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**REG IASB**

| **Project** | **Conceptual Framework** | | |
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| Paper topic | Draft discussion paper: Elements of financial statements | | |
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# Section 2

# Elements of financial statements

This paper is a very early draft of part of the Conceptual Framework discussion paper. It has been prepared by the staff for discussion by the IASB. Issues discussed and conclusions reached will be subject to change.

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## What does this section cover?

This section discusses:

- What is an asset or liability?
- What are income and expense?
- What should the conceptual framework say about unit of account?

## Why is this section important? What problems will this section help address?

This section addresses the following problems with the existing definitions of assets and liabilities:

- They contain references to expected inflows or outflows of economic benefits. Those references are confusing because some have read them as:
    - importing a notion of probability into the definitions, and into the recognition criteria for assets and liabilities
    - implying that the asset or liability is the ultimate inflow or outflow of economic benefits, rather than the underlying resource or obligation.
- It has been unclear how to apply the existing definitions in some cases.
- Recognition and measurement issues often depend on the unit of account. The existing framework does not discuss how the IASB should determine the unit of account.

## What are the IASB's preliminary views?

- An asset of an entity is a present economic resource controlled by the entity as a result of past events.
- A liability of an entity is a present obligation of the entity to transfer an economic resource as a result of past events.
- An economic resource is an item that is capable of producing economic benefits for the party that controls the item.
- No probability threshold should appear in the definitions of an asset and a liability, and in the recognition criteria for assets and liabilities.
- The Conceptual Framework should not set a probability threshold to determine whether an asset or liability exists in the rare cases when this is uncertain. If existence uncertainty is significant in a particular project, the IASB would decide in that project which threshold, if any, would result in the most relevant information for users. The IASB would also consider how to provide the most faithful representation of the circumstances, and how to make the information provided more complete, verifiable, timely and understandable.
- Income and expense would still be defined as changes in assets and liabilities.
- Determining the unit of account will normally be a standards level decision.
- The selected unit of account must provide relevant information and faithfully represent what it purports to represent.

1. This section deals with the following topics:

    (a) Summary of objectives and qualitative characteristics (paragraph 2)

    (b) Focus on financial statements (paragraphs 3-8)

    (c) Definitions of assets and liabilities (paragraphs 9-39)

    (d) Definitions of income and expense (paragraphs 40-52)

    (e) Other definitions (paragraphs 53)

    (f) Unit of account (paragraphs 54-60).

## Summary of objectives and qualitative characteristics

2. The following is a brief summary of the objective of general purpose financial reporting, and of the qualitative characteristics of useful financial information, as discussed in chapters 1 and 3 of the conceptual framework:

    (a) The objective of general purpose financial reporting[1] is to provide financial information about the reporting entity that is useful to users (existing and potential investors, lenders and other creditors) for decisions about providing resources to the entity.[2]

    (b) What those users find useful is information about the entity's resources and claims against the entity, and about how efficiently and effectively the entity's management and governing board[3] have discharged their responsibilities to use the entity's resources.[4]

    (c) Financial statements and other financial reports provide information about the reporting entity's financial position (its economic resources and claims against the entity). They also provide information about the

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[1] Throughout this discussion paper and the *Conceptual Framework*, the terms *financial reports* and *financial reporting* refer to *general purpose financial reports* and *general purpose financial reporting* unless specifically indicated otherwise.

[2] Paragraph OB2 of the Conceptual Framework. All references are to the Conceptual Framework, unless otherwise stated.

[3] Throughout the Conceptual Framework, the term management refers to management and the governing board of an entity unless specifically indicated otherwise.

[4] OB4

effects of transactions and other events and conditions that change those resources and claims. Both types of information provide useful input for decisions about providing resources to an entity.[5]

(d) If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.[6]

(e) Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.[7]

## Focus on financial statements

3. The *Conceptual Framework* deals with financial reports. This discussion paper deals with financial statements, which are one form of financial reports. The IASB does not plan to address in this project other forms of financial report, such as management commentary, interim financial reports, press releases and supplementary material provided to analysts.

