implications of the Conceptual Framework Project.

The same task force, with only one membership change, provided counsel in preparing both Discussion Memorandums. Eleven persons from academe, the financial community, industry, and public accounting served on the task force while the Discussion Memorandums were written.

92. The Board held public hearings (a) August 1 and 2, 1977 on the *Tentative Conclusions on Objectives of Financial Statements* and on Chapters 1-5 of the Discussion Memorandum concerning definitions of the elements of financial statements and (b) January 16-18, 1978 on the remaining chapters of the Discussion Memorandum concerning capital maintenance or cost recovery, qualities of useful financial information (qualitative characteristics), and measurement of the elements of financial statements.

93. The Board received 283 written communications on the subject of the August 1977 hearing, of which 221 commented on the elements, and 27 parties presented their views orally and answered Board members' questions at the hearing. The Board issued an Exposure Draft of a proposed Statement of Financial Accounting Concepts, *Objectives of Financial Reporting and Elements of Financial Statements of Business Enterprises*, dated December 29, 1977 and received 135 letters of comment.

94. During 1978, the Board divided the subject matter of the Exposure Draft. One part became FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, which was issued in November 1978. Another part became the basis for the revised Exposure Draft, *Elements of Financial Statements of Business Enterprises*, issued December 28, 1979, on which the Board received 92 letters of comment.

95. Although some changes in wording and organization have been made, the Board believes that the substance of this Statement is essentially the same as that of the revised Exposure Draft.

Appendix B: CHARACTERISTICS OF ASSETS, LIABILITIES, EQUITY, AND COMPREHENSIVE INCOME AND ITS COMPONENTS

Purpose and Summary of Appendix

96. This appendix elaborates on the descriptions of the essential characteristics that items must have to qualify under the definitions of elements of financial statements in this Statement. It includes some discussion and illustrations of how to assess the characteristics of items that are potential candidates for formal inclusion in financial statements and in general how to apply the definitions.

97. The remainder of this introductory section briefly illustrates the relationship of the definitions to recognition, measurement, and display issues and the function and some consequences of the definitions. It is followed by a discussion of the characteristics of assets, liabilities, equity, and comprehensive income and its components. The appendix concludes with a series of examples that are intended to illustrate the meanings of the definitions and the essential characteristics that form them.

98. This Statement emphasizes that the definitions of elements are not intended to answer recognition, measurement, or display questions, which are issues in other phases of the conceptual framework project. The definitions are, however, a significant first step in determining the content of financial statements. They screen out items that lack one or more characteristics of assets, liabilities, revenues, expenses, or other elements of financial statements (paragraphs 16 and 17).

99. Thus, unless an item qualifies as an asset of an enterprise under the definition in paragraph 19, for example, questions do not arise about whether to recognize it as an asset of the enterprise, which of its attributes to measure, or how to display it as an asset in the financial statements of the enterprise. Although items that fail to qualify under the definitions of elements during a period do not raise recognition issues, they may nevertheless raise issues about whether and, if so, how and at what amounts they should be disclosed. For example, contingencies that have not yet, and may never, become assets or liabilities may need to be estimated and disclosed. Thus, the first question about each potential candidate for formal inclusion in financial statements is whether it qualifies under one of the definitions of elements; recognition, measurement, and display questions follow.

100. An item does not qualify as an asset or liability of an enterprise if it lacks one or more essential characteristics. Thus, for example, an item does not qualify as an asset of an enterprise under the definition in paragraph 19 if (a) the item involves no future economic benefit, (b) the

item involves future economic benefit, but the enterprise cannot obtain it, or (c) the item involves future economic benefit that the enterprise may in the future obtain, but the events or circumstances that give the enterprise access to and control of the benefit have not yet occurred (or the enterprise in the past had the ability to obtain or control the future benefit, but events or circumstances have occurred to remove that ability). Similarly, an item does not qualify as a liability of an enterprise under the definition in paragraph 28 if (a) the item entails no future sacrifice of assets, (b) the item entails future sacrifice of assets, but the enterprise is not obligated to make the sacrifice, or (c) the item involves a future sacrifice of assets that the enterprise will be obligated to make, but the events or circumstances that obligate the enterprise have not yet occurred (or the enterprise in the past was obligated to make the future sacrifice, but events or circumstances have occurred to remove that obligation).

101. This appendix contains numerous examples of items that commonly qualify as assets or liabilities of an enterprise under the definitions in this Statement. It also includes several illustrations showing that items that may not qualify as assets may readily qualify as reductions (valuation accounts) of liabilities and that items that may not qualify as liabilities may readily qualify as reductions (valuation accounts) of assets. The following examples illustrate items that do not qualify as assets or liabilities of an enterprise under the definitions: (a) "dry holes" drilled by an exploration enterprise that has not yet discovered hydrocarbon, mineral, or other reserves are not assets (except to the extent of salvageable materials or equipment) because they provide no access to probable future economic benefit;[40] (b) estimated possible casualty losses from future floods or fires are not liabilities or impairments of assets because an event incurring a liability or impairing an asset has not occurred; (c) inventories or depreciable assets required (but not yet ordered) to replace similar items that are being or have been used up are not assets because no future economic benefits have been acquired, and the requirement to sacrifice assets to obtain them is not a liability because the enterprise is not yet obligated to sacrifice assets in the future; (d) deferrals relating to assets no longer held or liabilities no longer owed—such as a deferred loss on selling an asset for cash or a deferred gain on settling a liability for cash—are not assets or liabilities because they involve no future economic benefit or no required future sacrifice of assets; (e) receipts of grants of cash or other assets with no strings attached do not create liabilities because the enterprise is not required to sacrifice assets in the future; (f) other receipts of cash in return for which an enterprise is in no way obligated to pay cash, transfer other assets, or provide services do not create liabilities because the enterprise is not required to sacrifice assets in the future; (g) "know-how" of NASA or other governmental agencies placed in the public domain is not an asset of an enterprise unless the enterprise spends funds or otherwise acts to secure benefits not freely available to everyone; (h) estimated losses for two years from a decision to start up a new product line next year are not liabilities because the enterprise is not legally, equitably, or constructively obligated to sacrifice assets in the future; and (i) "stock dividends payable" are not liabilities because they do not involve an obligation to make future sacrifices of assets.

102. The Board expects most assets and liabilities in present practice to continue to qualify as assets or liabilities under the definitions in this Statement. That expectation is supported by the

examples in the preceding paragraph as well as by those throughout this appendix. The Board emphasizes that the definitions in this Statement neither require nor presage upheavals in present practice, although they may in due time lead to some evolutionary changes in practice or at least in the ways certain items are viewed. They should be especially helpful, however, in understanding the content of financial statements and in analyzing and resolving new financial accounting issues as they arise.

Characteristics of Assets of Business Enterprises

103. Paragraph 19 defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." The following discussion amplifies that definition and illustrates its meaning under three headings that correspond to the three essential characteristics of assets described in paragraph 20: future economic benefits, control by a particular enterprise, and occurrence of a past transaction or event.

Future Economic Benefits

104. Future economic benefit is the essence of an asset (paragraphs 21-24). An asset has the capacity to serve the enterprise by being exchanged for something else of value to the enterprise, by being used to produce something of value to the enterprise, or by being used to settle its liabilities.

105. The most obvious evidence of future economic benefit is a market price. Anything that is commonly bought and sold has future economic benefit, including the individual items that a buyer obtains and is willing to pay for in a "basket purchase" of several items or in a business combination. Similarly, anything that creditors or others commonly accept in settlement of liabilities has future economic benefit, and anything that is commonly used to produce goods or services, whether tangible or intangible and whether or not it has a market price or is otherwise exchangeable, also has future economic benefit.[41] Incurrence of costs may be significant evidence of acquisition or enhancement of future economic benefits (paragraphs 110-112).

106. To assess whether a particular item constitutes an asset of a particular enterprise at a particular time requires at least two considerations in addition to the general kinds of evidence just described: (a) whether the item obtained by the enterprise actually embodied future economic benefit in the first place and (b) whether all or any of the future economic benefit to the enterprise remains at the time of assessment.

107. Uncertainty about business and economic outcomes often clouds whether or not particular items that might be assets have the capacity to provide future economic benefits to the enterprise (paragraphs 37-40), sometimes precluding their recognition as assets. The kinds of items that may be recognized as expenses or losses rather than as assets because of uncertainty are some in which management's intent in taking certain steps or initiating certain transactions is clearly to acquire or enhance future economic benefits available to the enterprise. Thus, enterprises

engage in research and development activities, advertise, develop markets, open new branches or divisions, and the like, and spend significant funds to do so. The uncertainty is not about the intent to increase future economic benefits but about whether and, if so, to what extent they succeeded in doing so. Certain expenditures for research and development, advertising, training, start-up and preoperating activities, development stage enterprises, relocation or rearrangement, and goodwill are examples of the kinds of items for which assessments of future economic benefits may be especially uncertain.

