

# Getting a Better Framework

## THE ASSET/LIABILITY APPROACH

### Bulletin



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This Bulletin is issued by the European Financial Reporting Advisory Group (EFRAG), the French Autorité des Normes Comptables (ANC), the Accounting Standards Committee of Germany (ASCG), the Organismo Italiano di Contabilità (OIC) and the UK Financial Reporting Council (FRC). The publication of Bulletins is part of their strategy to stimulate debate within Europe, and keep European Constituents informed as the IASB develops its Conceptual Framework. Any views expressed are tentative; the issuing bodies will develop their final views after considering responses to this Bulletin and other developments in the debate.

Further information about the work of the project partners, including regular newsletters, is available on the partners' websites.

*We welcome views on any of the points addressed in this Bulletin. Specific questions are given at the end of the document. These comments should be sent by email to [commentletters@efrag.org](mailto:commentletters@efrag.org) or by post to*

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*So as to arrive no later than 15 November 2013.*

*All comments will be placed on the public record unless confidentiality is requested.*

- 1 One feature of the IASB Conceptual Framework that has attracted some controversy is that it defines assets and liabilities first: the definitions of equity, income and expenses rely on those definitions. The consequence is that income for a period equals changes in net assets (apart from transactions with shareholders). This is referred to in this Bulletin as ‘the asset/liability approach’, also called ‘the balance sheet approach’. The current definitions are set out in the panel.
- 2 The IASB Discussion Paper *A review of the conceptual framework for financial reporting*, issued in July 2013, proposes the following revised definitions:
  - (a) An asset of an entity is a present economic resource controlled by the entity as a result of past events;
  - (b) A liability of an entity is a present obligation of the entity to transfer an economic resource as a result of past events; and
  - (c) An economic resource is a right, or other source of value, that is capable of producing economic benefits.
- 3 No significant changes to the definitions of income and expenses are proposed, so the relationship between the definitions of the elements will remain as at present.

## The elements: Definitions as in the IASB’s Conceptual Framework (2010)

- 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.
- 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.
- 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.
- 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 Some question whether the asset/liability approach is appropriate. They are concerned that it has implications that impair the quality of financial reporting. The purpose of this Bulletin is to consider whether these implications necessarily follow from the adoption of the asset/liability approach. The issues addressed are:
- Whether adoption of the asset/liability approach implies that the presentation of relevant information on income will be subordinated to information on assets and liabilities (paragraphs 5 to 10);
  - Whether the asset/liability approach provides an appropriate basis for allocating income and expenses to a reporting period (paragraphs 11 to 19);
  - Whether the asset/liability approach requires that all assets and liabilities are recognised, including some that are of limited relevance (paragraphs 20 to 22); and
  - Whether the asset/liability approach implies that all assets and liabilities are to be stated at fair value (paragraphs 23 to 28).

## IMPORTANCE OF INFORMATION ON INCOME

- 5 It is sometimes suggested that the asset/liability approach does not provide an adequate basis for financial reporting, which should be focused on the creation of value: financial statements should explain how, and how efficiently, value is generated and reflected in cash flows. Users of financial statements are primarily interested in information on earnings, which shows the benefit to shareholders arising in the accounting period, and may be used as a proxy for 'normalised' cash flow. Information on the returns earned by the business is also important for accountability/stewardship purposes<sup>1</sup>, as it is necessary for an assessment of the efficiency and effectiveness with which management have used their resources.<sup>2</sup> Some conclude that the key element in the Framework should be that of income, and that the definition of other elements should be dependent on that.
- 6 In particular it is sometimes suggested that the asset/liability approach implies that the income for a period is simply the change in the amount at which assets and liabilities are reported - usually referred to as comprehensive income. Some take the view that the amount of comprehensive income is not usually a particularly meaningful indicator of the performance of the entity as it is the aggregate of a large number of diverse transactions and events.
- 7 It seems, however, that at the least in the view of some standard-setters who have adopted it, the asset/liability approach is compatible with attaching significant importance to the income statement. Before the revisions made in 2010, the FASB *Concepts Statements* stated that "the primary focus of financial reporting is information about an enterprise's performance provided by measures of earning and its components". The Basis for Conclusions to Chapter 1 of the IASB's Framework, which was published in 2010, states that "the Board concluded that to designate one type of information as the primary focus of financial reporting would be inappropriate". And the Discussion Paper states that "No primary financial statement has primacy over the other primary statements and they should be looked at as a group."
- 8 One justification for starting with definitions of assets and liabilities is that it is not possible to define a change, without defining what it is that has changed. Therefore, assets and liabilities must be defined before changes in them. However, some are unconvinced by this argument: they note that it assumes that income and expenses are to be defined as 'changes', and that definitions of assets and liabilities include notions of future inflows/outflows, and hence income and expense.
- 9 Supporters of the asset/liability approach often contend that starting with definitions of assets and liabilities does not imply that the balance sheet is the most important financial statement. An analogy may be drawn with games: what is of most interest is the result of a match and the quality of play. However, the rules (which usually attract little comment) must be established and agreed, before a match can be played.