4. Financial statements give information about:

   (a) an entity's financial position (its resources and the claims on the entity), reported in a statement of financial position.

   (b) changes in an entity's resources, and in the claims on the entity. An entity reports separately on the following components of those changes:

      (i) the entity's financial performance, reported in statement(s) of profit or loss and other comprehensive income;

      (ii) changes in the entity's equity, reported in a statement of changes in equity;

      (iii) the entity's cash flows, reported in a statement of cash flows;

[5] OB12, QC2

[6] QC4

[7] QC35

(iv) changes in other assets and liabilities, reported in the notes to the financial statements.

5. Financial statements portray the financial effects of transactions and other events by grouping them into broad classes, the *elements* of financial statements. Elements are the building blocks from which financial statements are constructed.

6. Classifying, characterising and presenting information clearly and concisely makes it understandable.[8] To provide an understandable presentation, each primary statement[9] includes only items that are elements defined for that statement, and totals and sub-totals derived from those elements.

7. The elements are:

   (a) in the statement of financial position: assets, liabilities and equity.

   (b) in the statement(s) of profit or loss and other comprehensive income: income and expense.

   (c) in the statement of changes in equity: income, expense, contributions of equity, distributions of equity, transfers between classes of equity, as well as the opening and closing amounts of equity (or of components of equity).

   (d) in the statement of cash flows: cash inflows and cash outflows, as well as the opening and closing cash balances.

8. Paragraphs 9-39 discuss assets and liabilities, section 5 [Agenda paper 10E(a)] discusses equity and paragraphs 40-53 discuss the remaining elements.

## Definitions of assets and liabilities

9. The elements of the statement of financial position are assets, liabilities and equity. This section discusses the definitions of assets and liabilities, and section 4 [Agenda paper 10D(a)] discusses guidance on those definitions. Section 5 [Agenda paper 10E(a)] discusses the definition of equity.

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[8] QC30

[9] Chapter 8 discusses the primary statements

10. These elements provide users with information about an entity's resources, obligations and other claims against the entity. This is part of the information that users need to assess the entity's prospects for future net cash inflows, and to assess how efficiently and effectively the entity's management have discharged their responsibilities to use the entity's resources.[10]

11. The statement of financial position includes recognised assets and liabilities. To recognise an asset or liability, an entity must answer yes to both the following questions:

    (a) Does something exist that meets the definition of an asset or liability of the entity? (see paragraphs 12-39)

    (b) Does that asset or liability meet the recognition criteria discussed in section 4 [Agenda paper 10D(a)] of this [draft] discussion paper?

12. The existing definitions of assets and liabilities are:

    (a) an asset: 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[11];

    (b) a liability: 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.[12]

13. These definitions have proved over many years to be a useful tool for solving many issues in standard setting. They focus on economic phenomena that exist in the real world (resources and obligations), are relevant to users and are understandable. Nevertheless, the IASB believes that two types of improvement are possible:

    (a) Confirming more explicitly that:

        (i) an asset is a resource (rather than the inflow of economic benefits that the resource may generate).

[10] OB4

[11] 4.4(a)

[12] 4.4(b)

(ii) a liability is an obligation (rather than the outflow of economic benefits that the obligation may generate).

(iii) an asset (or liability) must be capable of generating inflows (or outflows) of economic benefits. Those inflows (or outflows) need not be certain. The probability of those inflows (or outflows) need not reach any minimum threshold before the underlying resource (or obligation) meets the definition of an asset (or liability).

(b) Additions to the guidance supporting the definitions of assets and liabilities, to clarify various matters that have caused difficulties in projects to revise particular standards or to develop interpretations. Section 3 [Agenda paper 10C(a)] discusses suggestions for additional guidance.

