STAFF PAPER

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Project	**Conceptual Framework**
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Introduction

1. This paper notes the following issues that have arisen during the early stages of drafting the *Conceptual Framework* Exposure Draft:
   (a) definitions of income and expenses (paragraphs 3 – 4);
   (b) changes to discussion of income and expenses in the existing *Conceptual Framework* (paragraphs 5 – 6);
   (c) the objective of disclosure regarding the recalculation of amounts recognised or disclosed (paragraphs 7 – 9); and
   (d) the role of matching in the recognition of assets and liabilities (paragraphs 10 – 23).

2. Recommendations on each issue are given in each section. We do not plan to discuss each issue individually unless an IASB member wishes to do so. Rather we ask at the end of the paper whether IASB members disagree with any of the recommendations.

Definition of income and expenses

3. At the May 2014 IASB meeting, the IASB decided to continue to define income and expenses in terms of changes in assets and liabilities. However, at that meeting it was noted that some changes to the definitions of income and expense would be needed to reflect the proposed changes in the definitions of assets and liabilities. The table below sets out the definitions of the elements in the existing *Conceptual Framework*, and the definitions for assets, liabilities and equity that the IASB is proposing in the Exposure Draft. The table also includes revised definitions for income and expenses recommended by the staff.

4. To be consistent with the revised definitions of assets and liabilities, the revised definitions of income and expenses do not refer to economic benefits. Also, they do not include a reference to the accounting period. This is because items of income and expense can arise at any time. Income and expense for a period are recognised in the financial statements for that period, but that point is covered in the recognition section, and does not belong in the definition of the elements.

Definition in existing *Conceptual Framework*	**Proposed new definition**
An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.	An asset is a present economic resource controlled by the entity as a result of past events.
A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.	A liability is a present obligation of the entity to transfer an economic resource as a result of past events.
	An economic resource is a right that is capable of producing economic benefits.
Equity is the residual interest in the assets of the entity after deducting all its liabilities.	Equity is the residual interest in the assets of the entity after deducting all its liabilities.

Income is 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.	**Staff recommendation** **Income is increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from equity participants.**
Expenses are 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.	**Staff recommendation** **Expenses are decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to equity participants.**

Changes to discussion of income and expenses in the existing *Conceptual Framework*

5. Appendix A sets out the paragraphs on income and expenses in the existing *Conceptual Framework*, with an explanation of whether and how we plan to include those points in the Exposure Draft. The main points are:

   (a) Much of it is about presentation of income and expenses. We will cover providing information about performance in the presentation and disclosure chapter, not in the elements chapter.

   (b) When discussing presentation, the existing discussion makes several references to ordinary activities. Ordinary activities are not defined in the *Conceptual Framework* or in IFRSs and, in particular, there is no notion of extraordinary activities. We do not plan to refer to ordinary activities in the presentation and disclosure chapter because that term has not formed part of the IASB's thinking on the issue. As a consequence, the *Conceptual Framework* will no longer contain references to ordinary activities.

   (c) The existing discussion of income refers to revenue and gains, and the existing discussion of expenses refers to expenses and losses. We do not propose to include any such discussion in the elements chapter, because gains and losses are not defined elements. We also do not plan to include such a discussion in the presentation and disclosure chapter because the terms have not formed part of the IASB's thinking on the issue. We think it may be helpful to include in the elements chapter examples of different types of income and expenses, but without giving the impression we are trying to define distinct categories.

(d) We also plan to explain in the Basis for Conclusions that the removal of the existing material from the elements chapter as discussed in (a)-(c) above is not intended to change current practice. Rather the material does not seem very helpful in a chapter on elements.

6. The staff recommend changing the existing discussion in the elements chapter as discussed in paragraph 5.

Recalculation of amounts

7. Paragraph 7.36 of the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (the 'Discussion Paper') suggested:

> In setting disclosure guidance in IFRSs, the objective is not to have entities provide information that enables a user of financial statements to recalculate the amounts recognised in the primary financial statements[1]…

8. Only a few respondents to the Discussion Paper commented on that suggestion. Some of them supported the proposed guidance and agreed that it should be included in the *Conceptual Framework*. Others, including a user representative group, did not support that suggestion and requested that it is not included in the *Conceptual Framework*. They stated that information that enables a user to recalculate the amounts in financial statements could be useful in making economic decisions and expressed a concern that the proposed guidance could be used as the basis for not including useful disclosures in the financial statements.