108. Since many of the activities described in the preceding paragraph involve incurring costs, the distinction between the items just listed and assets, such as prepaid insurance and prepaid rent, that are described in paragraph 113 is often difficult to draw because the two groups tend to shade into each other. Indeed, the distinction is not based on the definition of assets in paragraph 19 but rather on the practical considerations of coping with the effects of uncertainty. If research or development activities or advertising result in an enterprise's acquiring or increasing future economic benefit, that future economic benefit qualifies as an asset as much as do the future benefits from prepaid insurance or prepaid rent. The practical problem is whether future economic benefit is actually present and, if so, how much—an assessment that is greatly complicated by the feature that the benefits may be realized far in the future, if at all.

109. Most assets presently included in financial statements qualify as assets under the definition in paragraph 19 because they have future economic benefits. Cash, accounts and notes receivable, interest and dividends receivable, investments in securities of other entities, and similar items so obviously qualify as assets that they need no further comment except to note that uncollectible receivables do not qualify as assets. Inventories of raw materials, supplies, partially completed product, finished goods, and merchandise likewise obviously fit the definition as do productive resources, such as property, plant, equipment, tools, furnishings, leasehold improvements, natural resource deposits, and patents. They are mentioned separately from cash, receivables, and investments only because they have commonly been described in accounting literature as "deferred costs" or occasionally as "deferred charges" to revenues. The point requires noting because comments received on the Discussion Memorandum and Exposure Drafts have manifested some misunderstanding: some respondents apparently concluded that all or most deferrals of costs were precluded by the definition of assets.

Assets and Costs

110. A business enterprise commonly incurs costs to obtain future economic benefits, either to acquire assets from other entities in exchange transactions or to add value through operations to assets it already has (paragraph 25). An enterprise acquires assets in exchanges with other entities by sacrificing other assets or by incurring liabilities to transfer assets to the other entity later. An enterprise also incurs a cost when it uses an asset in production—future economic benefits are partially or wholly used up to produce or acquire other assets, for example, product in process, completed product, or receivables from customers.

111. Although an enterprise normally incurs costs to acquire or use assets, costs incurred are not themselves assets. The essence of an asset is its future economic benefit rather than whether or not it was acquired at a cost. However, costs may be significant to applying the definition of assets in at least two ways: as evidence of acquisition of an asset or as a measure of an attribute of an asset.

112. First, since an enterprise commonly obtains assets by incurring costs, incurrence of a cost may be evidence that an enterprise has acquired one or more assets, but it is not conclusive evidence. Costs may be incurred without receiving services or enhanced future economic benefits. Or, enterprises may obtain assets without incurring costs—for example, from investment in kind by owners. The ultimate evidence of the existence of assets is the future economic benefit, not the costs incurred.

113. Second, cost may measure an attribute of future economic benefit. Costs of assets such as inventories, plant, equipment, and patents are examples of costs or unamortized costs of future benefits from present practice, as are prepayments such as prepaid insurance and prepaid rent, which are unamortized costs of rights to receive a service or use a resource.

114. Losses have no future economic benefits and cannot qualify as assets under the definition in paragraph 19. Stated conversely, items that have future economic benefits are not in concept losses, although practical considerations may sometimes make it impossible to distinguish them from expenses or losses.

Control by a Particular Enterprise

115. Paragraph 19 defines assets in relation to specific entities. Every asset is an asset of some entity; moreover, no asset can simultaneously be an asset of more than one entity, although a particular physical thing or other agent that provides future economic benefit may provide separate benefits to two or more entities at the same time (paragraph 117). To have an asset, a business enterprise must control future economic benefit to the extent that it can benefit from the asset and generally can deny or regulate access to that benefit by others, for example, by permitting access only at a price.

116. Thus, an asset of a business enterprise is future economic benefit that the enterprise can control and thus can, within limits set by the nature of the benefit or the enterprise's right to it, use as it pleases. The enterprise having an asset is the one that can exchange it, use it to produce goods or services, exact a price for others' use of it, use it to settle liabilities, hold it, or perhaps distribute it to owners.

117. The definition of assets focuses primarily on the future economic benefit to which an enterprise has access and only secondarily on the physical things and other agents that provide future economic benefits. Many physical things and other agents are in effect bundles of future economic benefits that can be unbundled in various ways, and two or more entities may have different future economic benefits from the same agent at the same time or the same continuing

future economic benefit at different times. For example, two or more entities may have undivided interests in a parcel of land. Each has a right to future economic benefit that may qualify as an asset under the definition in paragraph 19, even though the right of each is subject at least to some extent to the rights of the other(s). Or, one entity may have the right to the interest from an investment, while another has the right to the principal. Leases are common examples of agreements that unbundle the future economic benefits of a single property to give a lessee a right to possess and use the property and give a lessor a right to receive rents and a right to the residual value. Moreover, a mortgagee may also have a right to receive periodic payments that is secured by the leased property.

Control and Legal Rights

118. As some of the preceding discussion indicates, an entity's ability to obtain the future economic benefit of an asset commonly stems from legal rights. Those rights share the common feature of conferring ability to obtain future economic benefits, but they vary in other ways. For example, ownership, a contract to use, and a contract to receive cash confer different rights.

119. Although the ability of an enterprise to obtain the future economic benefit of an asset and to deny or control access to it by others rests generally on a foundation of legal rights, legal enforceability of a right is not an indispensable prerequisite for an enterprise to have an asset if the enterprise otherwise will probably obtain the future economic benefit involved. For example, exclusive access to future economic benefit may be maintained by keeping secret a formula or process.

Noncontrolled Benefits

120. Some future economic benefits cannot meet the test of control. For example, public highways and stations and equipment of municipal fire and police departments may qualify as assets of governmental units but they cannot qualify as assets of individual business enterprises under the definition in paragraph 19. Similarly, general access to things such as clean air or water resulting from environmental laws or requirements cannot qualify as assets of individual business enterprises, even if the enterprises have incurred costs to help clean up the environment.

121. Those examples should be distinguished from similar future economic benefits that an individual enterprise can control and thus are its assets. For example, an enterprise can control benefits from a private road on its own property, clean air it provides in a laboratory or water it provides in a storage tank, or a private fire department or a private security force, and the related equipment probably qualifies as an asset even if it has no other use to the enterprise and cannot be sold except as scrap. Equipment used to help provide clean air or water in the general environment may provide future economic benefit to the user, even if it has no other use and cannot be sold except as scrap. Moreover, a specific right to use a public highway from which the licensee might otherwise be excluded—for example, a license to operate a truck on the highways within a state—may have future economic benefit to the licensee even though it does not keep everyone else off the highway. Similarly, riparian rights and airspace rights may confer

future economic benefits on their holders even though they do not keep others' boats off the river or prevent airplanes from flying overhead.

Occurrence of a Past Transaction or Event

122. The definition of assets in paragraph 19 distinguishes between the future economic benefits of present and future assets of an enterprise. Only present abilities to obtain future economic benefits are assets under the definition, and they become assets of particular enterprises as a result of transactions or other events or circumstances affecting the enterprise. For example, the future economic benefits of a particular building can be an asset of a particular entity only after a transaction or other event—such as a purchase or a lease agreement—has occurred that gives it access to and control of those benefits. Similarly, although an oil deposit may have existed in a certain place for millions of years, it can be an asset of a particular enterprise only after the enterprise either has discovered it in circumstances that permit the enterprise to exploit it or has acquired the rights to exploit it from whoever had them.

123. Since the transaction or event giving rise to the enterprise's right to the future economic benefit must already have occurred, the definition excludes from assets items that may in the future become an enterprise's assets but have not yet become its assets. An enterprise has no asset for a particular future economic benefit if the transactions or events that give it access to and control of the benefit are yet in the future. The corollary is that an enterprise still has an asset if the transactions or events that use up or destroy a particular future economic benefit or remove the enterprise's access to and control of it are yet in the future. For example, an enterprise does not acquire an asset merely by budgeting the purchase of a machine and does not lose an asset from fire until a fire destroys or damages some asset.

Characteristics of Liabilities of Business Enterprises

124. Paragraph 28 defines liabilities as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." The following discussion amplifies that definition and illustrates its meaning under three headings that correspond to the three essential characteristics of liabilities described in paragraph 29: required future sacrifice of assets, obligation of a particular enterprise, and occurrence of a past transaction or event.

