

Statement of Financial Accounting Concepts No. 6

[CON6 Status Page](#)

Elements of Financial Statements

a replacement of FASB Concepts Statement No. 3
(incorporating an amendment of FASB Concepts
Statement No. 2)

December 1985



Financial Accounting Standards Board

of the Financial Accounting Foundation

401 MERRITT 7, P.O. BOX 5116, NORWALK, CONNECTICUT 06856-5116

Copyright © 1985 by Financial Accounting Standards Board. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the Financial Accounting Standards Board.

Statement of Financial Accounting Concepts No. 6

Elements of Financial Statements

December 1985

CONTENTS

	Paragraph Numbers
Highlights	
Introduction.....	1–23
Scope and Content of Statement.....	1–8
Other Possible Elements of Financial Statements	3–4
Elements and Financial Representations	5–7
Other Scope and Content Matters.....	8
Objectives, Qualitative Characteristics, and Elements	9–19
Interrelation of Elements—Articulation	20–21
Definition, Recognition, Measurement, and Display	22–23
Definitions of Elements	24–133
Assets	25–34
Characteristics of Assets.....	26–31
Transactions and Events That Change Assets	32–33
Valuation Accounts.....	34
Liabilities	35–43
Characteristics of Liabilities	36–40
Transactions and Events That Change Liabilities.....	41–42
Valuation Accounts.....	43
Effects of Uncertainty	44–48
Equity or Net Assets	49–59
Equity of Business Enterprises and Net Assets of Not-for-Profit Organizations	50–53
Equity and Liabilities.....	54–59
Equity of Business Enterprises	60–65
Characteristics of Equity of Business Enterprises	60–63
Transactions and Events That Change Equity of Business Enterprises.....	64–65
Investments by and Distributions to Owners.....	66–69
Characteristics of Investments by and Distributions to Owners.....	68–69
Comprehensive Income of Business Enterprises.....	70–77
Concepts of Capital Maintenance	71–72
Characteristics, Sources, and Components of Comprehensive Income.....	73–77
Revenues	78–79
Characteristics of Revenues	79

	Paragraph Numbers
Expenses	80–81
Characteristics of Expenses	81
Gains and Losses	82–89
Characteristics of Gains and Losses	84–86
Revenues, Expenses, Gains, and Losses	87–89
Net Assets of Not-for-Profit Organizations	90–106
Characteristics of Net Assets of Not-for-Profit Organizations	90–91
Classes of Net Assets	92–102
Donor-Imposed Restrictions	95–97
Temporary and Permanent Restrictions	98–100
Restrictions Affect Net Assets Rather Than Particular Assets	101–102
Maintenance of Net Assets	103–106
Transactions and Events That Change	
Net Assets of Not-for-Profit Organizations	107–116
Revenues, Expenses, Gains, and Losses	111–113
Reclassifications	114–116
Changes in Classes of Net Assets of Not-for-Profit Organizations	117–133
Change in Permanently Restricted Net Assets	119–122
Characteristics of Change in Permanently Restricted Net Assets	120–122
Change in Temporarily Restricted Net Assets	123–126
Characteristics of Change in Temporarily Restricted Net Assets	124–126
Change in Unrestricted Net Assets	127–133
Characteristics of Change in Unrestricted Net Assets	128–133
Accrual Accounting and Related Concepts	134–152
Transactions, Events, and Circumstances	135–138
Accrual Accounting	139–140
Accrual and Deferral (Including Allocation and Amortization)	141–142
Realization and Recognition	143
Recognition, Matching, and Allocation	144–152
Appendix A: Background Information	153–163
Appendix B: Characteristics of Assets, Liabilities, and Equity or	
Net Assets and of Changes in Them	164–255
Purpose and Summary of Appendix	164–170
Characteristics of Assets	171–191
Future Economic Benefits	172–182
Assets and Costs	178–182
Control by a Particular Entity	183–189
Control and Legal Rights	186–187
Noncontrolled Benefits	188–189
Occurrence of a Past Transaction or Event	190–191
Characteristics of Liabilities	192–211
Required Future Sacrifice of Assets	193–198

	Paragraph Numbers
Liabilities and Proceeds	198
Obligation of a Particular Entity	199–205
Occurrence of a Past Transaction or Event.....	206–211
Characteristics of Equity of Business Enterprises	212–214
Residual Interest	213
Invested and Earned Equity	214
Characteristics of Comprehensive Income of	
Business Enterprises and Its Components	215–220
Interest in Information about Sources of Comprehensive Income	219–220
Characteristics of Net Assets and Changes in the Classes of Net Assets of	
Not-for-Profit Organizations	221–228
Residual Interest	222
Interest in Information about Changes in Classes of Net Assets.....	223–228
Examples to Illustrate Concepts	229–255
Deferred Gross Profit on Installment Sales	232–234
Debt Discount, Premium, and Issue Cost	235–239
Deferred Income Tax Credits.....	240–242
Deferred Investment Tax Credits.....	243–245
Deferred Costs of Assets.....	246–250
Estimated Loss on Purchase Commitments.....	251–253
Minority Interests and Stock Purchase Warrants.....	254
Examples Do Not Govern Practice	255
Summary Index of Concepts Defined or Discussed	page 75
Amendment of FASB Concepts Statement No. 2,	
<i>Qualitative Characteristics of Accounting Information.....</i>	page 78

CON 6: Elements of Financial Statements

a replacement of FASB Concepts Statement No. 3
(incorporating an amendment of FASB Concepts Statement
No. 2)

CON 6 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 entity 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 replaces FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*, expanding its scope to encompass not-for-profit organizations as well.
- This Statement defines 10 interrelated elements that are directly related to measuring performance and status of an entity. (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 or net assets 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. In a not-for-profit organization, which has no ownership interest in the same sense as a

business enterprise, net assets is divided into three classes based on the presence or absence of donor-imposed restrictions—permanently restricted, temporarily restricted, and unrestricted net assets.

- Investments by owners are increases in equity of a particular business 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.
 - Distributions to owners are decreases in equity of a particular business 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.
 - Comprehensive income is the change in equity of a business enterprise 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) 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) 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 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 except those that result from expenses or distributions to owners.
- The Statement defines three classes of net assets of not-for-profit organizations and the changes in those classes during a period. Each class is composed of the revenues, expenses, gains, and losses that affect that class and of reclassifications from or to other classes.
 - Change in permanently restricted net assets during a period is the total of (a) contributions and other inflows during the period of assets whose use by the organization is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization, (b) other asset enhancements and diminishments during the period that are subject to the same kinds of

stipulations, and (c) reclassifications from (or to) other classes of net assets during the period as a consequence of donor-imposed stipulations.

— Change in temporarily restricted net assets during a period is the total of (a) contributions and other inflows during the period of assets whose use by the organization is limited by donor-imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of the organization pursuant to those stipulations, (b) other asset enhancements and diminishments during the period subject to the same kinds of stipulations, and (c) reclassifications to (or from) other classes of net assets during the period as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations.

— Change in unrestricted net assets during a period is the total change in net assets during the period less change in permanently restricted net assets and change in temporarily restricted net assets for the period. It is the change during the period in the part of net assets of a not-for-profit organization that is not limited by donor-imposed stipulations. Changes in unrestricted net assets include (a) revenues and gains that change unrestricted net assets, (b) expenses and losses that change unrestricted net assets, and (c) reclassifications from (or to) other classes of net assets as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations.

- The Statement also defines or describes certain other concepts that underlie or are otherwise closely related to the 10 elements and 3 classes defined in the Statement.
- Earnings is not defined in this Statement. FASB Concepts Statement 5 has now described earnings for a period as excluding certain cumulative accounting adjustments and other nonowner changes in equity that are included in comprehensive income for a period.
- 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 and classes, including some discussions and illustrations of how to apply the definitions.

- This Statement amends FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, to apply it to financial reporting by not-for-profit organizations.

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 (of 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*

INTRODUCTION

Scope and Content of Statement

1. This Statement defines 10 elements of financial statements: 7 elements of financial statements of both business enterprises and not-for-profit organizations—assets, liabilities, equity (business enterprises) or net assets (not-for-profit organizations), revenues, expenses, gains, and losses—and 3 elements of financial statements of business enterprises only—investments by owners, distributions to owners, and comprehensive income.¹ It also defines three classes of net assets of not-for-profit organizations and the changes in those classes during a period—change in permanently restricted net assets, change in temporarily restricted net assets, and change in unrestricted net assets. The Statement also defines or describes certain other concepts that underlie or are otherwise related to those elements and classes (See Summary Index).

2. This Statement replaces FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*, extending that Statement's definitions to not-for-profit organizations.² It confirms conclusions in paragraph 2 of Concepts Statement 3 that (a) assets and liabilities are common to all organizations and can be defined the same for business and not-for-profit organizations, (b) the definitions of equity (net assets), revenues, expenses, gains, and losses fit both business and not-for-profit organizations, and (c) not-for-profit organizations have no need for elements such as investments by owners, distributions to owners, and

comprehensive income. Thus, this Statement continues unchanged the elements defined in Concepts Statement 3, although it contains added explanations stemming from characteristics of not-for-profit organizations and their operations. It also defines three classes of net assets of not-for-profit organizations, distinguished by the presence or absence of donor-imposed restrictions, and the changes in those classes during a period—change in permanently restricted, temporarily restricted, and unrestricted net assets.

Other Possible Elements of Financial Statements

3. Although the elements defined in this Statement include basic elements and are probably those most commonly identified as elements of financial statements, 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 entity. Information about an entity'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, and FASB Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, paragraphs 38-53). Other statements or focuses may require other elements.³

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) borrowing, (c) issuing equity securities, (d) sale of assets, and so forth. Other projects 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.⁴

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 entity'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 entity's financial statements.⁵

Other Scope and Content Matters

8. Appendix A of this Statement contains background information. Appendix B contains explanations and examples pertaining to the characteristics of elements of financial statements of business enterprises and not-for-profit organizations.

Objectives, Qualitative Characteristics, and Elements

9. The focus of the FASB concepts Statements that underlie this one is usefulness of financial reporting information in making economic decisions—reasoned choices among alternative uses of scarce resources. Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, emphasizes usefulness to present and potential investors, creditors, and others in making rational investment, credit, and similar decisions. Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, emphasizes usefulness to present and potential resource providers and others in making rational decisions about allocating resources to not-for-profit organizations.⁶ Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, emphasizes that 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 other resource-allocation decisions and thus are relevant to financial reporting.⁷ Those decisions involve committing (or continuing to commit) resources to an entity. The elements defined are an entity's resources, the claims to or interests in those resources, and the changes therein from transactions and other events and circumstances involved in its use of resources to produce and distribute goods or services and, if it is a business enterprise, to earn a profit. Relevance of information about items that meet those definitions stems from the significance of an entity's resources and changes in resources (including those affecting profitability).

11. Economic resources or assets and changes in them are central to the existence and operations of an individual entity. Both business enterprises and not-for-profit organizations are in essence resource or assets processors, and a resource's capacity to be exchanged for cash or

other resources or to be combined with other resources to produce needed or desired scarce goods or services gives it utility and value (future economic benefit) to an entity.

12. Business enterprises and not-for-profit organizations obtain the resources they need from various sources. Business enterprises and some not-for-profit organizations sell the goods and services they produce for cash or claims to cash. Both buy goods and services for cash or by incurring liabilities to pay cash. Business enterprises receive resources from investments in the enterprise by owners, while not-for-profit organizations commonly receive significant amounts of resources from contributors who do not expect to receive either repayment or economic benefits proportionate to resources provided. Those contributions are the major source of resources for many not-for-profit organizations but are not significant for other not-for-profit organizations or for most business enterprises.⁸

13. A not-for-profit organization obtains and uses resources to provide certain types of goods or services to members of society, and the nature of those goods or services or the identity of the groups or individuals who receive them is often critical in donors' or other resource providers' decisions to contribute or otherwise provide cash or other assets to a particular organization. Many donors provide resources to support certain types of services or for the benefit of certain groups and may stipulate how or when (or both) an organization may use the cash or other resources they contribute to it. Those donor-imposed restrictions on a not-for-profit organization's use of assets may be either permanent or temporary.

14. Resources or assets are the lifeblood of a not-for-profit organization, and an organization cannot long continue to achieve its operating objectives unless it can obtain at least enough resources to provide goods or services at levels and of a quality that are satisfactory to resource providers. Organizations that do not provide adequate goods or services often find it increasingly difficult to obtain the resources they need to continue operations.

15. Economic resources or assets are also the lifeblood of a business 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 members of society and obtains cash and other assets with which it compensates those who provide it with resources, including its owners.

16. Although the relation between profit of an enterprise ⁹ 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.

17. 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.

18. In contrast to business enterprises, not-for-profit organizations do not have defined ownership interests that can be sold, transferred, or redeemed, or that convey entitlement to a share of a residual distribution of resources in the event of liquidation of the organization. A not-for-profit organization is required to use its resources to provide goods and services to its constituents and beneficiaries as specified in its articles of incorporation (or comparable document for an unincorporated association) or by-laws and generally is prohibited from distributing assets as dividends to its members, directors, officers, or others.¹⁰ Thus, not-for-profit organizations have operating purposes that are other than to provide goods or services at a profit or profit equivalent, and resource providers do not focus primarily on profit as an indicator of a not-for-profit organization's performance.¹¹

19. Instead, providers of resources to a not-for-profit organization are interested in the services the organization provides and its ability to continue to provide them. Since profit indicators are not the focus of their resource-allocation decisions, resource providers need other information that is useful in assessing an organization's performance during a period and in assessing how its managers have discharged their stewardship responsibilities, not only for the custody and safekeeping of the organization's resources, but also for their efficient and effective use—that is, information about the amounts and kinds of inflows and outflows of resources during a period and the relations between them and information about service efforts and, to the extent possible, service accomplishments.¹²

Interrelation of Elements—Articulation

20. Elements of financial statements are of two different types, which are sometimes explained as being analogous to photographs and motion pictures. The elements defined in this Statement include three of one type and seven of the other. (Three of the latter apply only to business enterprises.) Assets, liabilities, and equity (net assets) describe levels or amounts of resources or claims to or interests in resources at a moment in time. All other elements describe effects of transactions and other events and circumstances that affect an entity during intervals of time (periods). In a business enterprise, the second type includes comprehensive income and its components—revenues, expenses, gains, and losses—and investments by owners and

distributions to owners. In a not-for-profit organization, it includes revenues, expenses, gains, and losses.¹³

21. The two types of elements are related in such a way that (a) assets, liabilities, and equity (net assets) are changed by elements of the other type 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 (net assets). 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 type depend on statements that show elements of the first type and vice versa.¹⁴

Definition, Recognition, Measurement, and Display

22. 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.¹⁵

23. 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.¹⁶ 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 44-48).