[1] The Discussion Paper suggested that the primary financial statements are the statement(s) of profit or loss and other comprehensive income, the statement of financial position, the statement of cash flows and the statement of changes in equity. The IASB has tentatively decided not to retain the notion of 'primary financial statements'.

9. The staff note that the objective of disclosure guidance in Standards is currently being considered in the *Principles of Disclosure* research project in the Disclosure Initiative. Given the mixed feedback received on the suggestion in the Discussion Paper as well as the fact that this topic is currently being researched in the *Principles of Disclosure* research project, the staff recommend that the forthcoming *Conceptual Framework* Exposure Draft should not include a statement similar to the above extract from the Discussion Paper. Rather, the Disclosure Initiative should consider whether facilitating such recalculations should be an objective of disclosure.

The role of matching in the recognition of assets and liabilities

The issue

10. The IFRS Interpretations Committee (the 'Interpretations Committee') recently considered a question that it thought highlighted an underlying tension between the notion of matching costs with revenues and the definition of an asset. It has asked the IASB to consider this possible tension in the *Conceptual Framework* project.

Background

11. In some jurisdictions, companies that hold specific types of production asset (such as telecommunications and gas distribution networks) are subject to a levy. The levy is linked to the existence of the production assets at a given date each year, typically 1 January. Applying IFRIC 21 *Levies*, the obligation to pay the levy is recognised as a liability on the given date. Two companies asked the Interpretations Committee to clarify whether the cost should be recognised as an asset or an expense. Amongst other things, the companies asked whether the matching principle in IAS 18 *Revenue* provides an adequate basis for recognising an asset. Paragraph 19 of IAS 18 states that:

> Revenue and expenses that relate to the same transaction or other event are recognised simultaneously; this process is commonly referred to as the matching of revenues and expenses.

12. The Interpretations Committee considered this matter at its September 2014 meeting. It noted that it had discussed the accounting for costs that arise from recognising the liability for a levy when IFRIC 21 was developed. At that time it had considered whether such costs would be recognised as an expense, a prepaid expense or as an asset recognised in accordance with IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*. The Interpretations Committee had decided not to provide guidance on this matter at that time because it could not identify a general principle for accounting for the costs side of a levy-based transaction.

13. In the light of this previous decision, the Interpretations Committee concluded in September 2014 that it was unlikely that it would reach consensus on how the costs of this particular levy on production assets should be recognised. It also noted that it would not be efficient to give case-by-case guidance on individual fact patterns.

14. Consequently, the Interpretations Committee tentatively decided not to add this issue to its agenda.

15. The Interpretations Committee thought, however, that these submissions raised a broader issue concerning annual costs that are incurred irregularly over the year. In its view, a discussion of these types of costs highlighted an underlying tension between the notion of matching costs with revenues and the definition of an asset.

16. The Interpretations Committee asked the *Conceptual Framework* team to consider this question.

Staff analysis

References to matching in the existing Conceptual Framework

17. The existing *Conceptual Framework* refers to the role of matching in the recognition of expenses. It starts by noting that the recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or decrease in assets.[2] (This outcome is a consequence of defining income and expenses by reference to increases and decreases in assets and liabilities.)

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[2] Paragraph 4.49.

18. The *Conceptual Framework* goes on to say that:

> 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.[3]

19. This last sentence is consistent with the general concept that only items that meet the definition of an element are recognised in the statements of financial position and performance. The general concept is embodied in the description of recognition in the existing *Conceptual Framework*:

> Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition set out in [the existing *Conceptual Framework*].[4]

References to matching in revenue Standards

20. IAS 18 requires entities to apply a matching process without explicitly requiring the resulting balances to meet the definition of an asset or a liability. However, IAS 18 will be superseded by IFRS 15 *Revenue from Contracts with Customers* for annual reporting periods beginning on or after 1 January 2017. IFRS 15 makes no reference to matching, and clarifies that fulfilment costs (ie costs to fulfil a contract with a customer) are eligible for recognition as assets only if they

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[3] Paragraph 4.50.

