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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **18 October 2006, London**

Project: **Conceptual Framework**

Subject: **What is an element? What is its significance to us? (Agenda Paper 9)**

Introduction

1. The Boards started their deliberations of the elements phase of the project (Phase B) by focusing on the asset definition (Milestone I) and most recently on options over assets (Milestone II). Other milestones for Phase B are:

- effect of uncertainty (III)
- liability definition (IV)
- liabilities and equity (V)
- unit of account (VI)
- recognition (VII)
- derecognition (VIII)
- other elements (IX) (see paragraph 2)
- Phase B documents (X) (steps for processing PV, ED, and final).

2. At the April 2006 joint meeting, the staff noted that "a new milestone entitled "Other Elements" has been added to Phase B with two broad issues: (a) to

identify and define missing elements and (b) to converge existing elements".[1] Examples of potentially missing elements would include those for a statement of cash flows. However, before considering the issues of identifying and defining potential missing elements or converging the existing definitions of elements, we need to be clear about what an element is.

3. The staff thinks that would serve as a useful underpinning in (a) identifying potential missing elements, (b) considering how to converge existing elements, and (c) addressing issues relating to the definitions of liability and equity. In November, the staff plans to begin the Board discussions of two cross-cutting issues for the Milestone V on the liability and equity distinction. Those issues are:

   a. EL.25: Should there be a distinction between liabilities and equity?

   b. EL.26 Should there by only two elements, eg why not three – debt, equity and "dequity"?

   In essence, Issue EL.25 asks whether there should be only one element or two on the right-hand side of the statement of financial position, while Issue EL.26 asks whether there should be two or three (or possibly more).

4. At the October meeting, the Boards will be asked to discuss the meaning of an *element* and its significance to the Boards so that we may have a clear understanding of the intended use of that term. This paper will serve as the basis for that discussion. It is divided in three sections:

   a. What is an *Element*?

   b. What are the Main Classes of Elements?

   c. How Many different Elements should Be Defined?

Staff Recommendations

5. In summary, staff recommendations are below:

   a. The elements definitions should continue to define the economic things (resources and claims) and changes in them that pertain to a particular entity. (Those things and changes in them are also called "stocks" and "flows.")

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[1] Joint Agenda Paper 5B, FASB Memorandum 28, paragraph 17

b. The elements definitions should focus on the most basic of the real-world economic phenomena that pertain to an entity. Distinctions that are made for purposes of financial statement display or presentation go beyond the notion of basic elements.

What Is an *Element*?

6. The IASB's *Framework* and FASB's Concepts Statement 6, *Elements of Financial Statements*, do not define the term *elements* per se. Instead, both define *elements of financial statements*:

   a. **IASB**: Financial statements portray the effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. [Paragraph 47]

   b. **FASB**: Elements of financial statements are the building blocks with which financial statements are constructed – the classes of items that financial statements comprise. *Elements* refer to broad classes, such as assets, liabilities, revenues, and expenses. Particular economic things and events, such as cash on hand or selling merchandise, that may meet the definitions of elements are not elements as the term is used in this Statement. [Paragraph 5.]

7. In a general sense, the term *elements* can mean a number of things. The Oxford English Dictionary lists several definitions, including: "**1** a basic constituent part. **2** (also chemical element) each of more than one hundred substances that cannot be chemically interconverted or broken down. **3** any of the four substances (earth, water, air, and fire) regarded as the fundamental constituents of the world in ancient and medieval philosophy **4** a trace: *an element of danger*. **5** (**the elements**) the weather, especially bad weather. **7** one's natural or preferred environment."[2] The Webster English dictionary displays similar definitions.

8. Those notions of the term that relate to an item being basic or fundamental seem helpful for the Boards' purposes and are generally consistent with how elements are viewed in the existing frameworks.

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[2] Oxford online dictionary, http://www.askoxford.com/concise_oed/element?view=uk.

9. However, both the definition of an element and the definitions of the specific elements should also follow logically from the work that the Boards already have done in this project, as reflected in the Boards' recently-issued Preliminary Views/Discussion Paper. That document states that the objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit, and similar resource allocation decisions[3]. Therefore, to make these decisions, investors and creditors need *relevant* information about *real-world phenomena* that pertain to a *particular entity* about which they are considering making investment, credit, or similar resource allocation decisions. More specifically, the real-world phenomena relevant to them are *economic* things and changes in them.

10. Thus, to borrow from the first definition given by Oxford English Dictionary (paragraph 7), for purposes of financial reporting, when we refer to an element, we are focused on a basic constituent part (or fundamental class) of real-world economic phenomena that pertains to a particular entity. That focus on an entity is consistent with the Boards' previous decisions to define an asset (and a liability) **of an entity**, rather than defining assets broadly in terms of all things that might be of some value, for example, possessing sentimental or historical value but without economic value or relevance to investors, creditors and other resource providers.

11. The staff thinks that this also has significance for both our near-term and long-term thinking about issues relating to *elements* and the meaning of that term as it is used in the (new and improved) common framework that the Boards' are developing for *financial reporting*.