14. This paper proposes the following definitions to implement the changes identified in paragraph 13(a):

| | **Existing definitions** | **Proposed definition** |
|---|---|---|
| Asset (of an entity) | 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 | a present economic resource controlled by the entity as a result of past events |
| Liability (of an entity) | 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 present obligation of the entity to transfer an economic resource as a result of past events |
| Economic resource | | a right, or other source of value, that is capable of producing economic benefits, but only for the party that controls it |

15. The following discussion address two aspects of the proposed improvements to the definitions of an asset and a liability:

(i) an asset is a resource and a liability is an obligation (paragraphs 16-19)

(ii) the role of uncertainty (paragraphs 20-39).

### *An asset is a resource and a liability is an obligation*

16. Because the existing definitions refer to expected flows of economic benefits, some readers have sometimes confused the resource (asset) or obligation (liability) with the resulting inflow (or outflow) of economic benefits. Two factors cause this risk of confusion:

    (a) Some readers interpret the term 'expected' as conveying a probability threshold. Paragraphs 20-39 discuss whether the definition should include such a threshold.

    (b) The explicit reference to the flows of economic benefits blurs the distinction between the resource or obligation and the resulting flows of economic benefits. The proposed definition seeks to remove that source of confusion by moving the reference to economic benefits into the new definition of an economic resource. As a further benefit, that proposed change would make the definitions more concise and focused, and show more clearly the parallel between the definitions of an asset and of a liability.

17. The guidance supporting the definition of an asset would note that the asset is the resource, it is not the ultimate future inflow. For example:

    (a) For a call option on an underlying asset, the resource is the right to buy the underlying asset, not the underlying asset. (Similarly, the holder has no obligation to pay the strike price.)

    (b) For a free-standing put option on an asset, the resource is the right to sell the underlying asset, not the sale proceeds. (If the put option is not free-standing but embedded in the asset itself, the option might be viewed as being part of the asset rather than a separate asset. Whether that view is taken depends on the unit of account. Paragraphs 54-60 discuss unit of account.)

    (c) Under a forward purchase contract, the resource is the right to purchase the underlying asset at a future date. The purchaser also has an obligation to pay the consideration. Section 3 [Agenda paper 10C(a)]

of this paper, discusses, among other things executory contracts, including forward contracts.

(d) For pharmaceutical research in progress, the asset is the know-how, not the benefit that will arise if the research is successful (Although the measure of such assets might in some cases be very small, or immaterial, if the likelihood of future cash inflows is remote or the future cash inflow is small, that does not mean that an asset does not exist.)

(e) For a lottery ticket, the resource is the right to participate in the lottery, not the cash prize.

18. In existing practice, some of the economic resources identified above are not typically recognised as assets. The recognition criteria discussed in section 4 [Agenda paper 10D(a)] would determine whether an entity recognises those assets. Moreover, any decision to amend the recognition criteria in any existing IFRS would require the IASB to go through its normal process for adding a project to its agenda, and for developing an exposure draft and an amendment to that IFRS.

19. The existing definitions refer to past events that brought a resource under the entity's control, or that imposed the obligation on the entity. The proposed definition:

(a) retains the term 'present' in the proposed definition of a liability. This emphasises that, to determine whether an asset or liability exists, the key question is whether the entity has an economic resource or obligation at the reporting date. To answer this question, it is not necessary to identify precisely which past event brought the resource under the entity's control or imposed the obligation on the entity.

(b) adds the term 'present' to the proposed definition of an asset. This notion is already implicit in the existing definition. Making it explicit emphasises the parallel with the definition of a liability.

(c) retains in both definitions the phrase 'as a result of past events'. This emphasises the accounting for the past transaction or other event that brought the resource under the entity's control or imposed the

obligation on the entity. By identifying that event, an entity can determine how best to portray that event in its financial statements, for example how best to classify and present income, expense or cash flows arising from that event.