[4] Paragraph 4.37.

give rise to resources that will be used in satisfying performance obligations in the future and are expected to be recovered. The Basis for Conclusions accompanying IFRS 15 explains that those requirements ensure that only costs that meet the definition of an asset are recognised as such.[5]

Tentative decisions in Conceptual Framework project

21. A few respondents to the Discussion Paper suggested that the existing *Conceptual Framework* 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. A few respondents suggested that the revised *Conceptual Framework* should at least provide a rationale for this approach and describe its relationship with the process commonly referred to as matching (as the existing *Conceptual Framework* does in paragraph 4.50).

22. The IASB discussed these comments in May 2014.[6] It tentatively decided that the *Conceptual Framework* should continue to define income and expenses by references to changes in assets and liabilities. It noted that this approach would not pre-determine which assets and liabilities should be recognised, how they should be measured and how income and expenses should be aggregated, analysed and presented.

23. The IASB has also reached tentative decisions that acknowledge the need to consider mismatches in deciding whether to recognise and how to measure an item that *does* meet the definition of an asset or a liability:

    (a) <u>regarding recognition</u>: the IASB tentatively decided in May 2014 that the *Conceptual Framework* should describe factors to consider in deciding whether to recognise an asset or liability. Those factors include whether the resulting information would provide a faithful representation. The staff paper presented at that meeting noted that ‘in some cases, recognising an asset or liability may not result in a faithful and understandable representation if a related asset or liability cannot be

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[5] IFRS 15, Basis for Conclusions, paragraph BC308.

[6] Agenda Paper 10C *Elements: Approach to defining income and expense*, May 2014.

recognised'.[7] In such cases, recognising one asset or liability but not a related asset or liability would result in income and related expenses being recognised in different periods.

(b) regarding measurement: the IASB tentatively decided in July 2014 that, when it selects a measurement basis, it should consider the nature and relevance of the resulting information produced in both the statement of financial position and the statement(s) of profit or loss and other comprehensive income. It also tentatively decided to retain the discussion of faithful representation included in the Discussion Paper. Among other things, that discussion had suggested that, 'when assets and liabilities are related in some way, using different measurements for those assets and liabilities can create a measurement inconsistency (sometimes called an 'accounting mismatch'). Measurement inconsistencies can result in financial statements that do not faithfully represent the reporting entity's financial position and performance.'[8]

Staff conclusions

24. In summary, the staff note that:

(a) the IASB has previously tentatively decided that the *Conceptual Framework* should continue to define income and expenses by references to changes in assets and liabilities. Accordingly, the Exposure Draft will carry forward the existing *Conceptual Framework* guidance that, whilst the matching of revenue and directly associated costs is an outcome of recognising changes in related assets and liabilities, it does not allow the recognition in the statement of financial position of an item that *does not* meet the definition of an asset or a liability.

(b) the Exposure Draft will also acknowledge the need to consider mismatches in deciding whether to recognise and how to measure an item that *does* meet the definition of an asset or a liability. The IASB

[7] Agenda Paper 10B *Conceptual Framework—Recognition*, paragraph 19(e), May 2014.

[8] Paragraph 6.22.

has tentatively decided that the desirability of avoiding measurement mismatches may be a factor to consider in deciding whether the information resulting from recognising the asset or liability, or measuring it on a particular basis, will provide a faithful representation of the entity's financial position and performance.

(c) the replacement of IAS 18 by IFRS 15 will eliminate any possible tension between the *Conceptual Framework* and the revenue Standard.

25. Accordingly, in response to the Interpretations Committee request noted in paragraph 16, the staff conclude that the decisions that the IASB has already taken are sufficient to ensure that the revised *Conceptual Framework* will adequately explain the role of matching in IFRS, and will not be in conflict with IFRS 15. The staff recommend that the IASB conducts no further work on this matter.

Summary of recommendations

26. The staff recommendations on the issues in this paper are as follows:

(a) Income should be defined as increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from equity participants.

(b) Expenses should be defined as decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

(c) The discussion of income and expenses in the existing *Conceptual Framework* should be amended as discussed in paragraph 5.