DEFINITIONS OF ELEMENTS

24. All elements are defined in relation to a particular entity, which may be a business enterprise, an educational or charitable organization, a natural person, or the like. An item that qualifies under the definitions is a particular entity's asset, liability, revenue, expense, or so forth. 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, business enterprises, not-for-profit organizations, and the like. For example, employees, suppliers, customers or beneficiaries, lenders, stockholders, donors, and governments are all "other entities" to a particular entity. 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.¹⁷

Assets

25. Assets are probable ¹⁸ future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

Characteristics of Assets

26. 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 entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity'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 ¹⁹ 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 entity in producing or distributing other goods or services. Similarly, although the ability of an entity 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 the entity has the ability to obtain and control the benefit in other ways.

27. The kinds of items that qualify as assets under the definition in paragraph 25 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.

28. The common characteristic possessed by all assets (economic resources) is "service potential" or "future economic benefit," the scarce 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. In a not-for-profit organization, that service potential or future economic benefit is used to provide desired or needed goods or services to beneficiaries or other constituents, which may or may not directly result in net cash inflows to the organization. Some not-for-profit organizations rely significantly on contributions or donations of cash to supplement selling prices or to replace cash or other assets used in providing goods or services. The relationship between service potential or future economic benefit of its assets and net cash inflows to an entity is often indirect in both business enterprises

and not-for-profit organizations.

29. 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.²⁰

30. Assets other than cash benefit an entity by being exchanged for cash or other goods or services, by being used to produce goods or services or otherwise increase the value of other assets, or by being used to settle liabilities. To carry out their operating purposes, both business enterprises and not-for-profit organizations commonly produce scarce goods or services that have the capacity to satisfy human wants or needs. Both create utility and value in essentially the same way—by using goods or services to produce other goods or services that their customers or constituents desire or need. Business enterprises expect customers to pay for the utility and value added, and they price their outputs accordingly. Many not-for-profit organizations also distribute some or all of their outputs of goods or services at prices that include the utility and value they have added. Other not-for-profit organizations commonly distribute the goods or services they produce to beneficiaries gratis or at nominal prices. Although that may make measuring the value of their outputs difficult, it does not deprive them of value.

31. Services provided by other entities, including personal services, cannot be stored and are received and used simultaneously. They can be assets of an entity only momentarily—as the entity receives and uses them—although their use may create or add value to other assets of the entity. Rights to receive services of other entities for specified or determinable future periods can be assets of particular entities.

Transactions and Events That Change Assets

32. Assets of an entity are changed both by its transactions and activities and by events that happen to it. An entity obtains cash and other assets from other entities and transfers cash and other assets to other entities. It adds value to noncash assets through operations by using, combining, and transforming goods and services to make other desired goods or services. Some transactions or other events decrease one asset and increase another. An entity'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 entity 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.

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

Valuation Accounts

34. 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.

Liabilities

35. Liabilities are probable ²¹ future sacrifices of economic benefits arising from present obligations ²² 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

36. 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 entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened. Liabilities commonly have other features that help identify them—for example, most liabilities require the obligated entity 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 entity to pay cash but to convey other assets, to provide or stand ready to provide services, or to use assets. And the identity of the recipient need not be known to the obligated entity 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 for other reasons the entity has the duty or responsibility to pay cash, to transfer other assets, or to provide services to another entity.

37. 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.²³

38. Entities 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 entity to repay the amount borrowed, usually with interest; acquiring assets on credit obligates an entity 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 entity to pay cash or to repair or replace those that prove defective; and accepting a cash deposit or prepayment obligates an entity 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.

39. Although most liabilities result from agreements between entities, some obligations are imposed on entities 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 an entity to one or more other entities. Thus, taxes, laws, regulations, and other governmental actions commonly require business enterprises (and sometimes not-for-profit organizations) 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 entity may also incur liabilities for donations pledged to educational or charitable organizations or for cash dividends declared but not paid.

40. 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 from 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, a business 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 entity may create a constructive obligation to employees for vacation pay or year-end bonuses by paying them every year even though it is not contractually bound to do so and has not announced a policy to do so. 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 entity 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 entity, 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

41. Liabilities of an entity 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 entity'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 entity and its management.

42. Once incurred, a liability continues as a liability of the entity until the entity settles it, or another event or circumstance discharges it or removes the entity's responsibility to settle it.

Valuation Accounts

43. 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

44. 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 entity at the time the definitions are applied. The presence or absence of future economic benefit that can be obtained and controlled by the entity or of the entity'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 entity 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 entity 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.

45. 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.

46. 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.²⁴ 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, and so forth, and estimates and approximations will often be required unless financial statements are to be restricted to reporting only cash transactions.

47. 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 22 and 23).²⁵

48. 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.

Equity or Net Assets

49. Equity or net assets is the residual interest in the assets of an entity that remains after deducting its liabilities.

Equity of Business Enterprises and Net Assets of Not-for-Profit Organizations

50. The equity or net assets ²⁶ of both a business enterprise and a not-for-profit organization is the difference between the entity's assets and its liabilities. It is a residual, affected by all events that increase or decrease total assets by different amounts than they increase or decrease total liabilities. Thus, equity or net assets of both a business enterprise and a not-for-profit organization is increased or decreased by the entity's operations and other events and circumstances affecting the entity.

51. A major distinguishing characteristic of the equity of a business enterprise is that it may be increased through investments of assets by owners who also may, from time to time, receive distributions of assets from the entity. Owners invest in a business enterprise with the expectation of obtaining a return on their investment as a result of the enterprise's providing goods or services to customers at a profit. Owners benefit if the enterprise is profitable but bear the risk that it may be unprofitable (paragraphs 11, 12, 15-17).

52. In contrast, a not-for-profit organization has no ownership interest or profit purpose in the same sense as a business enterprise and thus receives no investments of assets by owners and distributes no assets to owners. Rather, its net assets often is increased by receipts of assets from resource providers (contributors, donors, grantors, and the like) who do not expect to receive either repayment or economic benefits proportionate to the assets provided ²⁷ but who are nonetheless interested in how the organization makes use of those assets and often impose temporary or permanent restrictions on their use (paragraphs 11-13, 18, and 19).

53. Since the interests of investor-owners of business enterprises and the interests of donors to not-for-profit organizations differ, this Statement discusses separately (a) equity of business enterprises (paragraphs 60-63) and the transactions and events that change equity (paragraphs 64-89) and (b) net assets of not-for-profit organizations (paragraphs 90-106) and the transactions and events that change net assets (paragraphs 107-133).

Equity and Liabilities

54. An entity's assets, liabilities, and equity (net assets) all pertain to the same set of probable future economic benefits. Assets are probable future economic benefits owned or controlled by the entity. Its liabilities are claims to the entity's assets by other entities and, 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. In contrast, equity is a residual interest—what remains after liabilities are deducted from assets—and depends significantly on the profitability of a business enterprise or on fund-raising or other major or central operations of a not-for-profit organization. A not-for-profit organization may provide goods or services to resource providers who are also employees, members, or beneficiaries, but except upon dissolution or final liquidation of the organization, it cannot distribute assets to members or other resource providers as owners. A business enterprise may distribute assets resulting from income to its owners, but 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, regulation, or agreement. An enterprise is generally not obligated to transfer assets to owners except in the event of the enterprise's liquidation. An enterprise's liabilities and equity are mutually exclusive claims to or interests in the enterprise's assets by entities other than the enterprise, and liabilities take precedence over ownership interests.

55. 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.

56. Similarly, the line between net assets and liabilities of not-for-profit organizations may be obscured in practice because donors' restrictions that specify the use of contributed assets may seem to result in liabilities, although most do not. The essence of a not-for-profit organization is that it obtains and uses resources to provide specific types of goods or services, and the nature of those goods or services is often critical in donors' decisions to contribute cash or other assets to a particular organization. Most donors contribute assets (restricted as well as unrestricted) to an organization to increase its capacity to provide those goods or services, and receipt of donated assets not only increases the assets of the organization but also imposes a fiduciary responsibility on its management to use those assets effectively and efficiently in pursuit of those service objectives.

57. That responsibility pertains to all of the organization's assets and does not constitute an equitable or constructive obligation as described in paragraphs 36-40. In other words, a not-for-profit organizations' fiduciary responsibility to use assets to provide services to beneficiaries does not itself create a duty of the organization to pay cash, transfer other assets, or provide services to one or more creditors. Rather, an obligation to a creditor results when the organization buys supplies for a project, its employees work on it, and the like, and the organization therefore owes suppliers, employees, and others for goods and services they have provided to it.²⁸

58. A donor's restriction focuses that fiduciary responsibility on a stipulated use for specified contributed assets but does not change the basic nature of the organization's fiduciary responsibility to use its assets to provide services to beneficiaries. A donor's gift of cash to be spent for a stipulated purpose or of another asset to be used for a stipulated purpose—for example, a mansion to be used as a museum, a house to be used as a dormitory, or a sculpture to be displayed in a cemetery—imposes a responsibility to spend the cash or use the asset in accordance with the donor's instructions. In its effect on the liabilities of the organization, a donor's restriction is essentially the same as management's designating a specified use for certain assets. That is, the responsibility imposed by earmarking assets for specified uses is fundamentally different, both economically and legally, from the responsibility imposed by incurring a liability, which involves a creditor's claim. Consequently, most donor-imposed restrictions on an organization's use of contributed assets do not create obligations that qualify as

liabilities of the organization.

59. To determine whether liabilities or equity (net assets) result from issuing specific securities with both debt and equity characteristics or from specific donors' stipulations 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).

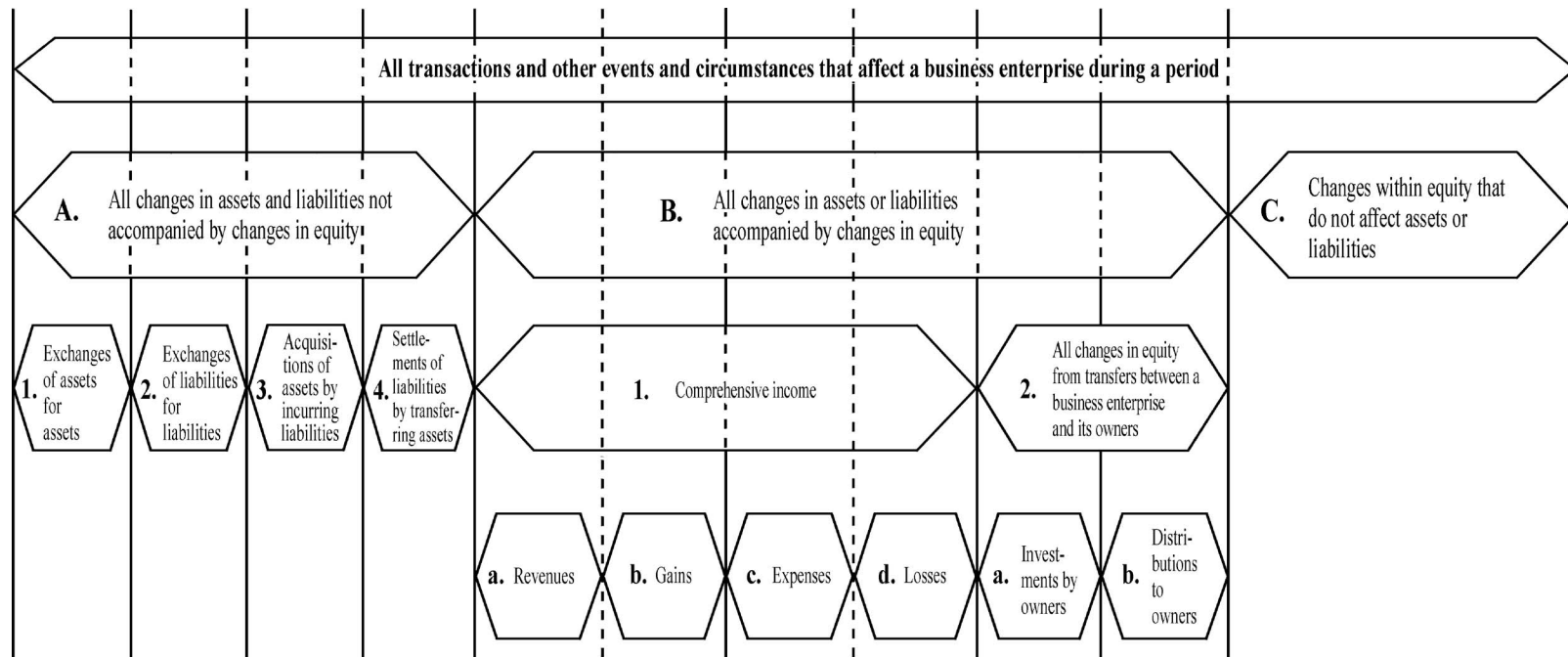
Equity of Business Enterprises

Characteristics of Equity of Business Enterprises

60. In a business enterprise, the equity is the ownership interest.²⁹ It stems from ownership rights (or the equivalent) ³⁰ and involves a relation between an enterprise and its owners as *owners* rather than as employees, suppliers, customers, lenders, or in some other nonowner role.³¹ Since equity 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 nonowner sources as well as investments by owners and distributions to owners.