Required Future Sacrifice of Assets

125. The essence of a liability is a duty or requirement to sacrifice assets in the future. A liability requires an enterprise to transfer assets, provide services, or otherwise expend assets to satisfy a responsibility to one or more other entities that it has incurred or that has been imposed on it.

126. The most obvious evidence of liabilities are contracts or other agreements resulting from exchange transactions and laws or governmental regulations that require expending assets to

comply. Although receipt of proceeds is not conclusive evidence that a liability has been incurred (paragraph 130), receipt of cash, other assets, or services without an accompanying cash payment is often evidence that a liability has been incurred. Evidence of liabilities may also be found in declarations of dividends, lawsuits filed or in process, infractions that may bring fines or penalties, and the like. Reductions in prices paid or offered to acquire an enterprise or a significant part of it to allow for items that a buyer must assume that require future transfers of assets or providing of services also may indicate the kinds of items that qualify as liabilities. Moreover, liabilities that are not payable on demand normally have specified or determinable maturity dates or specified events whose occurrence requires that they must be settled, and absence of a specified maturity date or event may cast doubt that a liability exists.

127. To assess whether a particular item constitutes a liability of a particular enterprise at a particular time requires at least two considerations in addition to the general kinds of evidence just described: (a) whether the enterprise actually incurred a responsibility to sacrifice assets in the future and (b) whether all or any of the responsibility remains unsatisfied at the time of assessment.

128. Most liabilities presently included in financial statements qualify as liabilities under the definition in paragraph 28 because they require an enterprise to sacrifice assets in the future. Thus, accounts and notes payable, wages and salaries payable, long-term debt, interest and dividends payable, and similar requirements to pay cash so obviously qualify as liabilities that they need no further comment. Responsibilities such as those to pay pensions, deferred compensation, and taxes and to honor warranties and guarantees also create liabilities under the definition. That they may be satisfied by providing goods or services instead of cash, that their amounts or times of settlement must be estimated, or that the identity of the specific entities to whom an enterprise is obligated is as yet unknown does not disqualify them under the definition, although some may not be recognized because of uncertainty or measurement problems (paragraphs 37-40).

129. Deposits and prepayments received for goods or services to be provided—"unearned revenues," such as subscriptions or rent collected in advance—likewise qualify as liabilities under the definition because an enterprise is required to provide goods or services to those who have paid in advance. They are mentioned separately from other liabilities only because they have commonly been described in the accounting literature and financial statements as "deferred credits" or "reserves." Comments on the Discussion Memorandum and Exposure Drafts have manifested some misunderstanding: some respondents apparently concluded that all or most "deferred credits" and "reserves" were precluded by the definition of liabilities.

Liabilities and Proceeds

130. An enterprise commonly receives cash, goods, or services by incurring liabilities (paragraph 31), and that which is received is often called proceeds, especially if cash is received. Receipt of proceeds may be evidence that an enterprise has incurred one or more liabilities, but it

is not conclusive evidence. Proceeds may be received from cash sales or by issuing ownership shares—that is, from revenues or other sales of assets or from investments by owners—and enterprises may incur liabilities without receiving proceeds—for example, by imposition of taxes. The essence of a liability is a legal, equitable, or constructive obligation to sacrifice economic benefits in the future rather than whether proceeds were received by incurring it. Proceeds themselves are not liabilities.

Obligation of a Particular Enterprise

131. Paragraph 28 defines liabilities in relation to specific entities. A required future sacrifice of assets is a liability of the particular entity that must make the sacrifice.

132. To have a liability, a business enterprise must be obligated to sacrifice its assets in the future—that is, it must be bound by a legal, equitable, or constructive duty or responsibility to transfer assets or provide services to one or more other entities. Not all probable future sacrifices of economic benefits (assets) are liabilities of an enterprise. For example, an enterprise's need to replace merchandise sold or raw materials or equipment used up, no matter how pressing, does not by itself constitute a liability of the enterprise because no obligation to another entity is present.

133. Most obligations that underlie liabilities stem from contracts and other agreements that are enforceable by courts or from governmental actions that have the force of law,[42] and the fact of an enterprise's obligation is so evident that it is often taken for granted. To carry out its operations, an enterprise routinely makes contracts and agreements that obligate it to repay borrowing, to pay suppliers and employees for goods and services they provide, to provide goods or services to customers or clients, or to repair or replace defective products sold with warranties or guarantees. Governmental units also routinely assess tax obligations against business enterprises, and courts may impose obligations for damages or fines on business enterprises.

134. Equitable or constructive obligations may underlie liabilities as well as those that are legally enforceable. Legal obligations are much more common, and their existence may be more readily substantiated, but other kinds of obligations are sometimes liabilities. For example, the question, which has resulted in differences of opinion, of the extent to which future payments under a lease agreement are legally enforceable against lessees is not necessarily significant in determining whether the obligations under lease agreements qualify as liabilities.

135. An enterprise may incur equitable or constructive obligations by actions to bind itself or by finding itself bound by circumstances, rather than by making contracts or participating in exchange transactions. An enterprise is not obligated to sacrifice assets in the future if it can avoid the future sacrifice at its discretion without significant penalty. The example of an enterprise that binds itself to pay employees 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 has already been noted (paragraph 33). It could refuse to pay only by risking substantial

employee relations problems.

136. Most liabilities are obligations of only one enterprise at a time. Some liabilities are shared—for example, two or more entities may be "jointly and severally liable" for a debt or for the unsatisfied liabilities of a partnership. But most liabilities bind a single enterprise or other entity, and those that bind two or more enterprises or other entities are commonly ranked rather than shared. For example, a primary debtor and a guarantor may both be obligated for a debt, but they do not have the same obligation—the guarantor must pay only if the primary debtor defaults and thus has a contingent or secondary obligation, which ranks lower than that of the primary debtor.

137. Secondary, and perhaps even lower ranked, obligations may qualify as liabilities under the definition in paragraph 28, but recognition criteria are highly significant in deciding whether they should formally be included in financial statements because of the effects of uncertainty (paragraphs 37-40). For example, the probability that a secondary or lower ranked obligation will actually have to be paid must be assessed to apply the definition.

Occurrence of a Past Transaction or Event

138. The definition of liabilities in paragraph 28 distinguishes between present and future obligations of an enterprise. Only present obligations are liabilities under the definition, and they are liabilities of a particular enterprise as a result of the occurrence of transactions or other events or circumstances affecting the enterprise.

139. Most liabilities result from exchange transactions in which an enterprise borrows funds or acquires goods or services and agrees to repay borrowing, usually with interest, or to pay for goods or services received. For example, using employees' services obligates an enterprise to pay wages or salaries and usually fringe benefits.

140. In contrast, the acts of budgeting the purchase of a machine and budgeting the payments required to obtain it result neither in acquiring an asset nor in incurring a liability. No transaction or event has occurred that gives the enterprise access to or control of future economic benefit or obligates it to transfer assets or provide services to another entity.

141. Many agreements specify or imply how a resulting obligation is incurred. For example, borrowing agreements specify interest rates, periods involved, and timing of payments; rental agreements specify rentals and periods to which they apply; and royalty agreements may specify payments relating to periods or payments relating to production or sales. The occurrence of the specified event or events results in a liability. For example, interest accrues with the passage of time (that is, providing loaned funds for another hour, day, week, month, or year), while royalties may accrue either with the passage of time or as units are produced or sold, depending on the agreement.

142. Transactions or events that result in liabilities imposed by law or governmental units also

are often specified or inherent in the nature of the statute or regulation involved. For example, taxes are commonly assessed for calendar or fiscal years, fines and penalties stem from infractions of the law or failure to comply with provisions of laws or regulations, damages result from selling defective products, and restoring the land after strip-mining the mineral deposit is a consequence of removing the ground cover or overburden and ore. For those imposed obligations, as for obligations resulting from exchange transactions, no liability is incurred until the occurrence of an event or circumstance that obligates an enterprise to pay cash, transfer other assets, or provide services to other entities in the future.

143. A liability once incurred by an enterprise remains a liability until it is satisfied in another transaction or other event or circumstance affecting the enterprise. Most liabilities are satisfied by cash payments. Others are satisfied by the enterprise's transferring assets or providing services to other entities, and some of those—for example, liabilities to provide magazines under a prepaid subscription agreement—involve performance to earn revenues. Liabilities are also sometimes eliminated by forgiveness, compromise, incurring another liability, or changed circumstances.