12. First, in the near-term, for purposes of Phase B its focus is not merely on identifying and defining the basic classes of economic things and changes in those things but also on those economic things and changes that by definition are relevant to users. That also links with paragraphs QC8-QC14 of the Boards' preliminary views, which discuss the qualitative characteristics of relevance, including predictive value and confirmatory value.

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[3] OB2 of the PV/DP

13. Second, in the longer-term, as we move forward to other phases of the project, it would be useful to think of the term *elements* more broadly in the context of financial reporting, which includes not only information that is recognized in the financial statements, but also information that is disclosed in the notes to financial statements, management discussions, and other forms of financial reporting. That is consistent with the Boards' previous decision that the framework should focus more broadly on *financial reporting* rather than only on *financial statements.*

14. Accordingly, the Boards may decide that information about certain items that meet the elements definitions, but which are not capable of being recognized in financial statements, should be disclosed in the notes to the statements or elsewhere in the financial report. For example, an unrecognized asset that is disclosed would meet the same definition as a recognized asset. Accordingly, "elements of financial statements" is a misnomer because it is too narrow.[4]

15. The staff thinks that the Boards can consider whether there is a need for additional elements after they have made further progress on Phase B. Consideration of additional elements could be included within Phase B, if desired, or in Phase E, which covers boundaries of financial reporting. Additional elements also may be necessary for Phase G, which will deal with applicability of the framework to not-for-profit entities and perhaps matters like reporting service efforts (inputs) and accomplishments (outputs).

What Are the Main Classes of Elements?

16. The particular elements that are defined in both the *Framework* and Concepts Statement 6 can be categorised as two broad kinds: the economic things that exist at a point in time (also called stocks) and their changes over a period of time (also called flows). Those flows reflect changes during a period resulting from transactions of the particular entity, as well as other events and circumstances affecting the entity (for example, exchanges with and transfers

[4] "Elements of financial reporting" also would be a misnomer, however. It is the need that investors and creditors and others have for information about real-world economic things and changes in them that pertain to an entity that gives rise to the information about them being included in financial statements or elsewhere in financial reporting. Thus, the fact that financial reporting provides that information is an outcome or consequence of that need for that information. In other words, "elements of financial reporting" puts the cart before the horse by suggesting that the elements are significant because financial reporting provides information about them; in fact, it's the other way around—it is because the elements are significant that financial reporting provides information about them.

to or from other entities, as well as price changes, creation, transformation, extinguishment). All stocks and flows are integrated, which means that all changes in stocks can be fully explained by the flows.

17. Assets, liabilities and equity, as defined in the existing frameworks, are stocks; all the other elements are flows. The flows elements are defined in terms of changes in assets and liabilities, but that does not mean that they are "second class" elements. Instead, it is because all conceptual structures have to start somewhere. The Boards agreed in the February 2006 meeting that elements other than assets should be defined by reference to assets.

How Many Different Elements Should Be Defined?

18. The IASB's *Framewo*rk defines only 5 specific elements of financial statements—assets, liabilities, income, expense and equity—and makes no mention of other potential elements. [paragraph 47]

19. In contrast, Concepts Statement 6 includes 10 specific elements—assets, liabilities, equity, investments by owners, distributions to owners, comprehensive income, and 4 elements that are components of comprehensive income: revenues, gains, expenses and losses. [paragraph 1] Concepts Statement 6 also notes that other types of financial reporting may include other types of elements. It says:

> Although the elements defined in this Statement include basic elements and are probably those most commonly identified as elements of financial statements, they are not the only elements of financial statements. The elements defined in this Statement are a related group with a particular focus—on assets, liabilities, equity, and other elements directly related to measuring performance and status of an entity. . . . Other statements or focuses may require other elements. [paragraph 3]

20. The number of specific elements of financial statements that are defined in the frameworks of other standard setters range from 5 to 7. The appendix to this memo includes a list of the elements defined in those other frameworks.

21. Deciding how many elements should be defined involves determining where to draw the line between fundamental or basic elements, on the one hand, and items that are principally matters of display, on the other hand. As Concepts Statement 6 explains in the context of equity:

> This Statement defines equity of business enterprises only as a whole, although the discussion notes that different owners of an enterprise may have different kinds of ownership rights and that equity has various sources. In financial statements of business enterprises, various distinctions *within* equity, such as those between common stockholders' equity and preferred stockholders' equity, between contributed capital and earned capital, or between stated or legal capital and other equity, are primarily matters of display that are beyond the scope of this Statement. [Footnote 29]

Thus, Concepts Statement 6 draws the line between equity, on the one hand, and common stockholders' equity and preferred stockholders' equity, on the other hand, or between *equity* and contributed capital and earned capital, etc.