61. Equity sets limits, often legal limits, on 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 16). 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.³² 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.

62. 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.

63. 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 70).

Transactions and Events That Change Equity of Business Enterprises

64. The following diagram shows the sources of changes in equity (class B) and distinguishes them from each other and from other transactions, events, and circumstances affecting an entity 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 has 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. In the diagram, dotted lines rather than solid boundary lines separate revenues and gains and separate expenses and losses because of display considerations that are beyond the scope of this Statement. Paragraphs 78-89 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. 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.

65. The full width of the diagram, represented by the two-pointed arrow labeled "All transactions and other events and circumstances that affect a business enterprise during a period," encompasses all potentially recordable events and circumstances affecting an entity. 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.)³³

- 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 entities. (Exchanges that affect equity belong in class B rather than class A.)
 - 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 borrowing, 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 70) whose components (broadly defined and discussed in paragraphs 78-89) are:
 - a. Revenues
 - b. Gains
 - c. Expenses
 - d. Losses
 - 2. All changes in equity from transfers between a business enterprise and its owners (defined in paragraphs 66 and 67):
 - 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 70-89 are those in class B1—comprehensive income—and its subclasses—revenues, expenses, gains, and losses.³⁴

Investments by and Distributions to Owners

66. Investments by owners are increases in equity of a particular business 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.

67. Distributions to owners are decreases in equity of a particular business 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.³⁵

Characteristics of Investments by and Distributions to Owners

68. 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 have. 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.

69. 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 creditors' claims; settlement of the liability by transfer of the assets is a transaction in class A4 in the diagram in paragraph 64 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 of Business Enterprises

70. Comprehensive income is the change in equity of a business enterprise 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

71. 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 would be recognized but called "capital maintenance adjustments" and would be included directly in equity and would not be included in return on capital. Under that concept, capital maintenance adjustments would be a separate element rather than gains and losses.

72. 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 70 is a return *on* financial capital.³⁶

Characteristics, Sources, and Components of Comprehensive Income

73. Over the life of a business enterprise, its comprehensive income equals the net of its cash receipts and cash outlays, excluding cash (and cash equivalent of noncash assets) invested by owners and distributed 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 measured³⁷ 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.

74. Comprehensive income of a business enterprise 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,³⁸ 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.

75. Comprehensive income is a broad concept. Although an enterprise's ongoing major or central operations are generally intended to be the primary source of comprehensive income, they are not the only source. Most entities occasionally engage in activities that are peripheral or incidental to their central activities. Moreover, all entities 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.

76. 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.

77. Comprehensive income comprises two related but distinguishable types of components. It consists of not only its basic components—revenues, expenses, gains, and losses—but also various intermediate components 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 in business enterprises are gross margin, income from continuing operations before taxes, income from continuing operations, and operating income. Those intermediate components 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.³⁹

Revenues

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

Characteristics of Revenues

79. Revenues represent actual or expected cash inflows (or the equivalent) that have occurred or will eventuate as a result of the entity's ongoing major or central operations. The assets

increased by revenues ⁴⁰ 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.⁴¹

Expenses

80. Expenses are outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, ⁴² rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

Characteristics of Expenses

81. Expenses represent actual or expected cash outflows (or the equivalent) that have occurred or will eventuate as a result of the entity's ongoing major or central operations. The assets that flow out or are used or the liabilities that are incurred ⁴³ may be of various kinds—for example, units of product delivered or produced, employees' services used, 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.

Gains and Losses

82. 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 except those that result from revenues or investments by owners.

83. 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 except those that result from expenses or distributions to owners.

Characteristics of Gains and Losses

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

85. 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 entity and other entities that are not its owners—for example, from gifts or donations,⁴⁴ 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.

86. Gains and losses may also be described or classified as "operating" or "nonoperating," depending on their relation to an entity'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

87. 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 entity'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.

88. 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 entity depend to a significant extent on the nature of the entity, its operations, and its other activities. Items that are revenues for one kind of entity may be gains for another, and items that are expenses for one kind of entity may be 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 for 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.

89. 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 64, 219-220, and 228).

Net Assets of Not-for-Profit Organizations

Characteristics of Net Assets of Not-for-Profit Organizations

90. In a not-for-profit organization, as in a business enterprise, net assets (equity) is a residual, the difference between the entity's assets and its liabilities but, in contrast to equity of a business enterprise, it is not an ownership interest. Distinguishing characteristics of a not-for-profit organization include absence of ownership interest(s) in the same sense as a business enterprise, operating purposes not centered on profit, and significant receipts of contributions, many involving donor-imposed restrictions (paragraphs 11-15, 18 and 19, and 49-53).

91. Net assets of not-for-profit organizations is divided into three mutually exclusive classes, permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets.⁴⁵

Classes of Net Assets

92. Permanently restricted net assets is the part of the net assets of a not-for-profit organization resulting (a) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization, (b) from other asset enhancements and diminishments subject to the same kinds of stipulations, and (c) from reclassifications from (or to) other classes of net assets as a consequence of donor-imposed stipulations.

93. Temporarily restricted net assets is the part of the net assets of a not-for-profit organization resulting (a) from contributions and other inflows of assets whose use by the organization is limited by donor-imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of the organization pursuant to those stipulations, (b) from other asset enhancements and diminishments subject to the same kinds of stipulations, and (c) from reclassifications to (or from) other classes of net assets as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations.

94. Unrestricted net assets is the part of net assets of a not-for-profit organization that is neither permanently restricted nor temporarily restricted by donor-imposed stipulations—that is,

the part of net assets resulting (a) from all revenues, expenses, gains, and losses that are not changes in permanently or temporarily restricted net assets and (b) from reclassifications from (or to) other classes of net assets as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations. The only limits on unrestricted net assets are broad limits resulting from the nature of the organization and the purposes specified in its articles of incorporation (or comparable document for an unincorporated association) or bylaws and perhaps limits resulting from contractual agreements—for example, loan covenants—entered into by the organization in the course of its operations.

Donor-Imposed Restrictions

95. The three classes of net assets reflect differences in, or absence of, donor-imposed restrictions on a not-for-profit organization's use of its assets. Thus, *restriction* and *restricted* in this Statement refer to limits placed on a not-for-profit organization's use of assets by donors' stipulations that are more specific than broad limits resulting from the nature of the organization and the purposes specified in its articles of incorporation (or comparable document for an unincorporated association) or bylaws. Restrictions generally do not create liabilities (paragraphs 56-58), but they do restrain the organization from using part of its resources for purposes other than those specified, for example, to settle liabilities, purchase goods, or provide services not within the scope of the restrictions.

96. Donors need not explicitly limit uses of contributed assets for a not-for-profit organization to classify the increase in net assets as restricted if circumstances surrounding those receipts make clear the donor's implicit stipulation of restricted use. For example, use of contributed assets is restricted despite absence of a donor's explicit stipulation about use if the assets are received in a fund-raising drive declared to be for a specific purpose, such as to add to the organization's endowment, to acquire a particular property, or to obtain resources for next year's operations.

97. Only donors' explicit, or clearly evident implicit, stipulations that limit a not-for-profit organization's use of its assets can result in permanently or temporarily restricted net assets (as this Statement uses those terms). Decisions, resolutions, appropriations, or the like by the directors, trustees, or managers of a not-for-profit organization may impose seemingly similar limits on the use of net assets that were not stipulated by donors. However, unless limits are imposed by donors' stipulations that place them beyond the organization's discretion to change, they differ substantively from donor-imposed limits that result in restricted net assets. For example, a voluntary resolution by the trustees of an organization to earmark a portion of its unrestricted net assets to function as an endowment is a revocable internal designation that does not give rise to restricted net assets.⁴⁶ Only in the relatively few instances in which self-imposed limits become legally irrevocable are they substantively equivalent to donor-imposed restrictions and the cause of restricted net assets.

Temporary and Permanent Restrictions

98. Contributions (or other enhancements) of assets with donor-imposed limits on their use increase assets and net assets of a not-for-profit organization in the period in which it receives them, but they do not increase unrestricted net assets, nor are they generally available for payment to creditors, as long as the restriction remains. Donor-imposed restrictions on use of assets may be either temporary or permanent.⁴⁷

99. Some donors stipulate that their contributions be used in a later period or after a specified date rather than be expended immediately; those are often called time restrictions. Other donors stipulate that their contributions be used for a specified purpose, such as sponsoring a particular program or service, acquiring a particular building, or settling a particular liability; those are often called purpose restrictions. Time and purpose restrictions have in common that they can be satisfied, either by passage of time or by actions of the organization, and that the contributed assets can be expended. Those restrictions are temporary. Once the stipulation is satisfied, the restriction is gone.

100. Still other donors stipulate that resources be maintained permanently—not used up, expended, or otherwise exhausted—but permit the organization to use up or expend the income (or other economic benefits) derived from the donated assets. That type of restricted gift is often called an endowment. The restriction lasts in effect forever. It cannot be removed by actions of the organization or passage of time. The donations do not increase the organization's unrestricted net assets in any period, and the donated assets are not available for payment to creditors.

Restrictions Affect Net Assets Rather Than Particular Assets

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

102. More commonly, donors' stipulations permit the organization to pool the donated assets with other assets and to sell or exchange the donated assets for other suitable assets as long as the economic benefits of the donated assets are not consumed or used for a purpose that does not comply with the stipulation. For example, a donor may contribute 100 shares of Security A to an organization's endowment, thereby requiring that the amount of the gift be retained permanently but not requiring that the specific shares be held indefinitely. Thus, permanently restricted net assets and temporarily restricted net assets generally refer to amounts of net assets that are restricted by donor-imposed limits, not to specific assets.

Maintenance of Net Assets

103. Although not-for-profit organizations do not have ownership interests or profit in the same sense as business enterprises, they nonetheless need a concept of capital maintenance or its equivalent to reflect "the relation between inflows and outflows of resources during a period." ⁴⁸ The activities of an organization during a period may draw upon resources received in past periods or may add resources that can be used in future periods.

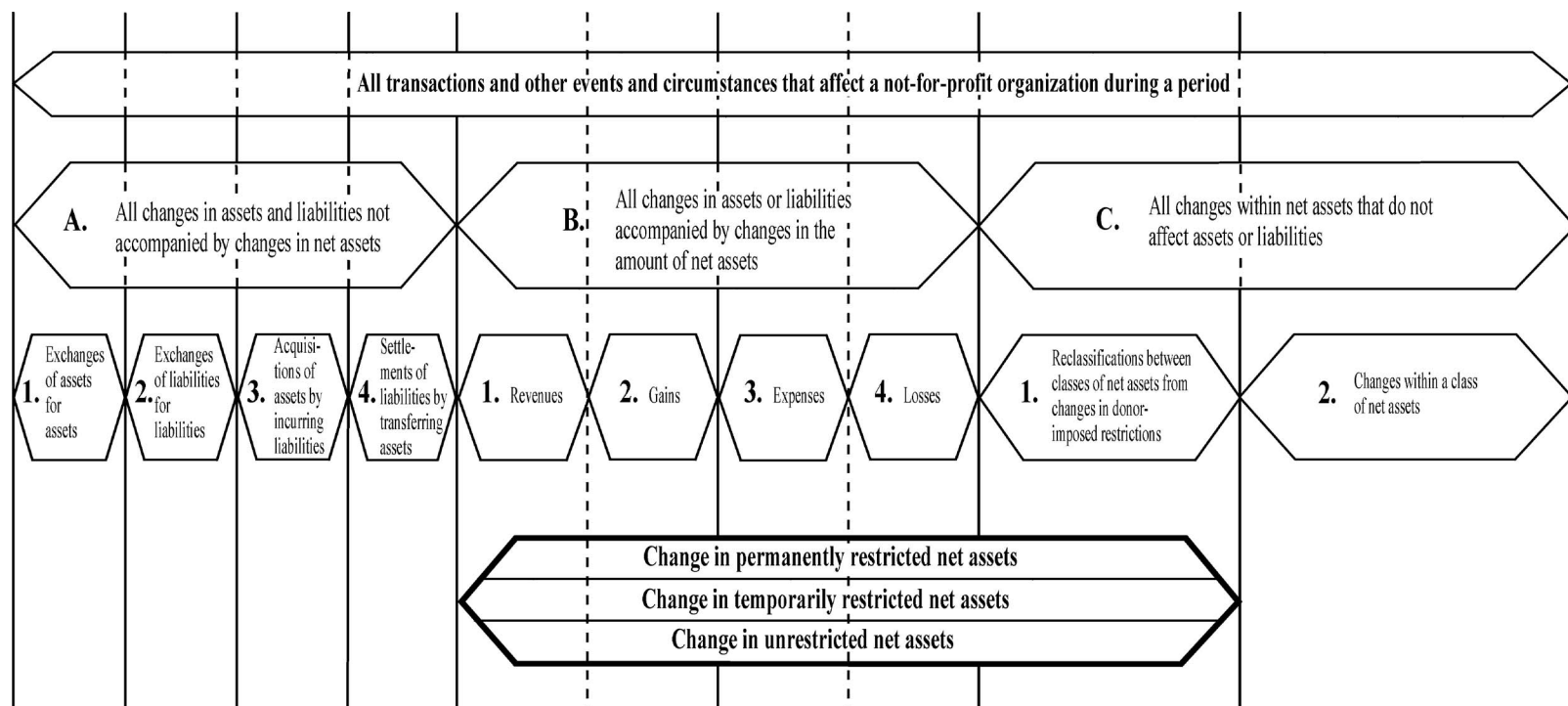
104. Unless a not-for-profit organization maintains its net assets, its ability to continue to provide services dwindles; either future resource providers must make up the deficiency or services to future beneficiaries will decline. For example, use of an asset such as a building to provide goods or services to beneficiaries consumes part of the future economic benefits or service potential constituting the asset, and that decrease in future economic benefits is one of the costs (expenses) of using the asset for that purpose.⁴⁹ The organization's net assets decrease as it uses up an asset unless its revenues and gains at least equal its expenses and losses, including the cost of consuming part of the asset during the period (depreciation). Even if that organization plans to replace the asset through future contributions from donors, and probably will be able to do so, it has not maintained its net assets during the current period.