Characteristics of Equity of Business Enterprises

144. Paragraph 43 defines equity as the "the residual interest in the assets of an entity that remains after deducting its liabilities." It adds that "in a business enterprise, the equity is the ownership interest." Characteristics of equity of business enterprises are briefly discussed under the headings: residual or ownership interest and invested and earned equity. Although *capital* is not a precise term in referring to ownership interests because it is also applied to assets and liabilities in various ways, it is used in this discussion because *capital* is part of so many terms commonly used to describe aspects of ownership interests; for example, investments by owners are commonly called capital contributions, distributions to owners are commonly called capital distributions, and discussions of comprehensive income and its components often refer to capital maintenance.

Residual or Ownership Interest

145. Equity is the cumulative result of investments by owners, comprehensive income, and distributions to owners. That characteristic, coupled with the characteristic that liabilities have priority over ownership interest as claims against enterprise assets, makes equity not determinable independently of assets and liabilities. Although equity can be described in various ways, and different recognition criteria and measurement procedures can affect its amount, equity always equals net assets (assets - liabilities). That is why it is a residual interest.

Invested and Earned Equity

146. Equity is defined only in total in this Statement. Although equity of business enterprises is commonly displayed in two or more classes, usually based on actual or presumed legal distinctions, those classes may not correspond to the two sources of equity: investments by

owners and comprehensive income. For example, a traditional classification for corporate equity is capital stock, other contributed capital, and retained or undistributed profit, with the first two categories described as invested or contributed capital and the third described as earned capital or capital from operations. That distinction holds reasonably well in the absence of distributions to owners or stock dividends; and cash dividends or dividends in kind that are "from profit" may not cause significant classification problems. However, transactions and events such as stock dividends (proportional distributions of an enterprise's own stock accompanied by a transfer of retained or undistributed profit to capital stock and other contributed capital) and reacquisitions and reissues of ownership interests (commonly called treasury stock transactions in corporations) mix the sources and make tracing of sources impossible except by using essentially arbitrary allocations. Thus, categories labeled invested or contributed capital or earned capital may or may not accurately reflect the sources of equity of an enterprise. However, those problems are problems of measurement and display, not problems of definition.

Characteristics of Comprehensive Income and Its Components

147. Paragraph 56 defines comprehensive income as "the change in equity (net assets) of an entity during a period from transactions and other events and circumstances from nonowner sources." It adds that "it includes all changes in equity during a period except those resulting from investments by owners and distributions to owners." Comprehensive income comprises four basic components—revenues, expenses, gains and losses—that are defined in paragraphs 63, 65, 67, and 68.

148. Comprehensive income and investments by and distributions to owners account for all changes in equity (net assets) of a business enterprise during a period, but not for all changes in its assets and liabilities. The diagram in paragraph 50 shows those relations. That makes the sources of comprehensive income significant to those attempting to use financial statements to help them with investment, credit, and similar decisions, especially since various sources may differ from each other in stability, risk, and predictability. That underlies the distinctions between revenues, expenses, gains, and losses as well as other components of comprehensive income that result from combining revenues, expenses, gains, and losses in various ways (paragraphs 59-62).

149. The principal distinction between revenues and expenses on the one hand and gains and losses on the other is that between an enterprise's ongoing major or central operations and its peripheral and incidental transactions and activities. Revenues and expenses result from an enterprise's productive efforts and most of its exchange transactions with other entities that constitute the enterprise's ongoing major or central operations. The details vary with the type of enterprise and activities involved. For example, a manufacturing or construction enterprise buys or contracts to use labor, raw materials, land, plant, equipment, and other goods and services it needs. Its manufacturing or construction operations convert those resources into a product—output of goods—that is intended to have a greater utility, and therefore a higher price, than the combined inputs. Sale of the product should therefore bring in more cash or other assets

than were spent to produce and sell it. Other kinds of enterprises earn more cash or other assets than they spend in producing and distributing goods or services through other kinds of operations—for example, by buying and selling goods without changing their form (such as retailers or wholesalers), by providing one or more of a wide variety of services (such as garages, professional firms, insurance companies, and banks), or by investing in securities of other enterprises (such as mutual funds, insurance companies, and banks). Some enterprises simultaneously engage in many different ongoing major or central activities.

150. Most enterprises also occasionally engage in activities that are peripheral or incidental to their ongoing major or central operations. For example, many enterprises invest in securities of other enterprises to earn a return on otherwise idle assets (rather than to control or influence the other enterprise's operations). Moreover, all enterprises are affected by price changes, interest rate changes, technological changes, thefts, fires, natural disasters, and similar events and circumstances that may be wholly or partly beyond the control of individual enterprises and their managements. The kinds of events and circumstances noted in this paragraph are commonly sources of gains and losses for business enterprises. Of course, the distinction between revenues and gains and between expenses and losses depends significantly on the nature of an enterprise and its activities (paragraphs 72 and 73).

Interest in Information about Sources of Comprehensive Income

151. Information about various components of comprehensive income is usually more useful than merely its aggregate amount to investors, creditors, managers, and others who are interested in knowing not only that an enterprise's net assets have increased (or decreased) but also *how* and *why*. The amount of comprehensive income for a period can, after all, be measured merely by comparing the ending and beginning equity and eliminating the effects of investments by owners and distributions to owners, but that procedure has never provided adequate information about an enterprise's performance. Investors, creditors, managers, and others need information about the causes of changes in assets and liabilities.

152. As the preceding paragraphs imply, financial accounting and reporting information that is intended to be useful in assessing an enterprise's performance or profitability focuses on certain components of comprehensive income. Ways of providing information about various sources of comprehensive income are the subject of conceptual framework projects on display, particularly the project on reporting earnings.[43] Pertinent issues involve questions such as: Should all components of comprehensive income be displayed in a single financial statement or in two or more statements and, if the latter, which statements should be provided? What level of aggregation or disaggregation is needed for revenues, expenses, gains, and losses? Which intermediate components or measures resulting from combining those elements should be emphasized and which, if any, should be emphasized to the extent of being the "bottom line" of a financial statement? Which, if any, intermediate component or components should be designated as *earnings*? May or should some components of comprehensive income be displayed as direct increases or decreases of equity?

Examples to Illustrate Concepts

153. The following paragraphs illustrate some possible applications of the definitions and related concepts. Two cautions apply. First, although the points involved are conceptually significant, they may be practically trivial—that is, the results may appear to make little difference in practice. However, since this Statement is part of the Board's conceptual framework project, it is intended to emphasize concepts and sound analysis and to foster careful terminology, classification, and disclosure. The illustrations are meant to focus on substance rather than form. They illustrate, among other things, (a) that the presence or absence of future economic benefit rather than whether or not an enterprise incurred a cost ultimately determines whether it has a particular kind of asset, (b) that the presence or absence of a legal, equitable, or constructive obligation entailing future sacrifice of economic benefit (assets) rather than whether or not an enterprise received proceeds ultimately determines whether it has a particular kind of liability, and (c) that debit balances are not necessarily assets and credit balances are not necessarily liabilities.

154. Second, the examples used are intended to illustrate concepts and are not intended to imply that the accounting illustrated or the display described should necessarily be adopted in practice. Statements of Financial Accounting Standards, not Statements of Financial Accounting Concepts, establish generally accepted accounting principles. Decisions about what should be adopted in practice involve not only concepts but also practical considerations, including the relative benefits and costs of procedures and the reliability of measures. For example, some of the kinds of items illustrated are significantly affected by the uncertainty that surrounds the activities of business enterprises (paragraphs 37-40), and those effects should be considered in applying the definitions in this Statement.

155. A particular item to which the definitions may be applied may belong to either of two groups of elements:

First Group	Second Group
an asset,	a liability,
a reduction of a liability (liability valuation),	a reduction of an asset (asset valuation),
an expense, or	a revenue, or
a loss.	a gain.

(None of the examples involves investments by owners or distributions to owners, and only the last one involves equity; those elements are therefore omitted from the two groups.) The nature of the elements and the relations between them dictate that the same item can be, for example, either an asset or an expense or either a liability or a gain, but the same item cannot be, for example, either an asset or a liability or either an expense or a gain. (Those who are familiar with the mechanics of accounting will recognize that the first group includes "debits" and the second group includes "credits.") Thus, to apply the definitions involves determining the group to which an item belongs and the element within the group whose definition it fits.

Deferred Gross Profit on Installment Sales

156. Deferred gross profit on installment sales falls into the second group. It is neither a revenue nor a gain; the recognition basis that results in deferred gross profit (in substance a cash receipts basis) permits no revenue or gain to be recognized at the time of sale, except to the extent of gross profit in a down payment. Designating the amount as "deferred gross profit" also indicates that it is not now a revenue or gain, although it may be in the future.

