Statement of Financial Accounting Concepts No. 5

Recognition and Measurement in Financial Statements of Business Enterprises

As Amended

December 2021
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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

* 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.
the pronouncements listed in item (b) based on personal interpretations of the objectives and concepts in the Statements of Financial Accounting Concepts.

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

Like other pronouncements of the Board, a Statement of Financial Accounting Concepts may be amended, superseded, or withdrawn by appropriate action under the Board’s Rules of Procedure.

† 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.
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HIGHLIGHTS

[Best understood in context of full Statement]

- This Statement sets forth recognition criteria and guidance on what information should be incorporated into financial statements and when.
- Recognition is the process of formally incorporating an item in the financial statements of an entity as an asset, liability, revenue, expense, or the like. A recognized item is depicted in both words and numbers, with the amount included in the statement totals.
- An item and information about it should meet four fundamental recognition criteria to be recognized and should be recognized when the criteria are met, subject to a cost-benefit constraint and a materiality threshold. Those criteria are:
  - Definitions. The item meets the definition of an element of financial statements.
  - Measurability. It has a relevant attribute measurable with sufficient reliability.
  - Relevance. The information about it is capable of making a difference in user decisions.
  - Reliability. The information is representationally faithful, verifiable, and neutral.
- Items currently reported in the financial statements are measured by different attributes (for example, historical cost, current [replacement] cost, current market value, net realizable value, and present value of future cash flows), depending on the nature of the item and the relevance and reliability of the attribute measured. The Board expects use of different attributes to continue.
- The monetary unit or measurement scale in current practice in financial statements is nominal units of money, that is, unadjusted for changes in purchasing power of money over time. The Board expects that nominal units of money will continue to be used to measure items recognized in financial statements.
INTRODUCTION, SCOPE, AND LIMITATIONS

1. This Statement sets forth fundamental recognition criteria and guidance on what information should be formally incorporated into financial statements and when. It builds on the foundation laid by earlier concepts Statements, bringing those concepts together to apply them to broad recognition issues.

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

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

8. The scope of this concepts Statement is limited to recognition (and measurement) in financial statements. Since recognition means depiction of an item in both words and
numbers, with the amount included in the totals of the financial statements, disclosure by other means is not recognition.

**RECOGNITION CRITERIA**

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

**Purposes of Criteria**

59. Criteria are set forth in this Statement to provide direction for resolving issues that involve accounting recognition. An entity’s assets and liabilities and the effects of events on them and on its equity are candidates for recognition in its financial statements.

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

**Fundamental Recognition Criteria**

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

- **Definitions**—The item meets the definition of an element of financial statements.
- **Measurability**—It has a relevant attribute measurable with sufficient reliability.
Relevance—The information about it is capable of making a difference in user decisions.

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

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

Definitions

64. To be recognized in financial statements, a resource must meet the definition of an asset, and an obligation must meet the definition of a liability. A change in equity must meet the definition of a revenue, expense, gain, or loss to be recognized as a component of comprehensive income.

Measurability

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

Measurement Attributes

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

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

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

b. **Current cost.** Some inventories are reported at their current (replacement) cost, which is the amount of cash, or its equivalent, that would have to be paid if the same or an equivalent asset were acquired currently.

c. **Current market value.** Some investments in marketable securities are reported at their current market value, which is the amount of cash, or its equivalent, that could be obtained by selling an asset in orderly liquidation. Current market value is also generally used for assets expected to be sold at prices lower than previous carrying amounts. Some liabilities that involve marketable commodities and securities, for example, the obligations of writers of options or sellers of common shares who do not own the underlying commodities or securities, are reported at current market value.

d. **Net realizable (settlement) value.** Short-term receivables and some inventories are reported at their net realizable value, which is the nondiscounted amount of cash, or its equivalent, into which an asset is expected to be converted in due course of business less direct costs, if any, necessary to make that conversion. Liabilities that involve known or estimated amounts of money payable at unknown future dates, for example, trade payables or warranty obligations, generally are reported at their net settlement value, which is the nondiscounted amounts of cash, or its equivalent, expected to be paid to liquidate an obligation in the due course of business, including direct costs, if any, necessary to make that payment.

e. **Present (or discounted) value of future cash flows.** Long-term receivables are reported at their present value (discounted at the implicit or historical rate), which is the present or discounted value of future cash inflows into which an asset is expected to be converted in due course of business less present values of cash outflows necessary to obtain those inflows. Long-term payables are similarly reported at their present value (discounted at the implicit or historical rate), which is the present or discounted value of future cash outflows expected to be required to satisfy the liability in due course of business.

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

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

70. Rather than attempt to characterize present practice as being based on a single attribute with numerous major exceptions for diverse reasons, this concepts Statement characterizes present practice as based on different attributes. Rather than attempt to select a single attribute and force changes in practice so that all classes of assets and liabilities use that attribute, this concepts Statement suggests that use of different attributes will continue, and discusses how the Board may select the appropriate attribute in particular cases.¹

Monetary Unit or Measurement Scale

¹This discussion of measurement attributes is based in part on the FASB Discussion Memorandum, Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement (December 2, 1976), paragraphs 388–574, which further describes and illustrates each of the attributes and remains a useful reference.
71. The monetary unit or measurement scale in financial statements in current practice is nominal units of money, that is, unadjusted for changes in purchasing power of money over time. An ideal measurement scale would be one that is stable over time. At low rates of change in general purchasing power (inflation or deflation), nominal units of money are relatively stable. Also, preparation and use of financial statements is simpler with nominal units than with other units of measure, such as units of constant general purchasing power (used, for example, in supplementary disclosures of the effects of changing prices), artificial monetary units (for example, the European Currency Unit or ECU), or units of a commodity (for example, ounces of gold). However, as rates of change in general purchasing power increase, financial statements expressed in nominal units of money become progressively less useful and less comparable.

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

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

Mr. March dissents from this Statement because (a) it does not adopt measurement concepts oriented toward what he believes is the most useful single attribute for recognition purposes, the cash equivalent of recognized transactions reduced by subsequent impairments or loss of service value—instead it suggests selecting from several different attributes without providing sufficient guidance for the selection process; (b) it identifies all nonowner changes in assets and liabilities as comprehensive income and return on equity, thereby including in income, incorrectly in his view, capital inputs from nonowners, unrealized gains from price changes, amounts that should be deducted to

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maintain capital in real terms, and foreign currency translation adjustments; (c) it uses a concept of income that is fundamentally based on measurements of assets, liabilities, and changes in them, rather than adopting the Statement’s concept of earnings as the definition of income; and (d) it fails to provide sufficient guidance for initial recognition and derecognition of assets and liabilities.

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

Mr. March objects to comprehensive income, defined in Concepts Statement 3 and confirmed in this Statement, as a concept of income because it includes all recognized changes (including price changes) in assets and liabilities other than investments by owners and distributions to owners. He would exclude from income, and include in the amount of capital to be maintained (in addition to transactions with owners), what he would consider to be direct capital inputs to the enterprise from nonowner sources. Those include governmental and other capital contributions or grants and capital arising in reorganizations, recapitalizations, and extinguishments or restatements of debt capital.

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

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

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