105. Maintenance of net assets in not-for-profit organizations, as in business enterprises (paragraph 72), is based on the maintenance of financial capital—that is, a not-for-profit organization's capital has been maintained if the financial (money) amount of its net assets at the end of a period equals or exceeds the financial amount of its net assets at the beginning of the period.

106. Since donor-imposed restrictions affect the types and levels of service a not-for-profit organization can provide, whether an organization has maintained certain classes of net assets may be more significant than whether it has maintained net assets in the aggregate. For example, if net assets were maintained in a period only because permanently restricted endowment contributions made up for a decline in unrestricted net assets, information focusing on the aggregate change might obscure the fact that the organization had not maintained the part of its net assets that is fully available to support services in the next period.

Transactions and Events That Change Net Assets of Not-for-Profit Organizations

107. The following diagram shows the sources of changes in the amount of or the restrictions on a not-for-profit organization's net assets and distinguishes them from each other and from other transactions, events, and circumstances affecting the organization during a period. While similar in many respects to the diagram in paragraph 64 for business enterprises, it reflects the different characteristics and financial reporting objectives of not-for-profit organizations. The importance to those organizations of donor-imposed restrictions on use of some assets focuses financial reporting information on changes in restrictions on net assets as well as on changes in the amount of net assets.



108. The full width of the diagram, represented by the two-pointed arrow labeled "All transactions and other events and circumstances that affect a not-for-profit organization during a period," encompasses all potentially recordable events and circumstances affecting a not-for-profit organization. [This 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.] Moving down the diagram, the next level is divided into three mutually exclusive classes that are the same as those of business enterprises (classes A, B, and C). Continuing down the diagram, however, classes B and C are divided differently from classes B and C in the business-enterprise diagram because not-for-profit organizations have no owners or transactions with owners in the same sense as business enterprises and because restrictions on net assets and changes in the restrictions are significant in not-for-profit organizations. (Size of classes does not indicate their relative volume or significance.)

- A. All changes in assets and liabilities not accompanied by changes in net assets. This class comprises four kinds of exchange transactions that are common in most entities; paragraph 65 includes examples. (Exchanges that affect the amount of net assets belong in class B rather than A.)
 - 1. Exchanges of assets for assets
 - 2. Exchanges of liabilities for liabilities
 - 3. Acquisitions of assets by incurring liabilities
 - 4. Settlements of liabilities by transferring assets
- B. All changes in assets or liabilities accompanied by changes in the amount of net assets. This class comprises four kinds of items that also exist for business enterprises:
 - 1. Revenues
 - 2. Gains
 - 3. Expenses
 - 4. Losses
- C. All changes within net assets that do not affect assets or liabilities.
 - 1. Reclassifications between classes of net assets from changes in donor-imposed restrictions, for example, temporarily restricted net assets become unrestricted net assets when a donor-imposed time stipulation expires. This class comprises events that increase one class of net assets while decreasing another but do not change the amount of net assets.
 - 2. Changes within a class of net assets, for example, an internal designation by trustees to establish a working capital reserve from a portion of the entity's unrestricted net assets.

109. The shaded arrow that is divided horizontally into three classes—change in permanently restricted net assets, change in temporarily restricted net assets, and change in unrestricted net assets—encompasses all transactions and other events and circumstances that change either the amount of net assets or the donor-imposed restrictions on net assets. It thus encompasses the

transactions and other events and circumstances that comprise class B (revenues, expenses, gains, losses), and class C1 (reclassifications), combined.

110. In other words, the third and fourth levels of the diagram show in two different ways the same set of transactions and other events and circumstances affecting net assets of a not-for-profit organization and the composition of its three classes during a period. The third level emphasizes sources of changes in net assets—transactions or other events that result in revenues, expenses, gains, or losses or in reclassifications within net assets. The fourth level emphasizes the effects of those events on each of the three classes of net assets—permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets. The components of class B—revenues, expenses, gains, and losses—are discussed collectively in paragraphs 111-113; reclassifications (class C1) are defined and discussed in paragraphs 114-116; and changes in classes of net assets (the fourth level) are defined and discussed in paragraphs 117-133.

Revenues, Expenses, Gains, and Losses

111. Revenues, expenses, gains, and losses are defined and discussed in paragraphs 78-89. Collectively, they include all transactions and other events and circumstances that change the amount of net assets of a not-for-profit organization. All resource inflows and other enhancements of assets of a not-for-profit organization or settlements of its liabilities that increase net assets are either revenues or gains and have characteristics similar to the revenues or gains of a business enterprise. Likewise, all resource outflows or other using up of assets or incurrences of liabilities that decrease net assets are either expenses or losses and have characteristics similar to expenses or losses of business enterprises.

112. Net assets of a not-for-profit organization changes as a result of (a) exchange transactions, (b) contributions and other nonreciprocal transfers from or to and other entities, (c) the organization's service-providing efforts,⁵⁰ and (d) price changes, casualties, and other effects of interactions between the organization and the economic, legal, social, political, and physical environment of which it is a part.

113. A not-for-profit organization's service-providing efforts, most of its fund-raising activities, and most of its exchange transactions with other entities are generally ongoing major activities that constitute the organization's central operations by which it attempts to fulfill its basic function of providing goods or services to its constituency and thus are the sources of its revenues and expenses. Its gains and losses result from activities that are peripheral or incidental to its central operations and from interactions with its environment, which give rise to price changes, casualties, and other effects that may be partly or wholly beyond the control of individual organizations and their managements. Items that are revenues (or expenses) for one kind of organization may be gains (or losses) for another. For example, donors' contributions are revenues to many not-for-profit organizations but are gains to others that do not actively seek them and receive them only occasionally. Similarly, contributions such as those for endowments

are usually gains because they occur only occasionally for most not-for-profit organizations.

Reclassifications

114. Reclassifications between classes of net assets result from donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations. Reclassifications simultaneously increase one class and decrease another class of net assets; they do not involve inflows, outflows, or other changes in assets or liabilities.

115. Reclassifications include events that remove or impose restrictions on an organization's use of its existing resources. Restrictions are removed from temporarily restricted net assets when stipulated conditions expire or are fulfilled by the organization. Time-restricted net assets generally become unrestricted when the stipulated time arrives; for example, net assets that are restricted by contribution of assets during 1985 for use in 1986 become unrestricted on January 1, 1986. Purpose-restricted net assets generally become unrestricted when the organization undertakes activities pursuant to the specified purpose, perhaps over several periods, depending on the nature of donors' stipulations. The resulting reclassifications increase unrestricted net assets, often at the same time that the activities that remove the restrictions result in expenses that decrease unrestricted net assets (paragraphs 151 and 152). Temporarily restricted net assets may become unrestricted when an organization incurs liabilities to vendors or employees as it undertakes the activities required by donor stipulations, rather than at the time those liabilities are paid. Restrictions occasionally may be withdrawn by the donor or removed by judicial action.

116. A donor's gift may impose restrictions on otherwise unrestricted net assets. For example, some donors provide endowment gifts on the condition that the organization agree to "match" them by permanently restricting a stated amount of its unrestricted net assets. "Matching agreements" that are not reversible without donors' consent result in a reclassification of unrestricted net assets to permanently restricted net assets or to temporarily restricted net assets.

Changes in Classes of Net Assets of Not-for-Profit Organizations

117. Those who provide, or may provide, resources to a not-for-profit organization usually need information not only about sources of changes in its net assets—about transactions and other events that result in revenues, expenses, gains, and losses—but also about their effects, and the effects of events that change donor-imposed restrictions, on classes of net assets. Effects on classes of net assets often may be more significant to them than sources of changes because donor-imposed restrictions may significantly affect the types and levels of services that a not-for-profit organization can provide.

118. Events that result in reclassifications within net assets and revenues, expenses, gains, and losses together encompass the transactions and other events and circumstances that comprise

change in permanently restricted net assets, change in temporarily restricted net assets, and change in unrestricted net assets (paragraphs 108-110).

Change in Permanently Restricted Net Assets

119. Change in permanently restricted net assets of a not-for-profit organization during a period is the total of (a) contributions and other inflows during the period of assets whose use by the organization is limited by donor-imposed stipulations that neither expire by passage of time nor can be fulfilled or otherwise removed by actions of the organization, (b) other asset enhancements and diminishments during the period that are subject to the same kinds of stipulations, and (c) reclassifications from (or to) other classes of net assets during the period as a consequence of donor-imposed stipulations.

Characteristics of Change in Permanently Restricted Net Assets

120. Most increases in permanently restricted net assets of a not-for-profit organization are from its accepting contributions of assets that donors stipulate must be maintained in perpetuity. Receipt of a contribution increases permanently restricted net assets if the donor stipulates that the resources received must be maintained permanently and those resources are capable of providing future economic benefit indefinitely. Only assets that are not by their nature used up in carrying out the organization's activities are capable of providing economic benefits indefinitely. Gifts of cash, securities, or nonexhaustible property, such as land and art objects, to be added to an organization's endowment or collections are common examples of those types of assets.

121. Donors' permanent restrictions on the use of contributed assets may also extend to enhancements of those assets or to inflows that result from them. For example, increases in the value of endowment investments that by donor stipulation or law become part of endowment principal also increase permanently restricted net assets. Events that diminish permanently restricted net assets may also occur. Examples include destruction of or damage to a permanently restricted work of art by fire, flood, or vandalism; decline in value of endowment investments that by donor stipulation or law reduces endowment principal; or external mandate (by judicial or similar authority) to transfer endowment securities to another organization.

122. Reclassifications also may increase the amount of permanently restricted net assets or occasionally decrease it (paragraphs 114-116).

Change in Temporarily Restricted Net Assets

123. Change in temporarily restricted net assets of a not-for-profit organization during a period is the total of (a) contributions and other inflows during the period of assets whose use by the organization is limited by donor-imposed stipulations that either expire by passage of time or can be fulfilled and removed by actions of the organization pursuant to those stipulations, (b) other asset enhancements and diminishments during the period subject to the same kinds of

stipulations, and (c) reclassifications to (or from) other classes of net assets during the period as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization pursuant to those stipulations.

Characteristics of Change in Temporarily Restricted Net Assets

124. Most increases in temporarily restricted net assets of a not-for-profit organization are from its accepting contributions of assets that donors limit to use after a specified future time—for example, to be used for next year's operations or to be invested for 10 years before becoming available for operations—or for a specified purpose—for example, sponsoring a particular program activity or acquiring a particular building or piece of equipment. Temporary restrictions pertain to contributions with donor stipulations that expire or can be fulfilled and removed by using assets as specified. And, in contrast to permanent restrictions, which pertain to assets that can provide economic benefits indefinitely and must be maintained in perpetuity by the receiving organization, temporary restrictions pertain to assets that by their nature are spent or used up in carrying out the receiving organization's activities or, if capable of providing economic benefits indefinitely, need not be retained after a stipulated time.

125. Donors' restrictions on the use of contributed assets may also extend to enhancements of those assets or to inflows that result from them. For example, if a donor stipulates that interest income derived from investment of contributed assets is limited to use after a specified date or for a specified operating purpose, the interest income is a restricted inflow that increases temporarily restricted net assets. Events that diminish temporarily restricted net assets, other than expirations and removals of restrictions (next paragraph), may also occur and are much like those that affect permanently restricted net assets (paragraph 121).

126. Reclassifications are the most common source of decreases in temporarily restricted net assets. Events resulting in the expiration or removal of temporary restrictions result in reclassifications from temporarily restricted net assets to unrestricted net assets.

Change in Unrestricted Net Assets

127. Change in unrestricted net assets of a not-for-profit organization during a period is the total change in net assets during the period less change in permanently restricted net assets and change in temporarily restricted net assets for the period. It is the change during the period in the part of net assets of a not-for-profit organization that is not limited by donor-imposed stipulations.

Characteristics of Change in Unrestricted Net Assets

128. Changes in unrestricted net assets include (a) revenues and gains that change unrestricted net assets, (b) expenses and losses that change unrestricted net assets, and (c) reclassifications from (or to) other classes of net assets as a consequence of donor-imposed stipulations, their expiration by passage of time, or their fulfillment and removal by actions of the organization

pursuant to those stipulations.

129. Revenues and gains that increase unrestricted net assets of a not-for-profit organization have characteristics similar to those of revenues and gains of business enterprises. Those revenues and gains and the transactions that give rise to them are in many forms and are called by various names—for example, fees for services, membership dues, unrestricted gifts, or bequests, interest income, and gains on sales of marketable securities.

130. Expenses and losses that decrease unrestricted net assets of a not-for-profit organization have characteristics similar to those of expenses and losses of business enterprises. Except for diminishments of donor-restricted contributed assets that decrease either permanently restricted or temporarily restricted net assets, all types of transactions, other events, and circumstances that decrease net assets of an organization are expenses or losses that decrease unrestricted net assets (paragraphs 121 and 125). Those expenses and losses and the transactions that give rise to them are in many forms and are called by various names—for example, cost of services provided, cost of goods sold, salaries and wages, rent, supplies, interest expense, depreciation, flood damage, and gifts to other entities.⁵¹

131. Reclassifications, although not changing the amount of net assets, may change the amount of unrestricted net assets. Reclassifications more commonly increase rather than decrease unrestricted net assets. Events resulting in the expiration or removal of temporary restrictions result in reclassifications from temporarily restricted net assets that increase unrestricted net assets.

132. A not-for-profit organization's activities that fulfill stipulated conditions and result in removing donor-imposed purpose restrictions on use of donated assets also commonly result in expenses that decrease unrestricted net assets. Activities undertaken pursuant to a specified purpose remove the related restriction, often as the organization pays cash or incurs liabilities to vendors or employees to carry out a stipulated activity (paragraph 115). Those transactions result in expenses either when cash is paid or liabilities are incurred or as the organization uses up assets acquired in the transactions.