### *Role of uncertainty*

20. In the existing conceptual framework, uncertainty appears to play a role both in the definitions of assets and liabilities and in the recognition criteria:
    (a) the existing definitions include the notion that future economic benefits (or a future outflow of resources) must be 'expected'.
    (b) the existing recognition criteria specify that an asset or liability is recognised if it is probable that any future economic benefit associated with the item will flow to or from the entity.
21. These features of the definitions and recognition criteria have given rise to several questions:
    (a) Are the terms 'expected' in the definitions and 'probable' in the recognition criteria both intended to address uncertainty? If so, what is the relationship between the two terms?
    (b) Is either of these terms intended to convey a requirement that the probability of an inflow or outflow of economic benefits must meet some minimum threshold?
    (c) If the term 'expected' is not intended to convey a minimum threshold, is it used in the mathematical sense of an 'expected value', which refers to a probability-weighted average of the possible outcomes (the mean of a statistical distribution)?
22. In considering the implications of those questions, it is worth distinguishing two forms of uncertainty:
    (a) uncertainty about whether an asset or liability exists (existence uncertainty, see paragraph 23-34).

(b) uncertainty about whether an asset or liability will result in any inflow or outflow (outcome uncertainty, see paragraphs 35-37)?

*Existence uncertainty*

23. In most cases, it is clear whether an entity has an asset or liability, but sometimes it is not clear. Existence uncertainty is present if it is uncertain whether an asset or liability exists. The most obvious example of existence uncertainty is litigation: for example, it might be uncertain whether an entity committed an act that, if committed, obliges the entity to pay a fine.

24. The Framework could stay silent on existence uncertainty, or it could address existence uncertainty in either the definitions of the elements or in the recognition criteria. Because existence uncertainty relates to the existence of an asset or liability, this paper considers it in relation to the definitions. The following questions arise in relation to existence uncertainty:

(a) Should the Conceptual Framework set a probability threshold in relation to existence uncertainty? (paragraph 25)

(b) If the Conceptual Framework does set such a threshold, which threshold should it set? (paragraphs 26-33)

25. Setting an explicit probability threshold in the Conceptual Framework could lead to more consistency in standards-level decisions. On the other hand, the arguments against an explicit probability threshold in the Conceptual Framework are that:

(a) existence uncertainty is rare. There is no need to establish a principle for these few cases.

(b) allowing for judgment is appropriate in principles-based standards.

(c) if existence uncertainty is significant in a particular project, the IASB could decide in that project which threshold, if any, would result in the most relevant information for users in that particular case. The Conceptual Framework could explain this point.

26. If the Conceptual Framework does set a probability threshold for existence uncertainty, the following questions arise:

(a) which threshold should it set? (paragraphs 27-29)

(b) should the same threshold apply in all circumstances? (paragraphs 30-33)

27. Possible probability thresholds include the following:

(a) An entity should consider an item to be asset or liability if it is virtually certain that the asset or liability exists (and is an asset or liability of the entity). As a precedent, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* currently uses this as a recognition criterion for contingent assets. Once it becomes virtually certain that an inflow of economic benefits will arise, IAS 37 treats this item as an asset to be recognised, not as a contingent asset.[13]

(b) An entity should consider an item to be asset or liability if it is probable that an asset or liability exists (and is an asset or liability of the entity). As a precedent, IAS 37 adopts this threshold for provisions. It also states that an outflow of resources or other event is probable if it is more likely than not to occur. (Other IFRSs do not define the term 'probable'.)

28. Some support using virtual certainty as the test in cases of existence uncertainty. They note that the definitions of assets and liabilities are the foundations of financial reporting. In their view, when there is not a high probability that an economic resource or obligation actually exists, reporting an asset or liability would not result in relevant and understandable information and would undermine the confidence of users in the integrity of financial statements.

29. Others support using probable (or more likely than not) as the test in cases of existence uncertainty. They note that existence uncertainty and outcome uncertainty are often related. When it is uncertain whether an asset or obligation exists, there may often also be uncertainty about the outcome that the asset or liability will produce if it does exist. Therefore, supporters of this approach

[13] IAS 37 defines a contingent asset as a possible asset that arises from past events and whose existence will be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the reporting entity. This paper does not propose that the conceptual framework should identify a separate category of 'contingent assets' or 'possible assets'.

believe that inconsistencies may arise if an entity does not recognise an asset or liability when its existence is deemed to be uncertain, but does recognise an asset or liability whose existence is deemed to be certain but whose outcome is uncertain.