<sup>1</sup> There is also a Bulletin on accountability/stewardship.


<sup>2</sup> An assessment of return must take into account the risks incurred in order to achieve them.

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- 10 The reporting of financial performance is unquestionably one of the most important issues in financial reporting. Another Bulletin in this series will discuss how it should be addressed in the Framework. For the present consideration of the asset/liability approach, it is sufficient to note that, according to the supporters of the asset/liability approach, it does not conflict with the development of sound thinking on performance, including the reporting of components of comprehensive income and not merely the aggregate amount. Indeed, the IASB has already done considerable work in this area, and it has not been suggested that this is inconsistent with its Framework.



## ALLOCATING INCOME AND EXPENSES TO A REPORTING PERIOD

- 11 The Framework notes that accruals accounting seeks to depict the effect of transactions and other events in the periods in which those effects occur. It is therefore necessary for the Framework to address how to determine in what period the income or expense from a transaction or event should be recognised.
- 12 One approach to this question, which would not rely on the asset/liability approach, is through matching. The idea of matching is that income and expenses are recognised in the accounting period to which they relate. Income and expenses that relate to a future period are deferred and reported in the balance sheet. For example, under a matching approach, a gain or loss arising on the repurchase of debt might not be reported in the period of the repurchase, but deferred and recognised over the remaining period of the debt.
- 13 Supporters of this approach believe that it prevents the recognition of unrealised gains in income, which they claim would be inappropriate and not reflect economic reality. In their view, the matching approach solves a problem that can arise under the asset/liability approach. They would suggest that the process should be the reverse: deferral should be justified in principle, and the reported result should be the consequence of applying that principle.
- 14 Critics of a matching approach may take the view that it does not directly address the question of how to decide to what period a transaction relates. Some would go as far as to suggest that in some cases matching may start from the premise that a particular transaction should (or should not) affect the income for the current period, and then selects the accounting treatment that gives that result. Matching, according to them, would therefore not be the basis for reliable financial reporting.
- 15 In their view, the asset/liability approach provides greater clarity as income or expense is deferred only if the deferral represents an asset or a liability—that is, there is a right to a future inflow of benefit or an obligation for a future outflow.

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- 16 Furthermore, they argue that the asset/liability approach ensures that only economic rights and obligations are reflected in the balance sheet. In contrast, under a matching approach, the balance sheet may contain deferred income and expenses that do not correspond to any current economic rights and obligations, but are merely the consequence of the accounting applied.
  - 17 Some claim that the asset/liability approach has led to significant improvements in financial reporting. Prior to its adoption, some income and expenses that were considered not to relate to the reporting period were either not recognised at all or amortised over periods of doubtful relevance. For example, pension deficits were not recognised, and foreign exchange differences were sometimes deferred on the basis that the movement was considered certain to reverse.
  - 18 The Appendix contains a discussion of some further examples in order to assist an assessment of the claim that the asset/liability approach can provide a basis for the development of sound accounting standards.
  - 19 Some others would take the view, that even if the Framework adopts an asset/liability approach, the effect on income of proposed accounting treatments should be fully addressed in the development of standards. For example, if it appears that a 'day one' profit or loss might emerge on the acquisition of an asset, it should be considered whether doing so would reflect economic reality, or whether the proposal should be reconsidered. This would be consistent with the view referred to above that no primary financial statement has primacy over the other primary statements.