(d) The *Conceptual Framework* should **not** comment on whether the objective of disclosure guidance in Standards includes providing information that enables a user of financial statements to recalculate the amounts recognised in the financial statements. Rather, the Disclosure Initiative should consider whether facilitating such recalculations should be an objective of disclosure.

(e) The IASB should conduct no further work regarding matching. The tentative decisions that the IASB has already taken are sufficient to ensure that the revised *Conceptual Framework* will adequately explain the role of matching in IFRS, and will not be in conflict with IFRS 15.

Question for the IASB
Do you agree with the recommendations in paragraph 26?

Appendix A – Material on income and expenses in existing *Conceptual Framework*

Performance

Paragraphs in existing *Conceptual Framework*		**Staff comment**
4.24	Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share. The elements directly related to the measurement of profit are income and expenses. The recognition and measurement of income and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the entity in preparing its financial statements. These concepts are discussed in paragraphs 4.57–4.65.	Discussion of role of profit or loss in assessing performance will be included in the presentation and disclosure chapter. Discussion of capital maintenance will be moved to measurement chapter.
4.25	The elements of income and expenses are defined as follows:	Revised definitions will be included in elements chapter.
(a)	Income is 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 are 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.	
4.26	The definitions of income and expenses identify their essential features but do not attempt to specify the criteria that would need to be met before they are recognised in the income statement. Criteria for the recognition of income and expenses are discussed in paragraphs 4.37–4.53.	Reference to recognition will be included in elements chapter.
4.27	Income and expenses may be presented in the income statement in different ways so as to provide information that is relevant for economic decision-making. For example, it is common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the entity and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the entity to generate cash and cash equivalents in the future; for example, incidental activities such as the disposal of a long-term investment are unlikely to recur on a regular basis. When distinguishing between items in this way consideration needs to be given to the nature of the entity and its operations. Items that arise from the ordinary activities of one entity may be unusual in respect of another.	Discussion of ordinary activities will not be retained.
4.28	Distinguishing between items of income and expense and combining them in different ways also permits several measures of entity performance to be displayed. These have differing	Discussion of providing information about performance will be included in the presentation and disclosure chapter, but will not include this exact wording.

	degrees of inclusiveness. For example, the income statement could display gross margin, profit or loss from ordinary activities before taxation, profit or loss from ordinary activities after taxation, and profit or loss.	

Income

4.29	The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent.	We do not plan any discussion of revenue or gains, because they are not separate elements. Revenue is defined and discussed in IFRS 15.
4.30	Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as constituting a separate element in this *Conceptual Framework*.	
4.31	Gains include, for example, those arising on the disposal of non-current assets. The definition of income also includes unrealised gains; for example, those arising on the revaluation of marketable securities and those resulting from increases in the carrying amount of long-term assets. When gains are recognised in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. Gains are often reported net of related expenses.	
4.32	Various kinds of assets may be received or enhanced by income; examples include cash, receivables and goods and services received in exchange for goods and services supplied. Income may also result from the settlement of liabilities. For example, an entity may provide goods and services to a lender in settlement of an obligation to repay an outstanding loan.	We plan to include in the recognition chapter a discussion of the various elements recognised in a single transaction.

Expenses

4.33	The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity. Expenses that arise in the course of the ordinary activities of the entity include, for example, cost of sales, wages and depreciation. They usually take the form of an outflow or depletion of assets such as cash and cash equivalents, inventory, property, plant and equipment.	No discussion of the difference between expenses and losses planned, because they are not separate elements.
4.34	Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the entity. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Hence, they are not regarded as a separate element in this *Conceptual Framework*.	
4.35	Losses include, for example, those resulting from disasters such as fire and flood, as well as those	

	arising on the disposal of non-current assets. The definition of expenses also includes unrealised losses, for example, those arising from the effects of increases in the rate of exchange for a foreign currency in respect of the borrowings of an entity in that currency. When losses are recognised in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. Losses are often reported net of related income.	

Capital maintenance adjustments

4.36	The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the income statement under certain concepts of capital maintenance. Instead these items are included in equity as capital maintenance adjustments or revaluation reserves. These concepts of capital maintenance are discussed in paragraphs 4.57–4.65 of this *Conceptual Framework*.	Discussion of capital maintenance will be moved to measurement chapter.