30. Some suggest that the Conceptual Framework should set different probability thresholds for different circumstances. For example, some believe that an entity should consider an item to be asset if it is virtually certain that the asset exists (and is an asset of the entity); it should consider an item to be a liability if it is probable that the liability exists (and is a liability of the entity). This is one feature of IAS 37, which sets different recognition criteria for contingent assets (virtually certain) than for liabilities (probable, defined as more likely than not).

31. Those who support different thresholds for different circumstances put forward the following arguments:

    (a) Some believe that at least some users are more concerned about downside risks than upside potential. Setting a higher threshold for assets (or gains) than for liabilities (or losses) would provide earlier warning of items that matter to users more.

    (b) Exercising a degree of caution in conditions of uncertainty would counter management's natural conscious or subconscious bias towards optimism.

32. Others believe that any probability threshold should apply equally in all circumstances. In their view, this achieves neutrality.

33. Some argue that an entity should not report a change in its equity without reasonable evidence. Therefore, they suggest that the IASB should be more willing to conclude that an asset or liability exists if an entity acquired the asset or incurred the liability in an exchange transaction (when a gain or loss would arise from *non-recognition*) than in other circumstances (when a gain or loss might arise from *recognition*). Another way to express this conclusion would be to set a probability threshold for recognising a gain or loss, rather than for recognising an asset or liability. This would treat all gains and losses consistently, but would result in different probability thresholds for the recognition of assets (and liabilities) acquired in different circumstances.

34. Paragraph 38 summarises the IASB's preliminary views on existence uncertainty, in the context of its preliminary views on other aspects of uncertainty.

*Outcome uncertainty*

35. Outcome uncertainty refers to cases where the asset or liability exists, but the outcome is uncertain. Outcome uncertainty arises much more commonly than existence uncertainty. Examples of outcome uncertainty include the following:

    (a) Lottery ticket where the total number of tickets is known, hence the probability of winning is also known. The holder has an asset (the ticket) but does not know whether the ticket will win. (Note also that the issuer is certain that it will make a payment to holders of winning tickets, though it does not know which ticket will win. If a probability threshold is applied, either in the definition or in the recognition criteria, the issuer would reach a different judgement for each individual ticket than it would for the whole pool of tickets.)[14]

    (b) Traded option held. Cash flows will occur if the holder exercises the option (ie if the option is in the money at expiry), or if the holder sells the option. The holder may be able to sell a traded option readily before expiry of the option.

    (c) Untraded option on unlisted equities, for which the terms of the option prohibit transfer to another party. In this case, the holder will receive cash only if the holder exercises the option at exercise.

    (d) Investment in a partnership that does not permit the holder to transfer the investment to another party. In this case, the investor will receive cash only if the partnership makes a distribution, or if the partnership is liquidated, or if the other partners buy out the investor.

    (e) Know-how generated by a research and development (R&D) project. This will generate cash if the project is successful. This case differs from the case of the lottery ticket because (i) the probability of success

[14] The lottery example is included as a simple illustration of the concepts involved. Most real life examples are much more complex.

may be unknown and unknowable (and cannot subsequently be back-tested) (ii) there is a very wide range of possible outcomes.

(f) Shares in an entity whose only activity is carrying out R&D. Few would dispute that shares in an entity generally meet the definition of an asset. On the other hand, if there are concerns about recognising know-how generated by an R&D project, presumably the same concerns would arise for shares in an entity whose only asset is the know-how developed in such a project.

(g) Litigation. The entity will have to pay out cash if it loses the litigation. It may be uncertain whether the entity has an obligation at all until the court determines whether this is the case (existence uncertainty). However, even if the entity has already concluded that it will lose the litigation, it may still be uncertain how much the entity will have to pay (outcome uncertainty).