157. Nor is the deferred gross profit a liability. The selling enterprise is not obligated to pay cash or to provide goods or services to the customer, except perhaps to honor a warranty or guarantee on the item sold, but that is a separate liability rather than part of the deferred gross profit. The deferred gross profit resulted because of doubt about the collectibility of the sales price (installment receivable), not because of cash payments or other asset transfers that the seller must make.

158. The essence of the installment sale transaction (using the recognition basis involved) is that the sale resulted in an increase in installment receivables and a decrease in inventory of equal amounts—the receivable reflects the unrecovered cost of the inventory sold. Gross profit (revenue less the related cost of goods sold) is recognized as cash is collected on the installment receivable, and the receivable continues to reflect the unrecovered cost—as it should using a cash receipts basis of recognition—if the deferred gross profit is deducted from it. Thus, no matter how it is displayed in financial statements, deferred gross profit on installment sales is conceptually an asset valuation—that is, a reduction of an asset.

Debt Discount, Premium, and Issue Cost

159. Unamortized or deferred debt discount belongs to the first group (paragraph 155) and was long commonly reported as an asset and amortized to interest expense by straight-line methods. APB Opinion No. 21, *Interest on Receivables and Payables*, changed that practice by requiring debt discount to be (a) deducted directly from the liability (as a "valuation account") and (b) "amortized" by the "interest" method using the effective interest or discount rate implicit in the borrowing transaction. That accounting reports the liability at the present value of the future cash payments for interest and maturity amount, discounted at the effective rate (which is higher than the nominal rate specified in the debt agreement), and reports interest expense at an amount determined by applying the effective rate to the amount of the liability at the beginning of the period.

160. The definitions in this Statement support the accounting required by Opinion 21. The debt

discount is not an asset because it provides no future economic benefit. The enterprise has the use of the borrowed funds but it pays a price for that use—interest. A bond discount means that the enterprise borrowed less than the face or maturity amount of the debt instrument and therefore pays a higher actual (effective) interest rate than the rate (nominal rate) specified in the debt agreement. Conceptually, debt discount is a liability valuation—that is, a reduction of the face or maturity amount of the related liability.

161. Debt issue cost also falls into the first group of elements and is either an expense or a reduction of the related debt liability. Debt issue cost is not an asset for the same reason that debt discount is not—it provides no future economic benefit. Debt issue cost in effect reduces the proceeds of borrowing and increases the effective interest rate and thus may be accounted for the same as debt discount. However, debt issue cost may also be considered to be an expense of the period of borrowing.

162. Unamortized or deferred debt premium is the exact counterpart of unamortized or deferred debt discount, and Opinion 21 requires counterpart accounting. Unamortized debt premium is not itself a liability—it has no existence apart from the related debt—and is accounted for under the Opinion by being (a) added directly to the related liability and (b) "amortized" by the "interest" method using the effective interest or discount rate implicit in the borrowing transaction. The lower interest rate and lower interest cost result because the proceeds of borrowing exceeded the face or maturity amount of the debt. Conceptually, debt premium is a liability valuation, that is, an addition to the face or maturity amount of the related liability.

Deferred Income Tax Credits

163. One view of deferred income tax credits—the liability method—is that they are taxes payable in future periods, that is, they are obligations of an enterprise that entail future cash payments. Another view—the net-of-tax method—is that they are valuations related to the effects of taxability and tax deductibility on individual assets. Deferred tax credits belong in the second group (paragraph 155), and the two views just noted exhaust the possibilities—deferred tax credits cannot be revenues or gains.[44] Both the liability method and the net-of-tax method are compatible with the definitions in this Statement.

164. Only the deferred method that is prescribed by APB Opinion No. 11, *Accounting for Income Taxes*, does not fit the definitions. Deferred income tax credits are neither liabilities nor reductions of assets in Opinion 11. That Opinion rejects the liability method and specifically denies that deferred tax credits are "payables in the usual sense" (paragraph 57). The Opinion also proscribes the net-of-tax method. It requires accounting for deferred tax credits as "tax effects of current timing differences [that] are deferred currently and allocated to income tax expense of future periods when the timing differences reverse" (paragraph 19) rather than either as accrued taxes to be paid in future periods when the timing differences reverse or as reductions in related assets.[45]

165. The compatibility of two of the three most widely suggested methods of accounting for tax effects of timing differences with the definitions in this Statement (and a possible compatible rationale for the results of the third method) is noted because several comments on the Discussion Memorandum and 1977 Exposure Draft had concluded, some with dismay and some with satisfaction, that the definitions ruled out deferred tax accounting or interperiod income tax allocation. However, the definitions are neutral on that recognition question: they affect only the method of allocation and neither require tax allocation nor rule it out.

Deferred Investment Tax Credits

166. Deferred investment tax credits were created by APB Opinion No. 2, *Accounting for the "Investment Credit,"* and the concept of deferred investment tax credits in that opinion is the basis of this example. Those deferred credits fall into the second group (paragraph 155) and are neither revenues nor gains. Deferred investment tax credits differ from deferred income tax credits in lacking a characteristic of liabilities that deferred income tax credits may have: deferred investment tax credits do not involve an obligation to pay taxes or otherwise sacrifice assets in the future. Conceptually, if investment tax credits are to be deferred and amortized over the life of the related assets, they are reductions of the acquisition costs of assets, not liabilities.

167. The Accounting Principles Board concluded in Opinion 2 that an investment tax credit was in substance a reduction of the cost of the related asset acquired and thereby a reduction of depreciation expense over the life of the asset rather than a reduction of income tax expense for the period of acquisition. The APB therefore concluded that "reflection of the allowable credit as a reduction in the net amount at which the acquired property is stated (either directly or by inclusion in an offsetting account)" was "preferable in many cases," and it permitted accounting for the credit as "deferred income" (a deferred credit) only if it were amortized over the productive life of the property (Opinion 2, paragraph 14). In other words, a deferred investment tax credit could be displayed as if it were a liability, and its amortization could be displayed as a reduction of income tax expense, but it must be accounted for as a reduction of an asset.[46]

168. The issue of whether the tax credit is a liability (deferred credit) or a reduction of the assets acquired is a significant conceptual question with a much less significant practical effect. Indeed, some consider the matter trivial because it does not affect reported profit. The issue of whether the investment tax credit is an asset valuation or a liability focuses, however, directly on the heart of the definition of liabilities. The essence of a liability is a legal, equitable, or constructive obligation to sacrifice economic benefits (assets) in the future, and a deferred investment tax credit based on the analysis in Opinion 2 wholly lacks that characteristic. If, therefore, liabilities were defined in a way that those deferred investment tax credits could qualify as liabilities, the concept would have virtually no meaning—almost any credit balance would qualify as a liability. A definition must set limits to be useful, and a definition broad enough to include deferred investment tax credits would be of little or no help in determining whether any other particular item were a liability of a particular enterprise.

Deferred Costs of Assets

169. Accountants, and others, are accustomed to describing costs incurred as assets, but costs incurred are at best evidence of the existence of assets (paragraphs 110-112). They result in assets only if an enterprise acquires or increases future economic benefits available to it in exchange transactions or through production. Once that conceptual point is made, however, it is obvious that cost incurred (acquisition cost or sometimes "historical cost") is commonly the attribute that is measured in financial reporting for many assets. Thus, inventories, plant, equipment, land, and a host of other future economic benefits are now represented in financial statements by some variation of costs incurred to acquire or make them.

170. Other "deferred costs" that are not themselves assets may be costs of the kinds of assets of an enterprise described in the preceding paragraph. For example, a procedure so long established that it rarely rates a second thought is to account for the costs (less salvage value, if any) of units normally spoiled in producing a product as additional costs of the salable units produced. Similarly, although a "dry hole" cannot by itself qualify as an asset, except perhaps for some salvageable materials or equipment, the costs of drilling a dry hole may be part of the cost of developing the future economic benefits of a mineral deposit that has been discovered.[47] Or, the legal and other costs of successfully defending a patent from infringement are "deferred legal costs" only in the sense that they are part of the cost of retaining and obtaining the future economic benefit of the patent.

171. The examples in the preceding paragraph illustrate costs that are accounted for in current practice as costs of other assets rather than as assets by themselves. The examples in this and the next two paragraphs illustrate costs that are of the same general nature but have sometimes been accounted for, and are commonly described, as if they were themselves assets. For example, enterprises that incur relocation, repair, training, advertising, or similar costs usually receive services (that is, something of value) in exchange for cash paid or obligations incurred. The question that needs to be answered to apply the definition of assets is whether the economic benefit received by incurring those costs was used up at the time the costs were incurred or shortly thereafter or future economic benefit remains at the time the definition is applied. Costs such as those of relocation, repair, training, or advertising services do not *by themselves* qualify as assets under the definition in paragraph 19 any more than do spoiled units, dry holes, or legal costs. The reason for considering the possibility that they might be accounted for as if they were assets stems from their possible relationship to future economic benefits.

