Accounting in Europe ›

Volume 7, 2010 - Issue 2

Refereed articles

On the Definitions of Income, Expenses and Profit in IFRS

Richard Barker

Pages 147-158 | Published online: 24 Nov 2010

Cite this article https://doi.org/10.1080/17449480.2010.511892

Abstract

This paper makes two contributions. First, it demonstrates that income and expenses are incorrectly defined in the IASB's conceptual framework, and it proposes alternative definitions. Second, the paper identifies that, in part as a consequence of these incorrect definitions, and in part because there are two, conflicting concepts of profit in IFRS, there is, first, no definition of profit in the Framework and, second, inconsistency and needless complexity in the concept of profit in IAS 1. The issues raised in this paper contribute to the current IASB projects on the conceptual framework and on financial statement presentation.

Acknowledgements

The author is grateful to Anne McGeachin and Geoff Whittington, for valuable comments and discussion, and to the editor and reviewers for helpful suggestions.

Notes

The same logic is fundamental to the Modigliani–Miller theorem in financial economics.

Revenue and gains are subsets of income. Hence, for example, revenue could be defined, consistently with the Framework, as ‘a particular type of increase in economic benefits that arises in the course of ordinary activities in the form of inflows or enhancements of assets or decreases in liabilities and results in an increase in equity’ (DRSC, EFRAG and CNC, 2007).

The same is true for US GAAP (FASB, 1984, 1985).

For example, expenses under Definition 2 would be: Expenses are decreases in equity, excluding distributions to equity participants.

There is a potential confusion in terminology here, which is that Hicks actually uses the term ‘income’ to refer to net income. Hence income for Hicks corresponds, in the lexicon of accounting, to profit and not to income.

The Framework's division of income between revenue and gains also finds its counterpart in Hicks. Specifically, Hicks' second definition of profit addresses the sustainability of the profit stream, for which revenue is directly relevant but gains are only indirectly relevant: ‘The income which is relevant to conduct must always exclude windfall gains; if they occur, they have to be thought of as raising income for future weeks (by the interest on them) rather as entering into any sort of effective income for the present week.’

Instead, IAS 1 (para. 88) requires simply that ‘an entity shall recognise all items of income and expense in a period in profit or loss unless an IFRS requires or permits otherwise’ (italics added).

There is again a connection here with Hicks, whose third and final definition of profit is expressed in real terms, thereby implicitly making the distinction between profit and capital maintenance.

The Framework does not express a preference for either financial or physical capital maintenance, and in principle it allows either.

IAS 1's Basis for Conclusions suggest that the IASB is actually willing but unable.

The term ‘other reserves’ is used here to mean reserves relating to other comprehensive income, as defined in IAS 1.

In this definition, ‘transactions with owners in their capacity as owners’ replaces ‘contributions from equity participants’, presumably because ‘transactions’ embraces both contributions and distributions, and because equity participants could transact in alternative roles, such as that of employees. If profit is defined simply as income less expenses, then both of these definitional complexities go away, enabling a less wordy definition.

Interestingly, it is defined correctly as a change in equity rather than as a change in net assets.

This is the case made by those IASB members dissenting to IAS 1. This position is also, of course, consistent with residual income valuation (Ohlson, 1995).

It might also be noted that the term total is redundant given that the term comprehensive is also in use.