36. Some suggest that the IASB should retain some probability threshold, either in the definition of the elements or in the recognition criteria, for cases of outcome uncertainty. They think that users will not factor low probability outcomes into their estimates of the amount, timing and uncertainty of future cash flows. Hence, when there is only a small probability of *any* future cash flows—for example, when an entity has given a guarantee that is very unlikely to be called upon— the costs of recognising and measuring the asset or liability may exceed the benefits to users. Further, they think that in some cases there is a wide range of outcomes, including zero, and the probabilities of the different outcomes are unknown and arguably unknowable (eg a highly speculative R&D project or some litigation). In such cases, measures derived from estimates of those probabilities, may, arguably, be neither relevant to users nor verifiable. They believe that retaining a probability criterion would be a practical and inexpensive way to filter these items out.

37. Some would be more willing to recognise an item with an uncertain outcome if the measure of the item can be supported by current market prices, if the item was acquired externally for observable consideration or if failure to recognise the item would lead to a gain or loss.

*Preliminary views on uncertainty*

38. This paper suggests the following:

(a) The definitions of assets and liabilities should not retain the notion that an inflow or outflow is 'expected'. Retaining such a notion might exclude many items that are clearly assets or liabilities, such as many purchased options or written options. The important thing is that there are at least some outcomes in which an economic resource will generate economic benefits, or in which an obligation will result in a transfer of economic resources. Thus, the proposed definition of an economic resource clarifies that an economic resource is *capable* of producing economic benefits. The definitions would not specify a minimum probability threshold. Similarly, it need not be certain that a present obligation will result in a transfer of an economic resource, but that present obligation must *capable* of resulting in a transfer of economic resources. Thus, if an obligation will require a transfer of economic resources only if an uncertain future event occurs (eg a stand ready obligation), that obligation is a liability, as discussed in section 3 [agenda paper 10C(a)].

(b) The Conceptual Framework should not set a probability threshold to determine whether an asset or liability exists in the rare cases when this is uncertain. If existence uncertainty is significant in a particular project, the IASB would decide in that project which threshold, if any, would result in the most relevant information for users. The IASB would also consider how to provide the most faithful representation of the circumstances, and how to make the information provided more complete, verifiable, timely and understandable.

(c) The reference to probability should be deleted from the recognition criteria. Including a probability threshold would lead to a failure to recognise some items (for example, options) that are undoubtedly assets or liabilities but are judged, at a particular time, to have a low probability of resulting in an inflow or outflow of economic benefits. Furthermore, some such items may swing above and below the

threshold as the probabilities change. In the IASB's preliminary view, uncertainty about the ultimate inflow or outflow should not, by itself, determine whether an entity recognises an asset or liability, though it may affect its measurement. Nevertheless, uncertainty may make some rights or obligations so difficult to measure that recognising them might result in information that is not relevant. Section 4 [agenda paper 10D(a)] discusses, among other things, whether to include recognition criteria relating to relevance.

39. Some measurement approaches may create an implicit recognition threshold. For example, if an item is measured at the most likely outcome and the most likely outcome is zero, it will be measured at zero (in effect, the same as not being recognised). Therefore, in considering the outcome of recognition decisions, it is necessary to consider not just the recognition criteria, but also the measure that will be used for items that are recognised.

## Definitions of income and expense

40. The existing Conceptual Framework states that the elements of the statement of comprehensive income are income and expense, defined as follows:

    (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.[15]

41. These elements provide users with information about some of the changes in an entity's resources and obligations. This is part of the information that users need to assess the entity's prospects for future net cash inflows, and to assess how

[15] 4.25

efficiently and effectively the entity's management have discharged their responsibilities to use the entity's resources.[16]

42. Some question whether an expense arises when an entity issues an equity instrument in exchange for services. This question is important for determining how to treat share-based payments (for example share options granted to employees). When an entity acquires an asset in exchange for issuing equity instruments, the entity recognises that asset (if the recognition criteria are met). Similarly, when an entity receives services in exchange for issuing equity instruments, the services received are an asset: when the entity consumes that asset, it recognises an expense. In many cases, an entity consumes that asset immediately; if so, the entity recognises the expense at the same time as it recognises the related increase in equity. The IASB believes that the revised Conceptual Framework should confirm this conclusion, which the IASB reached when it developed IFRS 2 *Share-based Payment*.[17]

43. The IASB has identified few other problems with the existing definition of income and expense (other than some minor drafting changes that may be required, mainly as a result of any changes to the definitions of the other elements).