172. Costs incurred for services such as research and development, relocation, repair, training, or advertising relate to future economic benefits in one of two ways. First, costs may represent rights to unperformed services yet to be received from other entities. For example, advertising cost incurred may be for a series of advertisements to appear in national news magazines over the next three months. Those kinds of costs incurred are similar to prepaid insurance or prepaid rent. They are payments in advance for services to be rendered to the enterprise by other entities

in the future. Second, they may represent future economic benefit that is expected to be obtained within the enterprise by using assets or in future exchange transactions with other entities. For example, prerelease advertising of a motion picture may increase the future economic benefits of the product, or repairs may increase the future economic benefits of a piece of equipment. Those kinds of costs may be accounted for as assets either by being added to other assets or by being disclosed separately. If costs are to be included in assets because they enhance future economic benefits of two or more assets, the only practical alternative to arbitrarily allocating them to those other assets may be to show them as separate assets.

173. The examples do not, of course, preclude accounting for the kinds of costs involved as expenses of the period in which they are incurred. Many, perhaps most, will not be shown as assets at all for practical reasons stemming from considerations of uncertainty or measurement (paragraphs 37-40 and 107-108).

Estimated Loss on Purchase Commitments

174. Estimated loss on purchase commitments belongs in the second group of elements (paragraph 155). It is not a revenue or gain because it results from a loss. It is at best part of a liability and is not *by itself* an obligation to pay cash or otherwise sacrifice assets in the future. There is no asset from which it may be a deduction in present practice. Thus, it seems not to fit in the second group, after all. That predicament results, however, because estimated loss on purchase commitments is the recorded part of a series of transactions and events that are mostly unrecorded.

175. A purchase commitment involves both an item that might be recorded as an asset and an item that might be recorded as a liability. That is, it involves both a right to receive assets and an obligation to pay for them.[48] A decrease in the price that leaves the committed buyer in the position of now being able to buy the assets cheaper were it not committed to buy them at the former, higher price does not by itself create an obligation that was not already present. If both the right to receive assets and the obligation to pay for them were recorded at the time of the purchase commitment, the nature of the loss and the valuation account that records it when the price falls would be clearly seen. The obligation to pay has been unaffected by the price decrease—the full amount must be paid if the assets are delivered. However, the future economic benefit and value of the right to receive the assets has decreased because the market value of the assets to be received has declined, and the estimated loss on purchase commitment is in concept a reduction of that asset.

176. As long as the commitment transaction remains unrecorded, however, the only way to recognize the loss on the commitment is to do as is done in current practice—to recognize the valuation account for estimated loss on purchase commitments and include it among the assets or liabilities. Although it can be deducted from assets in some way, even though the asset to which it applies is not recorded, it is sometimes shown among the liabilities. Paragraph 42, footnote 18, specifically notes that the Board does not intend to foreclose that latter possibility by issuing

this Statement.

Other Losses Incurred

177. The Board also does not wish to foreclose similar accounting for certain other items. Some events and circumstances that are largely beyond the control of an enterprise or its management may reduce or make unavailable to the enterprise future economic benefits of its existing assets in ways that virtually force the enterprise to pay cash or otherwise transfer or use assets in the future to restore the future economic benefit that has been diminished or lost. For example, a storm may destroy a bridge that provides the only access to a plant but is owned by another entity that has granted an easement and has no incentive to rebuild the bridge; grain stored in an elevator may spoil leaving the elevator unusable until it is cleaned out; a flood may deposit mud or other debris on the floor of a warehouse; a tornado may leave the customers' parking lot covered with rubble, wrecked automobiles, and trees; a snowfall may bury railroad tracks, access roads, or parking lots. Each of those examples involves a situation in which an asset that is essentially undamaged itself cannot provide services to the owning enterprise until the enterprise spends cash or uses other assets to rebuild the bridge, clean out the warehouse or elevator, or clean off the tracks, access roads, or parking lots. The cost of restoring the future economic benefits lost or diminished may sometimes exceed the carrying amount of the affected asset.

178. It is always conceptually sound accounting to reduce the assets affected for the losses that have been incurred from events and circumstances such as those described in the preceding paragraph. However, if an event or circumstance has occurred causing a loss of the kinds described, and a future sacrifice of assets to restore future economic benefit lost is probable, it may be necessary as a practical matter to recognize the loss by recognizing an amount akin to the estimated loss on purchase commitments described earlier. The amount recognized might be the expected cash outlays or other future sacrifice needed to restore the diminished or lost economic benefits.

Minority Interests and Stock Purchase Warrants

179. Minority interests in net assets of consolidated subsidiaries do not represent present obligations of the enterprise to pay cash or distribute other assets to minority stockholders. Rather, those stockholders have ownership or residual interests in components of a consolidated enterprise. The definitions in this Statement do not, of course, preclude showing minority interests separately from majority interests or preclude emphasizing the interests of majority stockholders for whom consolidated statements are primarily provided. Stock purchase warrants are also sometimes called liabilities but entirely lack the characteristics of liabilities. They also are part of equity.

Examples Do Not Govern Practice

180. The Board reiterates that the examples in paragraphs 156-179 are intended to illustrate the definitions and related concepts, not to establish standards for accounting practice (paragraph

154). The examples are intended to help readers understand the essential characteristics of the definitions and related concepts and thereby to help them understand the definitions in this Statement.

Summary Index of Concepts Defined or Discussed

In addition to defining ten elements of financial statements, this Statement defines or discusses other concepts, terms, or phrases that are used in the definitions or explanations or are otherwise related to the elements defined. This index identifies the paragraphs in which the ten elements and certain other significant concepts, terms, or phrases are defined or discussed.

Footnotes

CON3, Footnote *--Pronouncements such as APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises,* and the Accounting Terminology Bulletins will continue to serve their intended purpose--they describe objectives and concepts underlying standards and practices existing at the time of their issuance.

CON3, Footnote **--Rule 203 prohibits a member of the American Institute of Certified Public Accountants from expressing an opinion that financial statements conform with generally accepted accounting principles if those statements contain a material departure from an accounting principle promulgated by the Financial Accounting Standards Board, unless the member can demonstrate that because of unusual circumstances the financial statements otherwise would have been misleading. Rule 204 requires members of the Institute to justify departures from standards promulgated by the Financial Accounting Standards Board for the disclosure of financial information outside of financial statements in published financial reports.

CON3, Footnote 1--*Comprehensive income* is the name used in this Statement for the concept that was called *earnings* in the FASB Exposure Draft, *Objectives of Financial Reporting and Elements of Financial Statements of Business Enterprises* (December 1977), FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, and other conceptual framework documents previously issued *(Tentative Conclusions on Objectives of Financial Statements of Business Enterprises* [December 1976]; FASB Discussion Memorandum, *Elements of Financial Statements and Their Measurement* [December 1976]; and FASB Discussion Memorandum, *Reporting Earnings* [July 1979]). *Earnings* is not defined in this Statement. The Board has decided to reserve the term for possible use to designate a component part, as yet undetermined, of comprehensive income (par. 58).

CON3, Footnote 2--Some respondents to the Exposure Draft interpreted the discussion of other possible elements to mean that financial statements now called balance sheets and income statements might have elements other than those defined. However, the other elements referred to pertain to other possible financial statements. Although this Statement contains no conclusions about the identity, number, or form of financial statements, it defines all elements for balance sheets and income statements in their present forms except perhaps *earnings* (par. 1, footnote 1).

CON3, Footnote 3--The FASB Exposure Draft, *Objectives of Financial Reporting and Elements of Financial Statements of Business Enterprises* (December 29, 1977), attempted to distinguish the representations from what they represent by giving them different names. For example, *assets* referred only to the financial representations in financial statements, and *economic resources* referred to the real-world things that assets represented in financial statements. That aspect of the Exposure Draft caused considerable confusion and was criticized by respondents. The revised Exposure Draft, *Elements of Financial Statements of Business Enterprises*, reverted to the more common practice of using the same names for both, and this Statement adopts the same usage.

CON3, Footnote 4--Decision usefulness of information provided about those relevant economic things and events depends not only on their relevance but also on the reliability (especially representational faithfulness) of the financial representations called assets, liabilities, revenues, expenses, etc., in financial statements. Representational faithfulness depends not only on the way the definitions are applied but also on recognition and measurement decisions that are beyond the scope of this Statement (pars. 16 and 17).