133. Information about whether a not-for-profit organization has maintained particular classes of net assets may be more significant than whether it has maintained net assets in the aggregate (paragraph 106). Change in unrestricted net assets for a period indicates whether an organization has maintained the part of its net assets that is fully available—that is, free of donor-imposed restrictions—to support the organization's services to beneficiaries in the next period. The combined change in unrestricted net assets and change in temporarily restricted net assets for a period indicates whether an organization has maintained the part of its net assets that is now or can someday be available—that is, free of permanent restrictions—to support its services to beneficiaries in future periods.

ACCRUAL ACCOUNTING AND RELATED CONCEPTS

134. Items that qualify under the definitions of elements of financial statements and that meet criteria for recognition and measurement (paragraph 23) 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 135-152 define or describe several significant financial accounting and reporting concepts that are used in this Statement and other concepts Statements.

Transactions, Events, and Circumstances

135. This Statement commonly uses *transactions and other events and circumstances affecting an entity* to describe the sources or causes of changes in assets, liabilities, and equity or net assets. An event is a happening of consequence to an entity. It may be an internal event that occurs within an entity, such as using raw materials or equipment in production, or it may be an external event that involves interaction between an entity and its environment, such as a transaction with another entity, 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.⁵² Many events are combinations. For example, acquiring services of employees or others involves exchange transactions, which are external events; using those services, often simultaneously with their acquisition, is part of production, which involves a series of internal events (paragraph 79, footnote 40). An event may be initiated by an entity, such as a purchase of merchandise or use of a building, or it may be partly or wholly beyond the control of an entity and its management, such as an interest rate change, an act of vandalism or theft, the imposition of taxes, or the expiration of a donor-imposed time restriction.

136. 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.

137. 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 or educational contributions given or received, and thefts.⁵³

138. 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

139. Accrual accounting attempts to record the financial effects on an entity of transactions and other events and circumstances that have cash consequences for the entity in the periods in which those transactions, events, and circumstances occur rather than only in the periods in which cash is received or paid by the entity. Accrual accounting is concerned with an entity's acquiring of goods and services and using them to produce and distribute other goods or services. It is concerned with the process by which cash expended on resources and activities is returned as more (or perhaps less) cash to the entity, not just with the beginning and end of that process. It recognizes that the buying, producing, selling, distributing, and other operations of an entity during a period, as well as other events that affect entity performance, often do not coincide with the cash receipts and payments of the period (FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, paragraph 44, and FASB Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, paragraph 50).

140. Thus, accrual accounting is based not only on cash transactions but also on credit transactions, barter exchanges, nonreciprocal transfers of goods or services, changes in prices, changes in form of assets or liabilities, and other transactions, events, and circumstances that have cash consequences for an entity but involve no concurrent cash movement. By accounting for noncash assets, liabilities, revenues, expenses, gains, and losses, accrual accounting links an entity's operations and other transactions, events, and circumstances that affect it with its cash receipts and outlays. Accrual accounting thus provides information about an entity's assets and liabilities and changes in them that cannot be obtained by accounting for only cash receipts and outlays.

Accrual and Deferral (Including Allocation and Amortization)

141. 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 or liabilities and the related liabilities, assets, revenues, expenses, gains, or losses for amounts expected to be received or paid, usually in cash, in the future. Deferral is concerned with past cash receipts and payments—with prepayments received (often described as collected in advance) or paid: it is the accounting process of recognizing a liability resulting from a current cash receipt (or the equivalent) or an asset resulting from a current cash payment (or the equivalent) with deferred recognition of revenues, expenses, gains, or losses. Their recognition is deferred until the obligation underlying the liability is partly or wholly satisfied ⁵⁴ or until the future economic benefit underlying the asset is partly or wholly used or lost. Common examples of accruals include purchases and sales of goods or services on account, interest, rent (not yet paid), wages and salaries, taxes, and decreases and increases in marketable securities accounted for at lower of cost and market. Common examples of deferrals include prepaid insurance and unearned subscriptions.⁵⁵

142. 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

143. 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.⁵⁶

Recognition, Matching, and Allocation

144. Accrual accounting recognizes numerous noncash assets, liabilities, and transactions and other events that affect them (paragraphs 139-141). Thus, 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 entity in goods and services for its operations or other activities commonly do not all occur in the same period as revenues or other proceeds from selling the resulting products or providing the resulting services. Several periods may elapse between the time cash is invested in raw materials or plant, 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. Similarly, goods or services that a not-for-profit organization provides gratis to beneficiaries commonly result from using goods or services acquired with cash received and spent in earlier periods. A report showing cash receipts and outlays of the organization for a short period cannot tell much about the relation of goods or services provided to the resources used to provide them and thus cannot indicate whether or to what extent an organization is successful or unsuccessful in carrying out its service objectives. Cash receipts in a particular period may largely reflect the effects of activities of a business enterprise or a not-for-profit organization in earlier periods, while many of the cash outlays may relate to its activities and efforts expected in future periods.

145. Accrual accounting uses accrual, deferral, and allocation procedures whose goal is to relate revenues, expenses, gains, and losses to periods to reflect an entity'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 entities. The goal of accrual accounting is to account in the periods in which they occur for the effects on an entity of transactions and other events and circumstances, to the extent that those financial effects are recognizable and measurable.

146. Matching of costs and revenues is simultaneous or combined recognition of the revenues and expenses that result directly and jointly from the same transactions or other events. In most entities, some transactions or events 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.

147. 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.⁵⁷

148. 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.

149. However, many assets yield their benefits to an entity over several periods, for example, prepaid insurance, buildings, and various kinds of equipment. Expenses resulting from their 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 entity—allocation is applied if causal relations are generally, but not specifically, identified. For example, wear and tear from use is known to be a major cause of the expense called depreciation, but the amount of depreciation caused by wear and tear in a period normally cannot be measured. Those expenses are not related directly to either specific revenues or particular periods. Usually no traceable relationship exists, and they are recognized by allocating costs to periods in which assets are expected to be used and are related only indirectly to the revenues that are recognized in the same period.

150. Some revenues and gains result from nonreciprocal transfers to an entity from other entities and thus relate to the period in which cash or other assets are received by the entity, or in which its liabilities are reduced. Recognition of those nonreciprocal transfers seldom involves allocation or matching procedures. For example, not-for-profit organizations commonly receive donations in cash, and timing of cash receipts is normally readily verifiable. Similarly, receipts of other assets, including receivables (promises by another entity to pay cash or transfer other assets), or of reductions or remissions of liabilities are also usually readily identifiable with the periods in which they occur, and there is nothing to allocate to other periods.

151. Nonreciprocal transfers to an entity rarely result directly and jointly from the same transactions as expenses. Most contributions and expenses are much more closely related to time periods than to each other. For example, the receipt by a not-for-profit organization of contributed assets that involve donor stipulations restricting their use to particular types of services may be a cause of the expenses incurred in providing those services; however, the receipt of contributed assets—revenues or gains—and the subsequent incurring of liabilities or reduction of assets in providing services—expenses—are separate events recognized in the periods in which they occur.

152. Removal of restrictions on temporarily restricted net assets of a not-for-profit organization is an event that often occurs at the same time as the incurring of particular expenses. The discussion of donor-imposed restrictions in this Statement contemplates that removals of

restrictions on net assets—reclassifications—may be shown in financial statements in the same period(s) as the activities that remove the restrictions.

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
Victor H. Brown
Raymond C. Lauver
David Mosso
Robert T. Sprouse
Arthur R. Wyatt

Appendix A: Background Information

153. 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. Although that report focused primarily on business enterprises, it also included a brief discussion of "objectives of financial statements for governmental and not-for-profit organizations."

154. 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.

155. The Board first concentrated on concepts of financial accounting and reporting by business enterprises and issued three documents on December 2, 1976: *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.

156. The Board held public hearings (a) August 1 and 2, 1977 on the *Tentative Conclusions on Objectives of Financial Statements of Business Enterprises* 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.

157. 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.

158. 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. A second 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. That Exposure Draft led in December 1980 to FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*, following FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, which was issued in May 1980.

159. The Board's work on concepts of financial accounting and reporting by not-for-profit organizations began in August 1977. Professor Robert N. Anthony of the Harvard Business School prepared an FASB Research Report, *Financial Accounting in Nonbusiness Organizations*, published in May 1978, which was followed by a related Discussion Memorandum and an Exposure Draft. FASB Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, was issued in December 1980.

160. The four concepts Statements described are part of a single conceptual framework for financial accounting and reporting by all entities. The Board noted in Concepts Statements 2 and 3 its expectation that the qualitative characteristics and definitions of elements of financial statements should apply to both business enterprises and not-for-profit organizations and its intent to solicit views on that matter.

161. The Board issued an Exposure Draft, *Proposed Amendments to FASB Concepts Statements 2 and 3 to Apply Them to Nonbusiness Organizations*, on July 7, 1983. In considering similarities and differences of business enterprises and not-for-profit organizations that may affect qualitative characteristics of accounting information and definitions of elements of financial statements, the Board had the counsel of a task force consisting of 32 members knowledgeable about not-for-profit organizations and their financial reporting. The Board received 74 letters of comment on the Exposure Draft, and 20 parties presented their views orally

and answered Board members' questions at public hearings held on November 14 and 15, 1983.

162. That Exposure Draft was in two parts, and the Board made decisions on both. First, it reaffirmed the conclusion of the Exposure Draft that the qualitative characteristics of accounting information set forth in Concepts Statement 2 (relevance, reliability, comparability, and related qualities) apply to not-for-profit organizations as well as to business enterprises. Second, based on suggestions of respondents to the Exposure Draft and on its own further consideration of similarities and differences between business enterprises and not-for-profit organizations, the Board revised the proposed amendments to Concepts Statement 3 and issued a revised Exposure Draft, *Elements of Financial Statements*, on September 18, 1985. The following describe major changes from the 1983 Exposure Draft and identify major changes suggested but not made.

- This Statement does not define as elements of financial statements two that the 1983 Exposure Draft proposed: change in net assets (described as a concept equivalent to comprehensive income of business enterprises) and contributions. Instead, by identifying three broad classes of net assets of not-for-profit organizations—permanently restricted, temporarily restricted, and unrestricted net assets—and changes in those classes, it emphasizes the importance of donor-imposed restrictions on resources contributed to not-for-profit organizations and changes in both the amount and nature of net assets based on the presence or absence of donor restrictions. Numerous respondents, both those interested in not-for-profit organizations and those interested in business enterprises, questioned whether defining contributions separately from revenues and gains, though clearly possible, was either necessary or useful. This Statement notes that inflows of assets in nonreciprocal transfers from nonowners (contributions), like other transactions that increase net assets, result either in revenues (from ongoing major operating activities) or in gains (from peripheral or incidental transactions). It also notes that whether a particular contribution results in a revenue or a gain is often less important than whether it increases permanently restricted, temporarily restricted, or unrestricted net assets.
- A separate diagram now shows interrelationships between sources of changes in net assets of not-for-profit organizations (revenues, expenses, gains, and losses), reclassifications between classes of net assets, and changes in permanently restricted, temporarily restricted, and unrestricted net assets.
- This Statement reaffirms the conclusion in the 1983 Exposure Draft that under the definitions in Concepts Statement 3 (and this Statement) contributions or donations, whether or not subject to donor-imposed restrictions, generally increase net assets (equity) rather than liabilities. Several respondents had argued that purpose-restricted, and perhaps time-restricted, contributions result in (or should be considered to result in) liabilities.
- This Statement reaffirms the conclusion in the 1983 Exposure Draft that how an asset was acquired and whether and how it will be replaced are not germane to whether or not the entity's using it up results in an expense. Some respondents to the Exposure Draft had suggested that depreciation often should not be an expense (or cost) of a not-for-profit organization, in part because the related assets were, and their replacements are expected to

be, funded by contributions or special assessments.

- Some respondents to the 1983 Exposure Draft had suggested that depreciation based on historical cost is not the most relevant way of measuring a not-for-profit organization's cost of using up of long-lived assets. However, how depreciation expense should be measured is a measurement issue beyond the scope of this Statement.
- This Statement takes note of Board decisions on matters that were still under consideration as part of other projects at the time Concepts Statement 3 and the 1983 Exposure Draft were issued, particularly the recognition, measurement, and display matters for business enterprises that are the subjects of Concepts Statement 5.
- Although financial statement display is beyond the scope of this Statement, the Board has attempted to respond at various points to requests by a number of respondents for more explanation of the significance of the proposed definitions for reporting by not-for-profit organizations.

163. The Board received 60 letters of comment on the revised Exposure Draft. Some respondents reiterated the arguments referred to in paragraph 162, while others expressed new concerns. The Board has considered those comments. The following describe and identify changes made to the revised Exposure Draft and identify changes suggested by respondents but not made.

- This Statement reaffirms the conclusion that financial reporting by not-for-profit organizations requires a concept of maintenance of net assets. Some respondents suggested that depreciation is often irrelevant to not-for-profit organizations because the related expenses need not be "matched" with revenues to measure income, which in their view is not important for not-for-profit organizations. However, this Statement describes depreciation as a cost of using assets, not as a technique for "matching" expenses with revenues.
- This Statement reaffirms the conclusion in the Exposure Drafts that most restrictions do not create obligations that qualify as liabilities. The discussion has been expanded (paragraphs 56-58) to clarify the point.
- Some respondents suggested that the revisions to the characteristics of assets and liabilities proposed in the revised Exposure Draft had changed the related definitions and expressed concern about the intent of the revisions. The troublesome aspects of the revisions have been reworded to alleviate those concerns. The revisions to the last sentences in paragraph 26 and in paragraph 36 are meant to avoid circularity in the use of the term *probable* in explaining probable future benefit and sacrifice, and clarify the intended point, that there are ways other than legal enforceability by which an entity may obtain an existing benefit or may be unable to avoid paying an existing obligation.