44. Some have suggested that the revised Conceptual Framework should define different types of income or expense to differentiate:

    (a) revenue from gains, and expenses from losses (see paragraphs 45-48).

    (b) income and expense reported in profit or loss from income and expense reported in other comprehensive income (OCI) (see paragraphs 49-52).

### *Differentiating gains from revenue and expenses from losses*

45. The existing Framework distinguishes two categories of income:

    (a) revenue, which arises in the course of the ordinary activities of an entity; and

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[16] OB12

[17] Basis for Conclusions on IFRS 2, paragraphs BC45-BC53

(b) gains, which represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of the entity.

46. Similarly the existing Framework distinguishes two categories of expense:

(a) expenses that arise in the course of the ordinary activities of an entity; and

(b) losses which may, or may not, arise in the course of the ordinary activities of the entity.

47. The existing Framework notes that:

(a) gains are no different in nature from revenues (they both represent increases in economic benefits); and

(b) losses are no different in nature from expenses (they both represent decreases in economic benefits).

Hence, the Framework does not treat these four categories as four separate elements. However, the Framework does state that gains are usually presented separately from other income and losses are usually presented separately from other expenses. In addition the Framework notes that gains (losses) are often reported net of related expenses (income).

48. If differentiating gains from revenue and losses form expenses is useful, then, arguably, gains and revenue, losses and expenses should each be defined as separate elements. However, to do this it would be necessary to define more clearly the difference between these four items. Among other things, this would require the IASB to define ordinary activities. The IASB believes that distinguishing these four items would not solve any significant accounting problem. Consequently, the IASB intends to leave the discussion of gains, revenue, expenses and losses largely unchanged.

### *Differentiating items in profit or loss from items in OCI*

49. Section 8 [agenda paper 10H(a)] of this draft discussion paper discusses whether and how to distinguish profit or loss from other comprehensive income (OCI).

Some have suggested that the Conceptual Framework could improve the reporting of financial performance by defining separate elements for:

(a) income (expenses) reported in profit or loss; and

(b) income (expenses) reported in OCI.

50. The IASB would have to answer exactly the same questions in defining separate elements of income or expense as in defining separate categories for reporting financial performance (ie when should a change in an asset or liability be reported in OCI and when should it be reported in profit or loss?).

51. However, there are disadvantages to using definitions to distinguish income and expense reported in OCI from income and expense reported in profit or loss.

(a) It may not be a clear way to implement an approach that states when an item *could* be reported in OCI (rather than when it *must* be reported in OCI). Section 8 of this [draft] discussion paper [agenda paper 10H(a)] recommends providing guidance about when an item *could* be included in OCI.

(b) Defining one set of elements for use in profit or loss and a separate set of elements for OCI may not be straight-forward, particularly if the IASB would like to report in OCI only a component of a change in an asset or liability rather than the entire change (for example, that part of the change in the fair value of an asset or liability that arises from changes in interest rates).

52. Consequently, the IASB proposes not to define separate elements of income or expense to describe what should be reported in profit or loss and what should be reported in OCI. Instead, the revised Conceptual Framework would provide presentation guidance addressing this topic.