CON3, Footnote 5--*Profit* is used in this and the following paragraphs in a broad descriptive sense to refer to an enterprise's successful performance during a period. It is not intended to have a technical accounting meaning or to imply resolution of classification and display matters that are beyond the scope of this Statement, and no specific relation between *profit* and either *comprehensive income* or *earnings* (par. 1, footnote 1) is implied. *Loss* as in *profit or loss* (in contrast to *gain or loss*) is also used in a broad descriptive sense to refer to negative profit or unsuccessful performance and is not intended to have a technical accounting meaning.

CON3, Footnote 6--The two classes can also be distinguished as financial position and changes in financial position, without meaning to imply or describe particular financial statements. Used broadly, financial position refers to state or status of assets or claims to assets at moments in time, and changes in financial position refers to flows or changes in assets or claims to assets over time. In that sense, for example, both income statements and statements of sources and applications of funds (now commonly called statements of changes in financial position) show changes in financial position in present practice. Other statements, such as statements of retained earnings or analyses of property, plant, and equipment, may show aspects of both financial position at the beginning and end of a period and changes in financial position during a period. For business enterprises, at least, the other possible elements of financial statements referred to in paragraphs 3 and 4 also fall into this second class. That is, they are changes in financial position, describing effects of transactions and other events and circumstances that affect assets, liabilities, or equity during a period, for example, acquisitions and dispositions of assets, borrowings, and repayments of borrowings.

CON3, Footnote 7--The two relations described in this paragraph are commonly expressed as (a) balance at beginning of period ± changes during period = balance at end of period and (b) assets = liabilities + equity. "Double entry," the mechanism by which accrual accounting formally includes particular items that qualify under the elements definitions in articulated financial statements, incorporates those relations.

CON3, Footnote 8--Decisions about recognizing, measuring, and displaying elements of financial statements depend significantly on evaluations such as what information is most relevant for investment, credit, and similar decisions and whether the information is reliable enough to be trusted. Other significant evaluations of the information involve its comparability with information about other periods or other enterprises, its materiality, and whether the benefits from providing it exceed the costs of providing it. Those matters are discussed in Concepts Statement 2.

CON3, Footnote 9--*Probable* is used with its usual general meaning, rather than in a specific technical sense (such as that in FASB Statement No. 5, *Accounting for Contingencies*, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved (*Webster's New World Dictionary of the American Language*, 2d college ed. [New York and Cleveland: World Publishing Company, 1972], p. 1132). Its inclusion in the definition is intended to acknowledge that business and economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 37-40), not to describe a criterion for recognizing assets in financial statements, which is beyond the scope of this Statement.

CON3, Footnote 10--*Cost* is the sacrifice incurred in economic activities--that which is given up or forgone to consume, to save, to exchange, to produce, etc. For example, the value of cash or other resources given up (or the present value of an obligation incurred) in exchange for a resource measures the cost of the resource acquired. Similarly, the expiration of future benefits caused by using a resource in production is the cost of using it.

CON3, Footnote 11--Money's command over resources, or purchasing power, declines during periods of inflation and increases during periods of deflation (increases and decreases, respectively, in the level of prices in general). Since matters of measurement and unit of measure are beyond the scope of this Statement, it recognizes but does not emphasize that characteristic of money.

CON3, Footnote 12--Although this kind of distinction must be clearly drawn in concept because it is often essential to clear thinking, to maintain it in practice may not always be possible because of practical considerations relating to recognition and measurement stemming ultimately from the effects of uncertainty (pars. 16, 17, 41, 42, and 107-108).

CON3, Footnote 13--*Probable* is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in Statement 5, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved (*Webster's New World Dictionary*, 2d college ed., p. 1132). Its inclusion in the definition is intended to acknowledge that business and economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 37-40), not to describe a criterion for recognizing liabilities in financial statements, which is beyond the scope of this Statement.

CON3, Footnote 14--*Obligations* in the definition is broader than *legal obligations*. It is used with its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility, etc. (*Webster's New World Dictionary*, 2d college ed., p. 981). It includes equitable and constructive obligations as well as legal obligations (pars. 30-33).

CON3, Footnote 15--A common feature of liabilities is interest--the time value of money or the price of delay.

CON3, Footnote 16--The meaning of *probable* in these paragraphs is described in par. 19, footnote 9, and par. 28, footnote 13.

CON3, Footnote 17--The Board's projects on accounting recognition criteria (par. 63, footnote 30) and qualitative characteristics (par. 17, footnote 8) bear directly on the matter discussed in pars. 37-42.

CON3, Footnote 18--Since the description in paragraphs 41 and 42 involves recognition matters that are beyond the scope of this Statement, it is not intended to imply that the kinds of items described should necessarily be recognized. It notes an existing practical problem stemming from uncertainty, however, and is intended to make clear that the possibility of recognition is not precluded. Appendix B includes a brief discussion of the matter, including examples (pars. 174-178).

CON3, Footnote 19--This Statement defines equity only as a whole, although the discussion of equity of business enterprises in this Statement notes that different owners of an enterprise may have different kinds of ownership rights and that equity has various sources. In financial statements of business enterprises, 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 Statement.

CON3, Footnote 20--Other entities with proprietary or ownership interests in a business enterprise are commonly known by specialized names, such as stockholders, partners, and proprietors, and by more general names, such as investors, but all are also covered by the descriptive term *owners*. Equity of business enterprises is thus commonly known by several names, such as owners' equity, stockholders' equity, ownership, equity capital, partners' capital, and proprietorship. Some enterprises, (for example, mutual organizations) do not have stockholders, partners, or proprietors in the usual sense of those terms but do have participants whose interests are essentially ownership interests, residual interests, or both.

CON3, Footnote 21--Distinctions between liabilities and equity generally depend on the nature of the claim rather than on the identity of the claimant. The same entities 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 enterprise, or an owner of an enterprise may become also its creditor by lending to it or by receiving rights to unpaid cash dividends that it declares. 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, not part of equity. Exceptions involve situations in which doubts exist that the transactions are "at arm's length." In some circumstances, for example, a loan to an enterprise by a controlling stockholder may be considered to be in substance an investment by owners and thus may not qualify as a liability.

CON3, Footnote 22--A controlling interest or an interest that confers an ability to exercise significant influence over the operations of an enterprise may have more potential than other ownership interests to control or affect assets of the enterprise or distributions of assets to owners. Procedures such as consolidated financial statements and the equity method of accounting for intercorporate investments have been developed to account for the rights and relations involved.

CON3, Footnote 23--The diagram reflects the concept that value added by productive activities increases assets as production takes place, which is the basis for the common observation that revenues are *earned* by the entire process of acquiring goods and services, using them to produce other goods or services, selling the output, and collecting the sales price or fee. However, that value added is commonly *recognized* after production is complete, usually when product is delivered or sold but sometimes when cash is received or product is completed. Under those bases of recognition, certain internal transfers are viewed as falling into class A rather than class B. For example, using a sale basis of revenue recognition, internal transfers such as from raw materials on hand to product in process of production or from product in process to completed product fall into class A1 rather than class B1. The diagram does not, of course, settle recognition issues.

CON3, Footnote 24--Investments by owners are sometimes called capital contributions. Distributions to owners are sometimes called capital distributions; distributions of earnings, profits, or income; or dividends.

CON3, Footnote 25--Examples of the kinds of items that *might* be included in *comprehensive income* but not in *earnings*, when it is defined, include prior period adjustments and cumulative effects of changes in accounting principles. (The latter and many of the former are included in *net income* in present practice.)

CON3, Footnote 26--FASB Statement No. 33, *Financial Reporting and Changing Prices* (September 1979), par. 104. Capital maintenance concepts are the subject of Chapter 6 of the FASB Discussion Memorandum, *Elements of Financial Statements and Their Measurement* (December 2, 1976).

CON3, Footnote 27--"'Attributes to be measured' refers to the traits or aspects of an element to be quantified or measured, such as historical cost/historical proceeds, current cost/current proceeds, etc. Attribute is a narrower concept than measurement, which includes not only identifying the attribute to be measured but also selecting a scale of measurement (for example, units of money or units of constant purchasing power). 'Property' is commonly used in sciences to describe the trait or aspect of an object being measured, such as the length of a table or the weight of a stone. But 'property' may be confused with land and buildings in financial reporting contexts, and 'attribute' has become common in accounting literature and is used in this Statement" (Concepts Statement 1, par. 2, footnote 2).