## PROLIFERATION OF ASSETS AND LIABILITIES

- 20 A possible concern is that the asset/liability approach would require all assets and liabilities to be reported in financial statements. This would extend beyond those that have arisen from the purchase of assets out of the entity's capital, and might include innumerable rights (including internally-generated intangible assets) and obligations (including some that are unlikely to require a payment in settlement). Some fear that identifying and reporting such assets and liabilities in the balance sheet could impose a significant burden on preparers with little benefit to users. It may also be argued that many of these assets and liabilities, and changes in them, are not relevant to an understanding of the performance of the business, or that relevant information on them might be given more simply and cost-effectively.
- 21 Such a proliferation of assets and liabilities is not the inevitable result of the asset/liability approach. The outcome will depend on other aspects of the Framework—in particular the definitions of assets and liabilities and recognition criteria. The Discussion Paper proposes that relevance is a key consideration in determining which assets and liabilities are to be recognised. Furthermore, the Discussion Paper states that assets or liabilities need not, or should not, be recognised if no measure of the items would result in their faithful representation.
- 22 Some are concerned that the tentative decisions by the IASB may increase the risk that assets and liabilities will be recognised that are of doubtful relevance. They note that the new definitions of assets and liabilities seem more remote from inflows and outflows of economic benefits than the current definitions. They also note that the existing recognition criteria require that if an element is to be recognised, a future flow of benefit to or from the entity must be probable: the Discussion Paper proposes that this will be deleted. Those who take this view note that the Framework has always required that financial statements should be relevant: elevating relevance into part of the tests for recognition may therefore, they fear, have little impact and would not provide an effective replacement for the probability requirement.



## FAIR VALUE

- 23 Some believe that including in income changes in the fair value of assets and liabilities that are used in an entity causes a misunderstanding of the underlying performance of the entity. Furthermore, they believe that market-based valuation is the inevitable consequence of the asset/liability approach, which they therefore oppose, claiming that it unavoidably relies on abstract concepts and therefore generates complex valuations, thus less relevance and considerable market uncertainty, triggering in turn volatility and procyclicality, far from the entity's performance. The same explain that, in their view, accounting is primarily about reflecting transactions, which consist in flows, and as a result they cannot understand how starting with assets and liabilities would be relevant.

- 24 For some, subtotals within the statement of comprehensive income may be proposed as a way to meet these concerns, so that under an asset/liability approach relevant performance reporting can be provided. Some others, however, consider that inadequate. In their view, the bottom line of a statement of performance is a key line that users find highly significant, and would expect to have a greater importance than a mere subtotal. This was the view expressed by many respondents to the EFRAG PAAinE *Discussion Paper on Performance Reporting* issued in March 2009.
- 25 Others argue that the Framework requires that separate consideration is given to the definition of elements, the recognition criteria and the selection of a measurement basis. Hence the selection of a measurement basis is not predetermined by the definition of the elements: the asset/liability approach is consistent with the use of a number of measurement bases (or combination of bases). For example, the approach being developed by the IASB to revenue recognition is, arguably, consistent with the asset/liability approach, yet it uses an entry value (transaction price) to measuring performance obligations, rather than fair value, which is defined as an exit value. Therefore, they do not believe that the only way to provide information on future cash flows is by using fair value: other measurement bases are possible, and the balance sheet is not the only basis to assist users in forecasting future cash flows.
- 26 They note that it is, however, the case that under the asset/liability approach the measurement basis affects the amount of income reported in subsequent periods. It may be noted that the Discussion Paper proposes that the IASB should consider, when selecting the measurement basis, what information it will produce in BOTH the statement of financial position and the statement(s) of profit or loss and OCI.
- 27 The IASB has also discussed whether there may be circumstances where the most relevant basis for the balance sheet differs from that which is most relevant for profit or loss. One development of this approach would be to report assets and liabilities at fair value in the balance sheet, the change in amortised cost in profit or loss, and the balance of any change in other comprehensive income.
- 28 However, those who oppose the asset/liability approach because they believe that measurement of assets and liabilities should not be the starting point for financial reporting, cannot be satisfied by the IASB's preliminary views. Others welcome the IASB's early directions as promising for a sound application of the asset/liability approach.



## Our tentative views

- 29 We support the IASB’s conclusion that “No primary financial statement has primacy over the other primary statements and they should be looked at as a group”. A consequence of this is that the effect on income of proposed accounting treatments should be fully addressed in the development of standards.
- 30 Many of the issues raised by those who have reservations about the asset/liability approach are valid. The Framework should provide satisfactory principles for the reporting of financial performance: that assets and liabilities are not recognised where the benefits of doing so outweigh the costs, and that assets and liabilities are stated at fair value only if it is appropriate. We will continue to seek to influence the development of the Framework to ensure that its treatment of these issues is satisfactory. It is particularly important that the representation of performance should not be obscured by changes in asset and liability values that are not part of performance: the implications for reported performance should be explicitly addressed in the development of all proposed accounting treatments.
- 31 EFRAG, the ASCG, the OIC and the FRC do not think that the asset/liability approach—defining income and expenses in terms of changes in assets and liabilities—in itself prevents satisfactory approaches to these issues being developed. Also, in many cases, it seems to provide greater clarity for the development of accounting standards. The ANC does not share this view and considers that concerns and arguments developed in many parts of this Bulletin (paragraphs 5, 6, second part of 8, 12, 13, 23, second part of 24 and first part of 28) are important enough to call for a different approach: indeed performance cannot be appropriately represented in the accounts if primacy continues to be given to the balance sheet.