## Other definitions

53. The existing Conceptual Framework does not define separate elements for the cash flow statement and for the statement of changes in equity. This [draft]

discussion paper proposes that the Conceptual Framework should define elements for each primary statement. These elements would be:

(a) Cash flow statement:

    (i) Cash receipts

    (ii) Cash payments

(b) Statement of changes in equity:

    (i) Contributions to equity

    (ii) Distributions of equity

    (iii) Transfers between classes of equity

(c) This [draft] discussion paper does not propose definitions for these elements. The IASB does not foresee great difficulties in developing definitions of these elements for inclusion in an exposure draft of the revised Conceptual Framework.

## Unit of account

54. In order to recognise and measure assets and liabilities in the financial statements in a way that provides useful information to existing and potential investors, lenders and other creditors it is usually necessary to aggregate individual resources, or other rights, and obligations. The level of aggregation required is usually referred to as the unit of account.

55. For example, as discussed in section 3 [agenda paper 10C(a)], ownership of a physical asset such as a machine comprises several rights (the right to use the asset, the right to sell the asset, the right to pledge the asset and any other rights conferred by legal title to the asset). Although, in principle each of these rights is capable of being a separate asset, combining these rights into a single unit of account and recognising a single asset (the machine) will in many cases provide the most relevant and understandable information to the users of the financial statements. In other cases (for example when the machine has been leased), recognising (or derecognising) some of the rights separately may provide a more faithful representation of the financial position of the entity.

56. The unit of account used can also affect the measurement of recognised assets and liabilities. For example,

(a) A different measure of an equity investment may be obtained if:

(i) the value of an individual share is measured and multiplied by the number of shares; or

(ii) the value of the total equity investment is measured.

(b) In determining whether an asset is impaired, a different conclusion may be reached if the asset is reviewed for impairment in isolation or as part of a group of assets. This is because, within a group, gains on some assets may be offset against losses on other assets, whereas if they were reviewed in isolation the gains would be ignored.

(c) If assets or liabilities are measured by reference to the most likely outcome of uncertain future cash flows, that outcome may differ depending on whether it is determined for each asset or liability individually, or for a group of assets or liabilities.

57. Determining which unit of account will provide the most useful information to existing and potential investors, lenders and other creditors will normally be a decision for projects to create or revise particular standards, rather than a decision that can be resolved conceptually for a broad range of standards. In making that decision, the IASB will consider the qualitative characteristics of useful information. The selected unit of account must:

(a) provide relevant information. Information about individual rights or obligations may not be relevant if those rights or obligations cannot be, or are unlikely to be, the subject of separate transactions or if they would expire in different patterns.

(b) faithfully represent what it purports to represent. Grouping unrelated assets or liabilities together, in order to measure them, may not faithfully represent the financial position or performance of an entity

In addition, the costs associated with the selected unit of account must not exceed the benefits. In general, the costs associated with recognising and measuring items will increase with the level of disaggregation.

58. In some cases the IASB may not need to specify a particular unit of account (for example, if the unit of account is unlikely to affect the recognition or measurement of assets or liabilities). However, in other cases, the IASB may decide that it needs to specify a unit of account to ensure comparability either between entities or over time. The selected unit of account must also provide information that is understandable.

59. In some cases, the IASB may conclude that the business model plays a role in determining the most relevant unit of account.

60. The unit of account for recognition and measurement will normally be the same. However, in some situations the IASB may decide that a different unit of account should be used for recognition and measurement.

## Questions for respondents

61. Do you agree:

    (a) with the proposed definitions of an asset and a liability, and with the proposed supporting definition of an economic resource?

    (b) that no probability threshold should appear in the definitions of an asset and a liability, and in the recognition criteria for assets and liabilities?

62. Do you:

    (a) agree that the existing definitions of income and expense should be left largely unchanged? Income and expense would still be defined as changes in assets and liabilities.

    (b) have any other comments on the definitions of income and expense, or on the other items listed in paragraph 53?

63. Do you:

    (a) agree that determining the unit of account will normally be a standards level decision?

    (b) agree that the selected unit of account must provide relevant information and faithfully represent what it purports to represent?

(c) support the discussion of the unit of account in paragraphs 54-60? Should the Conceptual Framework provide further guidance on the unit of account? If so, what sort of guidance would be useful?