CON3, Footnote 28--An enterprise increases the values of goods or services it holds or acquires by adding time, place, or form utility. Thus, *productive efforts* and *producing and distributing activities* include not only manufacturing and other conversion processes but also other productive activities such as storing, transporting, lending, insuring, and providing professional services that might be overlooked if *producing* were narrowly equated with *manufacturing.*

CON3, Footnote 29--Comprehensive income is a broad concept, broad enough to include changes in net assets from price changes, casualties, and other sources in the environment as well as changes from sales of product or amortization of costs. Being broad, (a) it is neutral regarding measurement matters not yet considered in the Board's conceptual framework and (b) it includes those kinds of changes in present practice (accounting for construction contracts by a percentage-of-completion method, accounting for marketable securities at market values, accounting for inventories and marketable securities at the lower of cost and market, accounting for other impairments of assets, and accounting for flood and fire losses, for example). This Statement contains no conclusions about which attributes (for example, historical costs or "current values") of elements of financial statements should be measured or which unit of measure should be used and is intended to imply none.

CON3, Footnote 30--Timing of recognition of revenues--including existing recognition procedures, which usually recognize revenues when goods are delivered or services are performed but may sometimes recognize them when cash is received, when production is completed, or as production progresses--is major subject matter for the Board's conceptual framework project on accounting recognition criteria. This Statement contains no conclusions about recognition of revenues or of any other elements.

CON3, Footnote 31--In concept, revenues increase assets rather than decrease liabilities, but a convenient shortcut is often to record directly reduction of liabilities. Production is essentially an asset conversion process to create future economic benefit (par. 60, footnote 28, and, par. 51, footnote 23). It adds utility and value to assets and is the primary source of revenue, which may be recognized (as noted in the preceding footnote) when product is delivered, when cash is received, or when production is completed rather than as production takes place. Production does not directly incur or settle liabilities but is often closely related to exchange transactions in which liabilities are incurred or settled. Business enterprises acquire assets (economic benefits), not expenses or losses, to carry out their production operations, and most expenses are at least momentarily assets. Since many goods and services acquired are used either simultaneously with acquisition or soon thereafter, it is common practice to record them as expenses at acquisition. However, to record an expense as resulting from incurring a liability is a useful shortcut that combines two conceptually separate events: (a) an exchange transaction in which an asset was acquired and (b) an internal event (production) in which an asset was used up. The assets produced by operations may be used to settle liabilities (for example, by delivering product that has been paid for in advance). However, again, to record a liability as being directly reduced by recording revenue is a useful shortcut that combines two conceptually separate events: (a) an internal event (production) that resulted in an asset and revenue and (b) an exchange transaction in which the asset was transferred to another entity to satisfy a liability. In the diagram in par. 50, the exchange transactions are in class A, while the internal events (production) that result in revenues or expenses are in class B1.

CON3, Footnote 32--If manufactured products are accounted for at accumulated costs until sold, as is common in present practice, production costs are recognized as expenses in the periods in which product is sold rather than in periods in which assets are used to produce output. For example, use of raw materials and depreciation of factory machinery are included in the cost of product and are recognized as expenses as part of the cost of goods sold. In contrast, if products are accounted for at net realizable value using a percentage-of-completion method, as output under construction contracts often is, production costs such as raw materials used and depreciation of construction equipment are recognized as expenses in the periods in which the assets are used to produce output.

CON3, Footnote 33--In concept, most expenses decrease assets rather than increase liabilities. They involve using (sacrificing) goods or services, not acquiring them. However, acquisition and use of many goods or services may occur simultaneously or during the same period, and a convenient shortcut is often to record directly increases of liabilities (par. 64, footnote 31). Taxes and other expenses resulting from nonreciprocal transfers, as several comment letters noted, commonly do result directly from incurring liabilities.

CON3, Footnote 34--Some have held that an imputed cost of (imputed interest on) equity capital should be accounted for the same as interest on borrowed funds. Thus, it might be included in the cost of certain assets and would be deducted, either directly as interest expense or indirectly as perhaps depreciation or cost of goods sold, in measuring operating income or income from continuing operations. The matter involves the so-called entity theory vs. proprietary theory, specifically whether an intermediate component of comprehensive income (which is a return on equity) should be designated as *income (or earnings) of the enterprise*, a question that the Board has not considered. The measurement and display issues raised by that kind of proposal are, of course, beyond the scope of this Statement, and this Statement contains no conclusions on the procedure suggested, but the definitions in this Statement are not intended to foreclose it.

CON3, Footnote 35--The terms *gains and losses* and *gains or losses* in this Statement include the possibility of *other appropriately descriptive terms* for reasons given in par. 58.

CON3, Footnote 36--In contrast, APB Statement 4, *Basic Concepts and Accounting Principles*

Underlying Financial Statements of Business Enterprises (October 1970), par. 62, distinguishes external and internal events as follows: external events are "events that affect the enterprise in which other entities participate," while internal events are "events in which only the enterprise participates." In that classification, so-called acts of God, such as floods and earthquakes, which are external events in this Statement, are internal events.

CON3, Footnote 37--APB Statement 4, par. 62, and APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, beginning with par. 5.

CON3, Footnote 38--The expressions *accrued depreciation* or *to accrue depreciation* are sometimes used, but depreciation in present practice is technically the result of allocation or amortization, which are deferral, not accrual, techniques. Conversely, the expressions *unamortized debt discount or premium* and *to amortize debt discount or premium* are sometimes used, but accounting for debt securities issued (or acquired as an investment) at a discount or premium by the "interest" method is technically the result of accrual, not deferral or amortization, techniques (pars. 159-162 of this Statement). The "interest" method is described in APB Opinion No. 12, *Omnibus Opinion--1967*, pars. 16 and 17, and APB Opinion No. 21, *Interest on Receivables and Payables*, pars. 15 and 16.

CON3, Footnote 39--APB Statement 4 (pars. 154-161) describes "three pervasive expense recognition principles": associating cause and effect, systematic and rational allocation, and immediate recognition. Paragraphs 86-89 of this Statement describe generally the same three bases for recognizing expenses but not in the same order.

CON3, Appendix B, Footnote 40--Paragraph 170 notes an aspect of the cost of some "dry holes" in different circumstances.

CON3, Appendix B, Footnote 41--Absence of a market price or exchangeability of an asset may create measurement and recognition problems but it in no way negates future economic benefit that can be obtained by use as well as by exchange.

CON3, Appendix B, Footnote 42--Contracts and agreements and enforceability of agreements and statutes are necessary parts of the environment in which business and economic activities and financial reporting take place. Business and economic activities in the United States depend on flows of money and credit, and the fact that the participants largely keep their promises to pay money or provide goods or services is a necessary stabilizing factor. But, the definitions in this Statement are not legal definitions and do not necessarily agree with legal definitions of the same or related terms (which have a propensity to have diverse meanings, often depending on the context or the branch of law that is involved). Nor is existence of a legally enforceable obligation inevitably required for an enterprise to have a liability (pars. 30-33).

CON3, Appendix B, Footnote 43--An FASB Discussion Memorandum, *Reporting Earnings,* was issued July 31, 1979. *Earnings* in the title of the Discussion Memorandum has the same meaning as *comprehensive income* in this Statement (par. 1, footnote 1).

CON3, Appendix B, Footnote 44--Deferred tax charges are not discussed separately in this Statement. However, they are assets--prepaid taxes--in the liability method and reductions of related liabilities in the net-of-tax method.

CON3, Appendix B, Footnote 45--Some proponents of the deferred method hold that it is actually a variation of the net-of-tax method despite rejection of that method in Opinion 11. They view the deferred tax charges and credits as the separate display of the effects of interperiod tax allocation instead of as reductions of the related assets, liabilities, revenues, expenses, gains, and losses. They argue that separate display is necessary or desirable, but it is a matter of "geography" in financial statements rather than a matter of the nature of deferred income tax credits.

CON3, Appendix B, Footnote 46--The definitions in this Statement do not bear on the question of whether an investment tax credit should be accounted for by the "deferral and amortization" method (which is described in this paragraph) or the "flow-through" method (which the Board also accepted in Opinion 4 (amending Opinion 2]). That issue involves whether the tax credit reduces the cost of the asset and depreciation over its life or reduces income tax expense in the period of acquisition, which is a recognition or measurement question. The existence of an asset from whose cost the credit may be deducted is not in doubt.

CON3, Appendix B, Footnote 47--"The cost of a development well [in contrast to that of an exploratory well] is a part of the cost of a bigger asset--a producing system of wells and related equipment and facilities intended to extract, treat, gather, and store known reserves" (FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, par. 205). The "full-costing" method incorporates the same notion--costs of dry holes are not themselves assets but are costs of mineral deposits.

CON3, Appendix B, Footnote 48--Whether those rights and obligations might be accounted for as assets and liabilities is a subject for the Board's project on accounting recognition criteria. Although the definitions in this Statement do not exclude the possibility of recording assets and liabilities for purchase commitments, the Statement contains no conclusion or implications about whether they should be recorded.