STAFF PAPER

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REG IASB Meeting

Project	**Conceptual Framework**
Paper topic	Elements: Approach to defining income and expense

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Purpose of paper

1. This paper discusses the approach to defining income and expense. In it, the staff recommend that the *Conceptual Framework* should continue to define income and expense by reference to changes in assets and liabilities.

Background

2. The existing *Conceptual Framework* defines income and expense as follows:

   (a) income: increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

   (b) expenses: decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.[1]

3. The Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* stated that the IASB had identified few problems with the existing definitions of income and expense. The Discussion Paper noted that some drafting

[1] See paragraph 4.25 of the existing *Conceptual Framework*.

changes may be required, mainly because of any changes to the definitions of the other elements.

Feedback

4. The Discussion Paper did not ask explicitly whether the *Conceptual Framework* should continue to define income and expense by reference to changes in assets and liabilities. Few respondents commented explicitly on this topic. Some stated that focusing on changes in assets and liabilities:

    (a) provides greater clarity for the development of Standards than a matching approach does;

    (b) does not conflict with the objective of producing useful performance figures;

    (c) does not mean that the statement of financial position is more important than the statement(s) of profit or loss and other comprehensive income.

5. A few other respondents stated that:

    (a) The Discussion Paper provided no discussion of whether an approach to recognition based on defining assets and liabilities is appropriate, even though this has for centuries been a fundamental debate in financial reporting. The *Conceptual Framework* should provide at least a rationale for this approach, and describe its relationship with the process commonly referred to as matching, as it now does in paragraph 4.50 (see appendix to this paper).

    (b) The IASB places undue emphasis on the balance sheet by treating assets and liabilities as the primary elements of financial statements and defining income and expenses as changes in those assets and liabilities. Financial performance has more to do with transactions and cash flows than with changes between opening and closing balance sheets. The *Conceptual Framework* should identify income and expenses as well as assets and liabilities as the primary elements of financial statements.

(c) Accounting should focus on transactions, not on assets and liabilities. Assets and liabilities are a temporary allocation of transactions to the statement of financial position, with the objective of producing a more relevant profit and loss statement.

(d) The *Conceptual Framework* should acknowledge that some current or future Standards, such as those on share-based payment, employee benefits, income taxes, and revenue recognition, seem to be driven by determining income and expense, which then drive the amounts recognised as assets and liabilities (or at least debits and credits) in the statement of financial position. It can appear somewhat forced to describe these requirements in asset or liability terms, for example by relying on the concept of performance obligations. These items do not necessarily give rise to a 'present obligation', in the ordinary sense of these words, at the balance sheet date.

(e) Deferred costs and deferred tax assets are not capable of generating economic benefits as those are accounting concepts rather than economic concepts. Similarly, the proposed definition of a liability appears to restrict the recognition of liabilities and could be construed as outlawing provisions and constructive obligations.

Staff analysis

6. For this project, the IASB decided to build on the existing *Conceptual Framework*—updating, improving and filling in gaps rather than fundamentally reconsidering all aspects of the *Conceptual Framework*. In April 2014, the IASB tentatively approved the staff's recommendation to continue with that strategy.

7. In line with that strategy, we do not intend to reconsider fundamentally the approach of defining income and expense in terms of assets and liabilities. Nevertheless, the staff believe it is worth emphasising some important points about that approach:

(a) It is incorrect to assume that the IASB cares only about the balance sheet and that the IASB believes that financial performance is just the difference between this year's balance sheet and last year's balance sheet. Financial statements provide information about an entity's financial position (its economic resources and claims against the entity) and its financial performance. To provide reasonably complete information about its financial performance, an entity must identify and measure its economic resources and the claims against the entity. Consequently, the IASB did not designate one type of information (about financial position or about financial performance) as the primary focus of financial reporting.[2]

(b) Much of financial reporting is currently transaction based and will continue to be so. Information about transactions is relevant to users. The IASB will consider how best to present and disclose income and expense to provide relevant information to users by distinguishing, for example:

   (i) amounts generated by transactions;

   (ii) amounts generated by other events;

   (iii) value changes.

(c) Transactions that result in income and expenses generally also cause changes in assets and liabilities. Therefore, identifying income and expenses necessarily leads to identifying which assets and liabilities have changed.

(d) The Discussion Paper acknowledged that for decisions such as recognition, derecognition and measurement the IASB would need to continue to consider the nature of the information that would result not only in the statement of financial position, but also in the statement of profit or loss and OCI. Moreover, the Discussion Paper stated that no primary financial statement has primacy over the other primary statements and they should be looked at as a group.[3]

(e) The definitions of an asset and of a liability focus on resources and obligations. These definitions are not just accounting technicalities. An organised summary of an entity's resources and obligations provides users with more relevant and understandable information about an entity's

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[2] See paragraph BC1.32 of the *Basis for Conclusions* on the *Conceptual Framework*

[3] See paragraph 7.31 of the Discussion Paper

financial position than does a statement of unexpired residuals from a matching process.

(f) A matching approach does not explain how to identify the period to which a transaction relates. Thus, the IASB and other standard setters have found over many years that it is more effective, efficient and rigorous to define assets and liabilities first, and to define income and expense as changes in assets and liabilities, rather than to try to define income and expense first and then describe assets and liabilities as by-products of the recognition of income and expense.

(g) The existing approach to defining income and expenses does not predetermine:

(i) which assets and liabilities should be recognised;

(ii) how recognised assets and liabilities should be measured; and

(iii) how income and expense should be aggregated, analysed and presented.

8. The staff recommend that the *Conceptual Framework* should continue to define income and expense by reference to changes in assets and liabilities. In the staff's view, that is the most effective and efficient way to generate Standards that will result in useful information for users of financial statements.

Question
Does the IASB agree that the *Conceptual Framework* should continue to define income and expense by reference to changes in assets and liabilities?

Other matters

9. This paper does not address the following matters which will be addressed in future papers:

(a) Whether to make drafting changes to the definitions of income and of expense, perhaps as a result of any changes to the definitions of the other elements.

(b) Whether to confirm leaving largely unchanged the discussion of gains, revenue, expenses and losses.

(c) Whether to confirm not defining separate elements of income or expense to describe what should be reported in profit or loss and what should be reported in other comprehensive income (OCI).

(d) Whether to confirm in the *Conceptual Framework* that an expense arises when an entity issues an equity instrument in exchange for services.

Appendix
Extract from the Conceptual Framework
(paragraph 4.50)

Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this *Conceptual Framework* does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.