Appendix B: CHARACTERISTICS OF ASSETS, LIABILITIES, AND EQUITY OR NET ASSETS AND OF CHANGES IN THEM

Purpose and Summary of Appendix

164. 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.

165. The remainder of this 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 of business enterprises, comprehensive income of business enterprises and its components, and net assets and changes in the classes of net assets of not-for-profit organizations.⁵⁸ 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.

166. This Statement emphasizes that the definitions of elements are not intended to answer recognition, measurement, or display questions.⁵⁹ 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 22 and 23).

167. Thus, unless an item qualifies as an asset of an entity under the definition in paragraph 25, for example, questions do not arise about whether to recognize it as an asset of the entity, which of its attributes to measure, or how to display it as an asset in the financial statements of the entity. 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.

168. An item does not qualify as an asset or liability of an entity if it lacks one or more essential characteristics. Thus, for example, an item does not qualify as an asset of an entity under the definition in paragraph 25 if (a) the item involves no future economic benefit, (b) the

item involves future economic benefit, but the entity cannot obtain it, or (c) the item involves future economic benefit that the entity may in the future obtain, but the events or circumstances that give the entity access to and control of the benefit have not yet occurred (or the entity 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 entity under the definition in paragraph 35 if (a) the item entails no future sacrifice of assets, (b) the item entails future sacrifice of assets, but the entity is not obligated to make the sacrifice, or (c) the item involves a future sacrifice of assets that the entity will be obligated to make, but the events or circumstances that obligate the entity have not yet occurred (or the entity in the past was obligated to make the future sacrifice, but events or circumstances have occurred to remove that obligation).

169. This appendix contains numerous examples of items that commonly qualify as assets or liabilities of an entity 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 entity 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;⁶⁰ (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 entity 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 entity is not required to sacrifice assets in the future; (f) other receipts of cash in return for which an entity is in no way required to pay cash, transfer other assets, or provide services do not create liabilities because the entity is not presently obligated to sacrifice assets in the future;⁶¹ (g) "know-how" of NASA or other governmental agencies placed in the public domain is not an asset of an entity unless the entity 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 entity 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.

170. 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

171. Paragraph 25 defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." Paragraphs 26-34 amplify that definition. The following discussion further amplifies it and illustrates its meaning under three headings that correspond to the three essential characteristics of assets described in paragraph 26: future economic benefits, control by a particular entity, and occurrence of a past transaction or event.

Future Economic Benefits

172. Future economic benefit is the essence of an asset (paragraphs 27-31). An asset has the capacity to serve the entity by being exchanged for something else of value to the entity, by being used to produce something of value to the entity, or by being used to settle its liabilities.

173. 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.⁶² Incurrence of costs may be significant evidence of acquisition or enhancement of future economic benefits (paragraphs 178-180).

174. To assess whether a particular item constitutes an asset of a particular entity 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 entity embodied future economic benefit in the first place and (b) whether all or any of the future economic benefit to the entity remains at the time of assessment.

175. 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 entity (paragraphs 44-48), 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 entity. For example, business

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.

176. 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 181 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 25 but rather on the practical considerations of coping with the effects of uncertainty. If research or development activities or advertising results in an entity'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.

177. Most assets presently included in financial statements qualify as assets under the definition in paragraph 25 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 earlier 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

178. An entity 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 32). An entity acquires assets in exchanges with other entities by sacrificing other assets or by incurring liabilities to transfer assets to the other entity later. An entity also incurs a cost when it uses an asset in producing or distributing goods or services—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.

179. Although an entity 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.

180. First, since an entity commonly obtains assets by incurring costs, incurrence of a cost may be evidence that an entity 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, entities may obtain assets without incurring costs—for example, from investment in kind by owners or contributions of securities or buildings by donors. The ultimate evidence of the existence of assets is the future economic benefit, not the costs incurred.

181. 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.

182. Losses have no future economic benefits and cannot qualify as assets under the definition in paragraph 25. 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 Entity

183. Paragraph 25 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 185). To have an asset, an entity 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.

184. Thus, an asset of an entity is the future economic benefit that the entity can control and thus can, within limits set by the nature of the benefit or the entity's right to it, use as it pleases. The entity 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.

185. The definition of assets focuses primarily on the future economic benefit to which an entity 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 25, 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

186. 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.

187. Although the ability of an entity 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 entity to have an asset if the entity has the ability to obtain and control the benefit in some other way. For example, exclusive access to future economic benefit may be maintained by keeping secret a formula or process.

Noncontrolled Benefits

188. 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 other entities under the definition in paragraph 25. Similarly, general access to things such as clean air or water resulting from environmental laws or requirements cannot qualify as assets of individual entities, even if the entities have incurred costs to help clean up the environment.

189. Those examples should be distinguished from similar future economic benefits that an individual entity can control and thus are its assets. For example, an entity 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 entity 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

190. The definition of assets in paragraph 25 distinguishes between the future economic benefits of present and future assets of an entity. Only present abilities to obtain future economic benefits are assets under the definition, and they become assets of particular entities as a result of transactions or other events or circumstances affecting the entity. 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 entity only after the entity either has discovered it in circumstances that permit the entity to exploit it or has acquired the rights to exploit it from whoever had them.

191. Since the transaction or event giving rise to the entity's right to the future economic benefit must already have occurred, the definition excludes from assets items that may in the future become an entity's assets but have not yet become its assets. An entity 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 entity still has an asset if the transactions or events that use up or destroy a particular future economic benefit or remove the entity's access to and control of it are yet in the future. For example, an entity 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

192. Paragraph 35 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." Paragraphs 36-43 amplify that definition. The following discussion further amplifies that definition and illustrates its meaning under three headings that correspond to the three essential characteristics of liabilities described in paragraph 36: required future sacrifice of assets, obligation of a particular entity, and occurrence of a past transaction or event.

Required Future Sacrifice of Assets

193. The essence of a liability is a duty or requirement to sacrifice assets in the future. A liability requires an entity 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.

194. 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 198), 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.

195. To assess whether a particular item constitutes a liability of a particular entity at a particular time requires at least two considerations in addition to the general kinds of evidence just described: (a) whether the entity 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.

196. Most liabilities presently included in financial statements qualify as liabilities under the definition in paragraph 35 because they require an entity 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 entity 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 44-48).

197. 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 entity 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 earlier 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

198. An entity commonly receives cash, goods, or services by incurring liabilities (paragraph 38), and that which is received is often called proceeds, especially if cash is received. Receipt of proceeds may be evidence that an entity has incurred one or more liabilities, but it is not conclusive evidence. Proceeds may be received from cash sales of goods or services or other

sales of assets, from cash contributions by donors, or from cash investments by owners, and entities 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. Although proceeds received may be a useful attribute in measuring a liability incurred, proceeds themselves are not liabilities.

Obligation of a Particular Entity

199. Paragraph 35 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.

200. To have a liability, an entity 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 entity. For example, an entity'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 entity because no obligation to another entity is present.

201. 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,⁶³ and the fact of an entity's obligation is so evident that it is often taken for granted. To carry out its operations, an entity 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 to repair or replace defective products sold with warranties or guarantees. Governmental units also routinely assess tax obligations against business enterprises and some not-for-profit organizations, and courts may impose obligations for damages or fines.

202. 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.

203. An entity 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 entity 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 entity 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 40). It could refuse to pay only by risking substantial employee-relations problems.

204. Most liabilities are obligations of only one entity 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 entity, and those that bind two or more 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.

205. Secondary, and perhaps even lower ranked, obligations may qualify as liabilities under the definition in paragraph 35, but recognition considerations are highly significant in deciding whether they should formally be included in financial statements because of the effects of uncertainty (paragraphs 44-48). 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

206. The definition of liabilities in paragraph 35 distinguishes between present and future obligations of an entity. Only present obligations are liabilities under the definition, and they are liabilities of a particular entity as a result of the occurrence of transactions or other events or circumstances affecting the entity.

207. Most liabilities result from exchange transactions in which an entity 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 entity to pay wages or salaries and usually fringe benefits.

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

209. 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.

210. 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 entity to pay cash, transfer other assets, or provide services to other entities in the future.

211. A liability once incurred by an entity remains a liability until it is satisfied in another transaction or other event or circumstance affecting the entity. Most liabilities are satisfied by cash payments. Others are satisfied by the entity'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

212. Paragraph 49 defines equity or net assets as "the residual interest in the assets of an entity that remains after deducting its liabilities." Characteristics of equity of business enterprises are briefly discussed under two headings: residual interest, and invested and earned equity. Although *capital* is not a precise term in referring to equity 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 equity of business enterprises; 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. (The distinguishing characteristics of net assets of not-for-profit organizations are discussed in paragraphs 50-53 and 90-106.)

Residual Interest

213. Equity in a business enterprise is the ownership interest, and its amount 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 minus liabilities). That is why it is a residual interest.

Invested and Earned Equity

214. 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 of Business Enterprises and Its Components

215. Paragraph 70 defines comprehensive income as "the change in equity of a business enterprise 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 78-89.

216. The diagram in paragraph 64 shows that comprehensive income and investments by and distributions to owners account for all changes in equity (net assets) of a business enterprise during a period. The sources of comprehensive income are therefore significant to those attempting to use financial statements to help them with investment, credit, and similar decisions about the enterprise, especially since various sources may differ from each other in stability, risk, and predictability. Users' desire for information about those sources 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 73-77).

217. The principal distinction between revenues and expenses on the one hand and gains and losses on the other is the distinction between an entity's ongoing major or central operations and its peripheral and incidental transactions and activities. Revenues and expenses result from an entity's productive efforts and most of its exchange transactions with other entities that constitute the entity's ongoing major or central operations. The details vary with the type of entity 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 entities (such as mutual funds, insurance companies, and banks). Some enterprises simultaneously engage in many different ongoing major or central activities.

218. Most entities also occasionally engage in activities that are peripheral or incidental to their ongoing major or central operations. For example, many entities invest in securities of other entities to earn a return on otherwise idle assets (rather than to control or influence the other entities' operations). Moreover, all entities 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 entities and their managements. The kinds of events and circumstances noted in this paragraph are commonly sources of gains and losses. Of course, the distinction between revenues and gains and between expenses and losses depends significantly on the nature of an entity and its activities (paragraphs 87 and 88).

Interest in Information about Sources of Comprehensive Income

219. 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 entity'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 entity's performance. Investors, creditors, managers, and others need information about the causes of changes in assets and liabilities.

220. 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 matters of display that are beyond the scope of this Statement. 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*? Should some components of comprehensive income be displayed as direct increases or decreases of equity (net assets)? **64**

Characteristics of Net Assets and Changes in the Classes of Net Assets of Not-for-Profit Organizations

221. Paragraph 49 defines equity or net assets as "the residual interest in the assets of an entity that remains after deducting its liabilities." This Statement defines net assets of not-for-profit organizations in total and divides it into three classes—permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets—based on the presence or absence of donor-imposed restrictions and the nature of those restrictions. The two restricted classes of net assets at any time reflect existing limits on the organization's use of assets resulting from donor stipulations. When the limiting conditions are met, expire, or are withdrawn, temporarily restricted net assets are reclassified as unrestricted net assets. Characteristics of net assets of a not-for-profit organization and the interests in information about changes in the classes of net assets are briefly discussed in the following paragraphs.

Residual Interest

222. Net assets in a not-for-profit organization is the cumulative result of changes in permanently restricted, temporarily restricted, and unrestricted net assets, each of which, in turn, is the result of revenues, gains, expenses, and losses and of reclassifications within net assets. That characteristic, coupled with the characteristic that net assets is subject to the priority of liabilities as claims against organization assets, makes net assets not determinable independently of assets and liabilities. Although equity or net assets can be described in various ways, and different recognition criteria and measurement procedures can affect its amount, it is always the amount that remains after deducting liabilities from assets. That is why it is a residual interest.

Interest in Information about Changes in Classes of Net Assets

223. Resource providers are interested in knowing not only that a not-for-profit organization's net assets has increased (or decreased) but also *how* and *why*. That stems from the common interests of contributors, creditors, and others who provide resources to not-for-profit organizations in information about the services those organizations provide, their efficiency and effectiveness in providing those services, and their continuing ability to provide those services. Some resource providers, such as contributors and members, may be interested in that information as a basis for assessing how well the organization has met its objectives and for determining whether to continue their support. Other resource providers, such as lenders, suppliers, and employees, view a not-for-profit organization as a source of payment for the cash, goods, or services they supply and accordingly are interested in assessing the organization's ability to generate the cash needed for timely payment of the organization's obligations to them.⁶⁵

224. Because the use of resources provided to not-for-profit organizations is often restricted by providers to a particular purpose or time, information about the restrictions on the use of resources and the amounts and kinds of inflows and outflows of resources that change its net

assets is usually more useful to present and potential resource providers than merely the amount of change in net assets. The amount of change in net assets for a period can be measured by comparing the ending and beginning net assets, but that procedure alone does not provide adequate information for assessing (a) the services a not-for-profit organization provides, (b) its ability to continue to provide those services, or (c) how managers have discharged their stewardship responsibilities to contributors and others for use of its resources entrusted to them, all of which are important in assessing an organization's performance during a period.

225. Information about purpose restrictions may help assess the organization's ability to provide particular types of services or to make cash payments to creditors. Similarly, information about time restrictions may help creditors and others assess whether an organization has sufficient resources to provide future services or to make cash payments when due. Information about the amounts and kinds of changes in those restrictions is useful in assessing the extent to which activities of a not-for-profit organization during a period may have drawn upon resources obtained in past periods or have added resources for use in future periods.

226. Information about permanent restrictions is useful in determining the extent to which an organization's resources may not be a source of cash for payments to present or prospective lenders, suppliers, or employees. Thus, information that distinguishes permanently restricted resource inflows from other kinds of changes in an organization's net assets is useful in identifying the resource inflows that are not directly available for providing its services or cash for paying creditors in that (or any other) period (even though they may be a source of future income or other continuing economic benefits).⁶⁶

227. Information about the change in unrestricted net assets for a period is a useful indicator of whether an organization's activities have drawn upon, maintained, or added to the part of its net assets that is fully available—that is, free of donor-imposed restrictions—to support the organization's operating activities. Information about the combined change in unrestricted net assets and in temporarily restricted net assets for a period indicates whether an organization has maintained the part of its net assets that is now or, at some time will be, available to support its operating activities.