# Questions for respondents

**We would welcome views on any of the points addressed in this Bulletin.**

**In particular:**

- (i) Are there any arguments for and against the asset/liability approach - defining income and expenses in terms of changes in assets and liabilities - that are not discussed in the Bulletin?**
- (ii) Do you believe that the asset/liability approach should be retained or revised? If changed, what alternative would you propose?**
- (iii) Do you have any other comments on this Bulletin?**

**Comments should be addressed to: [commentletters@efrag.org](mailto:commentletters@efrag.org), so as to be received before 15 November 2013.**

## Appendix: examples

The following discusses a number of accounting issues and considers the possible implications of the asset/liability approach for their accounting treatment. It is intended to assist in a consideration of whether the asset/liability approach provides a satisfactory basis for the development of accounting standards.

### Revenue recognition

- A1 An issue that arises in the context of revenue recognition is the accounting treatment that should be used when a customer makes a payment before goods are delivered (or services are rendered). Many would agree that the payment should be recognised as revenue in the period in which it is earned, i.e. when the company performs what is required to earn the payment. Before then, the payment should be credited to deferred revenue.
- A2 Some who favour the asset/liability approach have argued that deferred revenue does not represent a liability, and conclude that the income should be recognised on receipt, after allowing for the cost of fulfilling the order. However, the IASB has concluded in its project on revenue recognition that unfulfilled performance obligations are liabilities. It has also agreed that these obligations are measured at the transaction price. The result is that revenue is recognised in the period in which performance takes place. It can be argued that this is consistent with an asset/liability approach.

### Major overhaul costs

- A3 Some long-lived assets such as ships, aircraft and blast furnaces require significant overhauls at intervals every few years. It is generally agreed that the cost of such overhauls should not be treated as an expense of the year in which the overhaul is carried out but rather as an expense of the periods in which the asset is operated.
- A4 In past practice this was achieved by accruing a liability for the cost of such overhauls. However, this is arguably incompatible with an asset/liability approach because the accrual does not represent a liability. Reflecting this view, IAS 37 prohibits such accruals. However, a similar pattern of expense recognitions is obtained under IFRS by reflecting the need for overhauls in depreciation, and by capitalising the cost of overhauls when they are carried out.

### Transaction costs

- A5 Transaction costs include expenses such as commissions, legal fees or tax that are sometimes paid on the acquisition of an asset. Some take the view that these costs should be treated as part of the cost of the asset. Others consider that they should be reported as an expense of the period in which the asset is acquired: it may be suggested that this is consistent with the asset/liability approach as the costs relate to the transaction rather than the asset.
- A6 The current treatment under IFRS is inconsistent. Under IAS 16 they are treated as part of the cost of an asset, but under IFRS 3 they are treated as expenses in the period in which they are incurred. Transaction costs are excluded from the concept of fair value as set out in IFRS 13: that standard requires that such costs are accounted for in accordance with other IFRS.

## Regulatory assets

- A7 An entity which is subject to regulation that limits the prices it is allowed to charge its customers may incur costs that would normally be treated as an expense of the period in which they are incurred. However, if regulation permits the entity to increase its prices in subsequent periods so as to recover the cost, the accounting treatment is questionable. If the asset/liability approach is adopted and it is concluded that there is no asset (which may be because the entity has no right to make sales at the increased price, only to charge that price to those who agree to pay it) the costs would be reported as an expense when incurred, and income for subsequent periods would be increased, reflecting the increased charges made on customers. Whilst some would agree that this is appropriate, considering that this treatment properly reflects the economic events, others would not. Those favouring deferral of the costs might consider that doing so provides an amount of income for each period that provides a better basis for the assessment of future income.

## Share-based payment

- A8 IFRS 2 requires that an expense is recognised for the issue of employee share options. This may be seen as inconsistent with the asset/liability approach as the issue of such options does not result in any change to the entity's assets and liabilities.
- A9 The contrary view is that the asset/liability approach is consistent with the recognition of an expense for employee share options. On this view, the entity receives an asset—employee services—in exchange for the issue of the options. Just because that asset is immediately consumed does not justify omitting the expense of consuming those services. It may be noted, however, that this analysis suggests that the measurement of the transaction should be at the value of the consideration received, and some would argue that if the value of equity instruments issued exceeds the consideration, it is also necessary to reflect the excess as an expense. It is not clear how this would be reconciled with the asset/liability approach.