228. As the preceding paragraphs suggest, financial reporting information that is intended to be useful in assessing a not-for-profit organization's performance focuses on information about changes in the three classes of a not-for-profit organization's net assets, classes based on the effects of donor-imposed restrictions.⁶⁷ Ways of presenting information about the various sources of those changes—revenues, expense, gains, and losses—and of changes in donor-imposed restrictions on net assets—reclassifications—are matters of display rather than problems of definition, and thus are beyond the scope of this Statement. Pertinent issues for later study involve questions such as: Should changes in classes of net assets be displayed in a single financial statement or in two or more statements? What level of aggregation or disaggregation is needed for revenues, expenses, gains, or losses? How should reclassifications of temporarily restricted net assets that become unrestricted be displayed?

Examples to Illustrate Concepts

229. 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 entity 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 settlement by future sacrifice of economic benefit (assets) rather than whether or not an entity 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.

230. 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 and not-for-profit organizations (paragraphs 44-48), and those effects should be considered in applying the definitions in this Statement.

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

First Group

an asset,
a reduction of a liability (liability valuation),⁶⁸
an expense, or a loss.

Second Group

a liability,
a reduction of an asset (asset valuation),⁶⁸
a revenue, or 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.⁶⁹

Deferred Gross Profit on Installment Sales

232. 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.

233. Nor is the deferred gross profit a liability. The selling entity 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.

234. 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

235. Unamortized or deferred debt discount belongs to the first group (paragraph 231) 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.

236. 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 entity has the use of the borrowed funds but it pays a price for that use—interest. A bond discount means that the entity 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.

237. 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.

238. 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.

239. Terms such as *unamortized or deferred discount or premium* and *to amortize discount or premium* are carry-overs from the days when debt discount was considered to be an amortizable asset (paragraph 235) and do not describe accurately either the assets or liabilities and events involved or the interest method of accounting for them. Paragraphs 141 and 142 of this Statement define and describe accrual, deferral, and amortization. A simple example shows the distinction described in footnote 55: "... 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."

The proceeds are \$87 (ignoring debt issue costs) if a 2-year debt security with a \$100 face amount and 7 percent interest (payable annually) is issued to yield 15 percent. The interest method gives this accounting (all amounts are rounded to nearest dollar) if the usual valuation account—debt discount—is omitted.

1/1/X1		
Cash	\$87	
Debt payable		\$87

12/31/X1		12/31/X2	
Interest expense	\$13	Interest expense	\$14
Interest payable	\$13	Interest payable	
(.15 × \$87)		[.15 × (\$87 + \$6)]	
Interest payable	\$ 7	Debt payable	\$87
Cash	\$ 7	Interest payable	20
		Cash	

Thus, despite references to the *interest method of amortization* in Opinion 21 and APB Opinion No. 12, *Omnibus Opinion—1967*, the interest method that both Opinions describe is straightforward accounting for cash receipts and payments and accrual of interest expense and interest payable at the effective rate. It involves neither deferring costs nor amortizing deferred costs. Similarly, accounting for investments in debt securities by the interest method involves accruing interest income and receivable but involves no deferrals or amortizations.⁷⁰

Deferred Income Tax Credits

240. 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 entity 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 231), and the two views just noted exhaust the possibilities—deferred tax credits cannot be revenues, or gains.⁷¹ Both the liability method and the net-of-tax method are compatible with the definitions in this Statement.

241. 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 23) rather than either as accrued taxes to be paid in future periods when the timing differences reverse or as reductions in related assets.⁷²

242. 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

243. 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 231) and are not revenues, or 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.

244. 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.⁷³

245. 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 was a liability of a particular entity.

Deferred Costs of Assets

246. Accountants, and others, are accustomed to describing costs incurred as assets, but costs incurred are at best evidence of the existence of assets (paragraphs 178-180). They result in assets only if an entity 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.

247. Other "deferred costs" that are not themselves assets may be costs of the kinds of assets of an entity 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.⁷⁴ 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.

248. 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, entities 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 25 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.

249. 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 entity by other entities in the future. Second, they may represent future economic benefit that is expected to be obtained within the entity 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.

250. 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 44-48 and 175 and 176).

Estimated Loss on Purchase Commitments

251. Estimated loss on purchase commitments belongs in the second group of elements (paragraph 231). 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.

252. 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.⁷⁵ 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 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 accepted upon delivery, or damages must be paid if the assets are not accepted. 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.

253. 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 now sometimes shown among the liabilities.

Minority Interests and Stock Purchase Warrants

254. 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

255. The Board reiterates that the examples in paragraphs 232-254 are intended to illustrate the definitions and related concepts, not to establish standards for accounting practice (paragraph 230). 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 10 elements of financial statements and 3 classes of net assets (of not-for-profit organizations) and changes in those classes during a period, this Statement defines or discusses other concepts, terms, or phrases that are used in the definitions or explanations or that are otherwise related to those elements and classes. This index identifies the paragraphs in which those elements and classes and certain other significant concepts, terms, or phrases are defined or discussed.

	Paragraph Numbers
Accrual	141
Accrual accounting	134, 139–141, 145
Allocation	142, 149–150
Amortization	142, 149
Articulation	20–21, 64, 107
Assets	25–34, 64–65, 107–108, 171–191
Attributes measured	(footnote 37) 73
Capital maintenance	71–72, 103–106
Change in permanently restricted net assets	107–110, 117–122, 226
Change in temporarily restricted net assets	107–110, 117–118, 123–126, 225
Change in unrestricted net assets	107–110, 117–118, 127–133, 227
Changes in classes of net assets of not-for-profit organizations	107–110, 117–133, 223–228
Changes in financial position	(footnote 13) 20
Circumstances	136

Classes of net assets of not-for-profit organizations	91–94, 101–102, 221
Comprehensive income of business enterprises	64–65, 70–77, 215–220
Constructive obligations	(footnote 22) 35, 40, (footnote 28) 57, 202–203
Cost	(footnote 19) 26
Deferral	141–142
Distributions to owners	64–69
Donor-imposed restrictions	56–58, 95–102
Earnings	(footnote 1) 1
Economic resources	11–15, 27–31
Elements of financial statements	5–7
Entity	24
Equitable obligations	(footnote 22) 35, 40, (footnote 28) 57, 202–203
Equity of business enterprises	49–55, 60–65, 212–214
Equity or net assets	49–65, (footnote 26) 50, 90–110, 212–214, 221–222
Events	135–138
Exchange transactions	137
Expenses	64–65, 80–81, 87–89, 107–113, 215–220
External events	135, 137
Financial position	(footnote 13) 20
Fund balance	(footnote 45) 91
Future economic benefit	26–30, 172–173
Gains	64–65, 82–89, 107–113, 215–220
Internal events	135, 138
Internal transactions	138
Investments by owners	64–69
Item (contrast with <i>element</i>)	5–7
Liabilities	35–43, 54–59, 64–65, 107–108, 192–211
Losses	64–65, 82–89, 107–113, 215–220
Maintenance of net assets	71–72, 103–106
Matching of costs and revenues	146
Measurement	22, (footnote 37) 73
Net assets of not-for-profit organizations	49–53, 56–58, 90–110, 221–222

Net assets or equity	49–65, (footnote 26) 50, 90–110, 212–214, 221–222
Nonreciprocal transfers	137, 150–151, (footnote 61) 169
Not-for-profit organizations (distinguishing characteristics of)	(footnote 8) 12,90
Obligations	(footnote 22) 35, 36–40, 193–194, 200–203
Other entities	24
Ownership interest	49–55, 60–65, 212–214
Permanently restricted net assets	91–92, 218, 95–102, 107–110, 221
Permanent restrictions	98–100
Prepayments	141
Probable	(footnote 18) 25,(footnote 21) 35, 46
Production	30,(footnote 33)65,(footnote 38) 74, (footnote 40) 79, (footnote 50)112
Profit and loss	(footnote 9) 16
Realization	143
Realized	143
Reclassifications (not-for-profit organizations)	107–110, 114–116, 152
Recognition	22, 143
Residual interest	49–50, 90, 212–213, 221–222
Resources (economic)	11–15, 27–31
Restricted or restrictions (not-for-profit organizations)	91–93, 95–102, 221
Revenues	64–65, 78–79, 87–89, 107–113, 215–220
Service potential (synonym for <i>future economic benefit</i>)	26–30, 172–173
Service-providing efforts	(footnote 50),112
Systematic and rational allocation	149
Temporarily restricted net assets	91, 93–95, 95–102, 107–110, 221
Temporary restrictions	98–100
Transactions	135, 137
Unrealized	143
Unrestricted net assets	91, 94, 107–110, 221
Valuation accounts	34, 43

AMENDMENT OF FASB CONCEPTS STATEMENT NO. 2, QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION

As discussed in Appendix A (paragraphs 160-162) the Board has reaffirmed the conclusion that the qualitative characteristics of accounting information set forth in Concepts Statement 2 (relevance, reliability, comparability, and related qualities) apply to both not-for-profit organizations and business enterprises. Accordingly, paragraph 4 and footnote 2 of Concepts Statement 2 are superseded and replaced by the following:

4. The qualities of information discussed in this Statement apply to financial information reported by business enterprises and by not-for-profit organizations. Although the discussion and the examples in this Statement are expressed in terms commonly related to business enterprises, they generally apply to not-for-profit organizations as well. "Objectives of financial reporting by business enterprises," "investors and creditors," "investment and credit decisions," and similar terms are intended to encompass their counterparts for not-for-profit organizations, "objectives of financial reporting by not-for-profit organizations," "resource providers," "resource allocation decisions," and similar terms.²

²This paragraph is as amended by FASB Concepts Statement No. 6, *Elements of Financial Statements* (December 1985).

Footnotes

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.

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 information outside of financial statements in published financial reports.

CON6, Footnote 1--*Comprehensive income* is the name used in this Statement and in FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*, for the concept that was called *earnings* in 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]; FASB Exposure Draft, *Objectives of Financial Reporting and Elements of Financial Statements of Business Enterprises* [December 1977], and FASB Discussion Memorandum, *Reporting Earnings* [July 1979]). Concepts Statement 3 did not define *earnings* because the Board decided to reserve the term for possible use to designate a component part, then undetermined, of comprehensive income.

FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (December 1984), has now described earnings for a period as excluding certain cumulative accounting adjustments and other nonowner changes in equity that are included in comprehensive income for a period.

CON6, Footnote 2--The term *not-for-profit organizations* in this Statement encompasses private sector organizations described in FASB Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations* (December 1980). Financial reporting by state and local governmental units is within the purview of the Governmental Accounting Standards Board (GASB), and the FASB has not considered the applicability of this Statement to those units.

CON6, Footnote 3--Some respondents to the 1977 Exposure Draft on elements of financial statements of business enterprises (par. 157) 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 of business enterprises in their present forms, except perhaps *earnings* (par. 1, footnote 1), and for balance sheets and statements of changes in net assets of not-for-profit organizations in their present forms.

CON6, Footnote 4--Paragraphs 5-9 of Concepts Statement 5 discuss the role of notes and their relation to financial statements.

CON6, Footnote 5--The 1977 Exposure Draft on elements of financial statements of business enterprises 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* (December 28, 1979), reverted to the more common practice of using the same names for both, and this Statement adopts the same usage.

CON6, Footnote 6--Those who make decisions about allocating resources to not-for-profit organizations include both (a) lenders, suppliers, employees, and the like who expect repayment or other direct pecuniary compensation from an entity and have essentially the same interest in and make essentially the same kinds of decisions about the entity whether it is a not-for-profit organization or a business enterprise and (b) members, contributors, donors, and the like who provide resources to not-for-profit organizations for reasons other than expectations of direct and proportionate pecuniary compensation (Concepts Statement 4, pars. 15-19, 29).

CON6, Footnote 7--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, and so forth 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. 22 and 23).

CON6, Footnote 8--Concepts Statement 4 (par. 6) lists as the distinguishing characteristics of not-for-profit organizations (a) contributions from resource providers who do not expect pecuniary return, (b) operating purposes other than to provide goods or services at a profit, and (c) absence of ownership interests like those of business enterprises. Not-for-profit organizations have those characteristics in varying degrees. "The line between nonbusiness [not-for-profit] organizations and business enterprises is not always sharp since the incidence and relative importance of those characteristics in any organization are different. . . . As happens with any distinction, there will be borderline cases. . . . especially for organizations that possess some of the distinguishing characteristics of nonbusiness [not-for-profit] organizations but not others. Some organizations have no ownership interests but are essentially self-sustaining from fees they charge for goods and services. . . . the objectives of Concepts Statement 1 may be more

appropriate for those organizations" (Concepts Statement 4, pars. 7 and 8).

CON6, Footnote 9--*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.

CON6, Footnote 10--Some not-for-profit organizations, for example, many membership organizations, may be permitted under law to distribute assets to members upon dissolution or final liquidation. However, assets of many other not-for-profit organizations are held subject to limitations (a) permitting their use only for religious, charitable, eleemosynary, benevolent, educational, or similar purposes or (b) requiring their return to donors or their designees if the organization is dissolved. Thus, upon dissolution of a not-for-profit organization, its assets, or a significant part of them, must often be transferred to another not-for-profit organization engaged in activities substantially similar to those of the dissolving organization, to donors, or, in some cases, to other unrelated entities.

CON6, Footnote 11--Concepts Statement 4, pars. 6-9.

CON6, Footnote 12--Concepts Statement 4, pars. 9, 38, 41, and 47-53.

CON6, Footnote 13--The two types 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 funds statements (now commonly called statements of changes in financial position for business enterprises) 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. The other possible elements of financial statements referred to in paragraphs 3 and 4 also fall into this second types. 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, borrowing, and repayments of borrowing. Financial statements of not-for-profit organizations may have different names from those of business enterprises but have the same distinctions between financial position and changes in financial position.

CON6, Footnote 14--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.

CON6, Footnote 15--FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, addresses those questions for business enterprises. Those conceptual questions as they relate to not-for-profit organizations and more detailed development of those concepts for all entities may be the subject of further concepts Statements or standards.

CON6, Footnote 16--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 other resource-allocation 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 entities, its materiality, and whether the benefits from providing it exceed the costs of providing it. Those matters are discussed in Concepts Statement 2, and criteria and guidance for business enterprises based on them are set forth in Concepts Statement 5.

CON6, Footnote 17--The concept of a "reporting entity" for general-purpose external financial reporting is the subject of a separate Board project that includes consolidated financial statements, the equity method, and related matters.

CON6, Footnote 18--*Probable* is used with its usual general meaning, rather than in a specific accounting or 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 Simon and Schuster 1982], p. 1132). Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 44-48).

CON6, Footnote 19--*Cost* is the sacrifice incurred in economic activities--that which is given up or forgone to consume, to save, to exchange, to produce, and so forth. 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.

CON6, Footnote 20--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, including unit of measure, are beyond the scope of this Statement, it recognizes but does not emphasize that characteristic of money.

CON6, Footnote 21--*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*, p. 1132). Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 44-48).

CON6, Footnote 22--*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, and so forth (*Webster's New World Dictionary*, p. 981). It includes equitable and constructive obligations as well as legal obligations (pars. 37-40).

CON6, Footnote 23--A common feature of liabilities is interest--the time value of money or the price of delay.

CON6, Footnote 24--The meaning of *probable* in these paragraphs is described in paragraph 25, footnote 18, and paragraph 35, footnote 21.

CON6, Footnote 25--The Board's Concepts Statements 2 and 5 bear directly on the matter discussed in paragraphs 44-48.

CON6, Footnote 26--This Statement generally applies the term *equity* to business enterprises, which is common usage, and the term *net assets* to not-for-profit organizations, for which the term *equity* is less commonly used. The two terms are interchangeable.

CON6, Footnote 27--Since, in common use, *grants* mean not only gifts but also exchange transactions in which the *grantor* expects to receive commensurate value, this Statement generally avoids those terms.

CON6, Footnote 28--Most liabilities are legally enforceable, and the concepts of equitable and constructive obligations have a relatively narrow area of application. To assess all or most donor-restricted contributions to not-for-profit organizations as having the essential characteristics of liabilities is too broad an interpretation of the definition of liabilities. A not-for-profit organization's need to acquire goods and services to provide services to beneficiaries in the future, or to expand to provide new services, is analogous to a business enterprise's need to replace merchandise sold or raw materials or equipment used up (paragraph 200), or to buy new assets, not to its liability to provide magazines to customers who have paid in advance.

CON6, Footnote 29--This Statement defines equity of business enterprises only as a whole, although the discussion 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.

CON6, Footnote 30--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.

CON6, Footnote 31--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 also become 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 relationships between the parties cast doubts that they are liabilities in substance rather than investments by owners.

CON6, Footnote 32--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.

CON6, Footnote 33--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. The diagram does not, of course, settle recognition issues.

CON6, Footnote 34--The definitions of revenues, expenses, gains, and losses in paragraphs 78-89 also apply to the changes in net assets of not-for-profit organizations as discussed in

paragraphs 107-113.

CON6, Footnote 35--Investments by owners are sometimes called capital contributions. Distributions to owners are sometimes called capital distributions; distributions of earnings, profits, or income; or dividends.

CON6, Footnote 36--Concepts Statement 5, paragraphs 45-48 adopted financial capital maintenance as the concept on which the full set of articulated financial statements it discusses is based.

CON6, Footnote 37--"'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). The choice of measurement attribute, measurement unit, and recognition criteria are discussed in Concepts Statement 5.

CON6, Footnote 38--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*.

CON6, Footnote 39--Earnings as adopted in Concepts Statement 5 and its relation to comprehensive income is discussed in paragraph 1, footnote 1.

CON6, Footnote 40--In concept, revenues increase assets rather than decrease liabilities, but a convenient shortcut is often to directly record reduction of liabilities. Production is essentially an asset conversion process to create future economic benefit (par. 30; par. 65, footnote 33; and, par. 74, footnote 38). It adds utility and value to assets and is the primary source of revenue, which may be recognized (as noted in footnote 41) 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. Entities 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 paragraph 64, the exchange transactions are in class A, while the internal events (production) that result in revenues or expenses are in class B1.

CON6, Footnote 41--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 a subject of Concepts Statement 5. This Statement contains no conclusions about recognition of revenues or of any other elements.

CON6, Footnote 42--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.

CON6, Footnote 43--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. 79, footnote 40). Taxes and other expenses resulting from nonreciprocal transfers to other entities commonly do result directly from incurring liabilities.

CON6, Footnote 44--Gifts or donations received by not-for-profit organizations may be revenues or gains (pars. 111-113).

CON6, Footnote 45--This Statement does not use the terms *funds* and *fund balances* because the most common meanings of those terms refer respectively to a common group of assets and related liabilities within a not-for-profit organization and to the net amount of those assets and liabilities. This Statement classifies net assets, not assets or liabilities. While some not-for-profit organizations may choose to classify assets and liabilities into fund groups, information about those groupings is not a necessary part of general purpose external financial reporting. Issues that affect how, if at all, classifications of assets and liabilities may be displayed in financial statements, for example, by using multicolumn presentations or disclosure

in the notes, are outside the scope of this Statement and may be the subject of future Board projects.

CON6, Footnote 46--However, the nature and amounts of self-imposed limits on use of assets and of limits imposed by others as a condition of operating activities (for example, by debt covenants or other arrangements) may be significant information for financial statement users and may need to be disclosed.

CON6, Footnote 47--This Statement makes distinctions among resource flows based on the presence or absence of donor-imposed restrictions on their use. In the past, other distinctions have been made, for example, between "nonoperating" and "operating," "nonexpendable" and "expendable," "noncapital" and "capital," and "restricted" and "unrestricted." Those terms have been used by not-for-profit organizations in practice to name groups of resource flows that, while similar in many respects, have differed in important details.

CON6, Footnote 48--FASB Concepts Statement 4, par. 49. The Statement also says, "A nonbusiness [not-for-profit] organization cannot, in the long run, continue to achieve its operating objectives unless the resources made available to it at least equal the resources needed to provide services at levels satisfactory to resource providers and other constituents" (par. 39).

CON6, Footnote 49--Some assets--for example, land and endowment investments in securities--are generally not used up or consumed by productive use. The extent, if any, to which the future economic benefits or service potential of particular kinds of assets are used up by productive use involves measurement issues beyond the scope of this Statement.

CON6, Footnote 50--A not-for-profit organization, like a business enterprise, increases the values of goods or services it acquires by adding time, place, or form utility. Thus, *service-providing efforts* and *producing and distributing activities* include conversion processes and other utility-adding activities such as storing, transporting, distributing, providing professional services, and many others. Since a not-for-profit organization may provide goods, services, or cash to its beneficiaries, the term *service-providing efforts* may refer to activities for producing and distributing goods or cash as well as services.

CON6, Footnote 51--Information about the service efforts of a not-for-profit organization should focus on how the organization's resources are used in providing different programs or services (Concepts Statement 4, pars. 51-53). Accordingly, it may be useful to group and report separately the costs of providing various services or other activities for each significant program or supporting activity. However, whether expenses and unrestricted losses are reported by program or supporting activity, by kind (such as salaries and wages, rent, supplies, and other purchased services), or otherwise is a display matter beyond the scope of this Statement.

CON6, Footnote 52--In contrast, APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises* (October 1970), paragraph

62, distinguishes external and internal events as follows: External events are "events that affect the enterprise and 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.

CON6, Footnote 53--APB Statement 4, par. 62, and APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, beginning with par. 5.

CON6, Footnote 54--For example, paragraph 79, footnote 40, explains how liabilities that result from customers' cash advances are later satisfied by delivery of goods or services.

CON6, Footnote 55--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. 235-239 of this Statement). The "interest" method is described in APB Opinion No. 12, *Omnibus Opinion--1967*, paragraphs 16 and 17, and APB Opinion No. 21, *Interest on Receivables and Payables*, paragraphs 15 and 16.

CON6, Footnote 56--Concepts Statement 5 uses the term *recognition* in the same way as does this Statement and distinguishes it from *realization*. It also uses *realized* in the same sense and defines the related concept *realizable* (par. 83 and footnote 50).

CON6, Footnote 57-- APB Statement 4 (pars. 154-161) describes "three pervasive expense recognition principles": associating cause and effect, systematic and rational allocation, and immediate recognition. Paragraphs 146-149 of this Statement describe generally the same three bases for recognizing expenses but not in the same order.

Guidance for recognition of expenses and losses, set forth for business enterprises in Concepts Statement 5 (pars. 85-87), is based in large part on the considerations in paragraphs 146-149.

CON6, Appendix B, Footnote 58--As noted in paragraph 50, footnote 26, this Statement often uses *equity* and *net assets* interchangeably but generally applies *equity* to business enterprises and *net assets* to not-for-profit organizations.

CON6, Appendix B, Footnote 59--Those questions are a subject of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. Recognition, measurement, and display questions for not-for-profit organizations, and more detailed development of those concepts for all entities, may be the subject of further concepts or standards Statements.

CON6, Appendix B, Footnote 60--Paragraph 247 notes an aspect of the cost of some "dry holes" in different circumstances.

CON6, Appendix B, Footnote 61--Examples (e) and (f) describe receipts of assets in nonreciprocal transfers to an entity, for example, contributions. Although restrictions may place limits on assets received, most donor-imposed restrictions do not create obligations that qualify as liabilities of the recipient. Moreover, the transaction necessarily is an exchange rather than a nonreciprocal transfer if an entity receives assets and incurs liabilities in the same transaction. Although restrictions on the use of donated assets may lead to the future use of cash (or other assets) to provide stipulated services, that future use of cash is not a required "sacrifice" of assets. Rather, it generally is a future exchange of assets to purchase goods or services from suppliers or employees (pars. 56-58, 137, and 150 and 151).

CON6, Appendix B, Footnote 62--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.

CON6, Appendix B, Footnote 63--Contracts and agreements and enforceability of agreements and statutes are necessary parts of the environment in which business and other economic activities and financial reporting take place. Business and other 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 entity to have a liability (pars. 36-40).

CON6, Appendix B, Footnote 64--Concepts Statement 5 addresses many of those matters and notes that those matters may be developed further at the standards level.

CON6, Appendix B, Footnote 65--Concepts Statement 4, par. 30. Paragraphs 29, 31, and 32 also discuss the interest of other types of users of financial information, including those having specialized needs and those of internal users, such as managers and governing bodies, and explain that special-purpose reports and detailed information often required by those types of users is beyond the scope of general-purpose external financial reporting.

CON6, Appendix B, Footnote 66--Permanently restricted resource inflows (for example, endowment contributions) are sometimes said to resemble the "capital" inflows of a business enterprise--investments by its owners. However, as this Statement indicates, characteristics of and changes in net assets of not-for-profit organizations and equity of business enterprises are often more different than similar. For example, unlike investments by owners, donations of assets with permanent restrictions are not a source of cash for payment to creditors. Furthermore, the rights of owners and donors are fundamentally different. A not-for-profit

organization that accepts a permanently restricted contribution is obligated only to comply with the restriction. It generally operates for the benefit of the recipients of its services--not for the financial benefit of its donors.

CON6, Appendix B, Footnote 67--Donors that provide restricted resources may have specific interests in how those resources are used. Information focused on donor-imposed restrictions may be useful to them; however, broad distinctions are not intended to provide external users with assurance that managers have exercised their responsibilities in the manner specifically designated by a particular resource provider. General purpose external financial reporting can best meet the need for information about managers' special responsibilities by disclosing any failures to comply with restrictions that may impinge on an organization's financial performance or on its ability to continue to provide a satisfactory level of services (Concepts Statement 4, par. 41).

CON6, Appendix B, Footnote 68--Valuation accounts are part of the assets or liabilities to which they pertain and are neither assets nor liabilities in their own right (pars. 34 and 43). That distinction is significant in several of the examples.

CON6, Appendix B, Footnote 68--Valuation accounts are part of the assets or liabilities to which they pertain and are neither assets nor liabilities in their own right (pars. 34 and 43). That distinction is significant in several of the examples.

CON6, Appendix B, Footnote 69--The examples generally concern transactions and other events of business enterprises and are expressed in business terms. Since not-for-profit organizations may have similar transactions (except those related to ownership interests and perhaps those related to income taxes) these examples and the concepts they illustrate relate to those organizations as well.

CON6, Appendix B, Footnote 70--The proceeds are \$114.50 if the example is changed to a 15 percent security issued to yield 7 percent. Interest income and receivable accrued is \$8.00 (.07 x \$114.50) for the first year and \$7.50 [.07 x (\$114.50 - \$7.00)] for the second. Accounting for cash received is:

12/31/X1		
Cash	\$15.00	
Interest receivable		\$ 8.00
Investment		7.00
12/31/X2		
Cash	\$115.00	
Interest receivable		\$ 7.50
Investment		\$107.50

CON6, Appendix B, Footnote 71--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.

CON6, Appendix B, Footnote 72--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.

CON6, Appendix B, Footnote 73--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 APB Opinion No. 4, *Accounting for the "Investment Credit,"* [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.

CON6, Appendix B, Footnote 74--"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.

CON6, Appendix B, Footnote 75--Whether those rights and obligations might be accounted for as assets and liabilities is a question of recognition, criteria for which are established by Concepts Statement 5 and may be developed further as they are applied at the standards level. Although the definitions in this Statement do not exclude the possibility of recording assets and liabilities for purchase commitments, the Statement contains no conclusions or implications about whether they should be recorded.