22. However, Concepts Statement 6 arguably goes beyond the fundamental or basic elements, particularly with regard to the "flows" elements. For example, the FASB has four specific elements (2 pair) that are primarily for purposes of making display distinctions—that is, (a) *revenues* and *gains* and (b) *expenses* and *losses*. The FASB also includes an element for *comprehensive income*, which is an aggregation of those four elements. In fact, Concepts Statement 6 acknowledges that revenues, expenses, gains, and losses were defined largely for reasons of display:

> Since a primary purpose of distinguishing gains and losses from revenues and expenses is to make displays of information about an enterprise's sources of comprehensive income as useful as possible, fine distinctions between revenues and gains and between expenses and losses are principally matters of display or reporting… [Paragraph 89]

23. The IASB (and others) do not define or use elements to make those finer display distinctions. The *Framework* only has 2 specific elements for financial performance. The main reasons are noted in its paragraphs 72 and 73:

> 72. The IASB's framework notes that 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. …
>
> 73. Distinguishing between items of income and expense and combining them in different ways also permits several

> measures of entity performance to be displayed. … For example, the income statement could display gross margin … and profit and loss.

24. Using elements definitions to make distinctions of display, which are without specific limits, goes beyond the "broad classes" notion as used in both the *Framework* and Concepts Statement 6, as well as beyond the notions of "basic" or "fundamental" in the Oxford English dictionary.

25. In the staff's view, the term *element* should be used to mean or describe broad classes of economic things and changes in them that are very basic, fundamental or elemental. That suggests we discipline ourselves to limiting the number of elements of financial statements (fundamental classes of items) to only those most basic distinctions that are essential for the intended purpose. Finer distinctions of items (e.g., cash, receivables, property, equipment, copyrights) that fit in the same fundamental class do not require different elements for purposes of identifying the items to be included in a particular financial statement. Certainly making finer distinctions through display adds usefulness, but display is a separate matter. Aggregations or combinations of elements is also a matter of display (for example, combining *income* and *expense* to show a net amount).

26. Moreover, this discipline may help clarify the difference between an element and an item separately displayed in the financial statements. For example, it will be easier to distinguish between what we call an asset or assets and a broad class of individual items called property, plant and equipment.

Questions for the Boards

27. The elements definitions should continue to define the economic things (also called "stocks") and the changes in them (also called "flows") that pertain to a particular entity. Do the Boards agree?

28. The elements definitions should focus on the most basic of the real-world economic phenomena that pertain to an entity. Distinctions that are made for purposes of financial statement display or presentation go beyond the notion of basic elements. Do the Boards agree?

Appendix: Definition and/or List of Elements in other frameworks/bodies

Standard-setter/ Body	No of Elements of Financial Statements	Explanation

IASB	5	• Financial statements portray the effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements.
		• Related to measurement of financial position in the balance sheet:
		  o Assets
		  o Liabilities
		  o Equity:
		• Related to measurement of financial performance in the income statement:
		  o Income (including revenues and gains)
		  o Expenses

FASB	10	• Elements of financial statements are building blocks with which financial statements are constructed – the classes of items that financial statements comprise. The items in financial statements represent in words and numbers certain entity resources, claims to those resources, and the effects of transactions and other events and circumstances that result in changes in those resources and claims.
		  o Assets
		  o Liabilities
		  o Equity/net assets
		  o Investments by owners
		  o Distribution to owners
		  o Comprehensive income
		  o Revenues
		  o Expenses
		  o Gains
		  o Losses

Australia	5	• No explanation of what is an element of financial statement
		• Financial measures in statement of financial position:
		  o Assets
		  o Liabilities
		  o Equity:
		    ▪ Contribution by owners
		    ▪ Distribution to owners
		• Financial measures in statement of financial performance:
		  o Revenues:
		    ▪ Includes savings in the outflows of future economic benefits (eg forgiveness of liabilities)
		  o Expenses

Standard-setter/ Body	No of Elements of Financial Statements	Explanation
Canada	7	• Elements of financial statements are the basis categories of items portrayed therein in order to meet the objectives of financial statements. • Two types of elements: o Describes economic resources, obligations and equity/net assets over a point in time o Describes changes in economic resources, obligation and equity/net assets over a period in time. • Notes are not elements of financial statements • Balance sheet: o Assets o Liabilities o Equity/net assets • Income statement: o Revenues o Expenses o Gains o Losses
France (based on staff translation on its framework for non-PLCs)	7	• Does not explicitly state what are “elements of financial statements”. Rather, it requires displays of certain categories of financial statements. They are: o Assets, o Liabilities, o Prepaid expenses, o Deferred charges, o Revenues o Expenses o Equity
[Section deleted from Observer Notes]		
Japan (Draft framework)	7	• Balance sheet: o Assets o Liabilities o Net assets • Income Statement: o Revenues/gains o Expenses/losses o Net income • Comprehensive income

Standard-setter/ Body	No of Elements of Financial Statements	Explanation
New Zealand	5 (plus 3 of non-financial elements)	• Financial reports portray the effects of transactions and other events by grouping them into broad classes according to their economic characteristics in order to meet their objectives specified in paragraph 3.1. These broad classes are termed elements. (para 7.1) • Financial elements: • Directly related to financial position: o Assets o Liabilities o Equity ▪ Contribution by owners and Distribution to owners (7.27+7.28) ▪ Capital Maintenance Adjustments (7.30) • Directly related to financial performance: o Revenues o Expenses • Non-financial elements (related to service performance): o Inputs o Outputs o Outcomes
United Kingdom	7	• Elements of financial statements are building blocks with which financial statements are constructed – the classes of items that financial statements comprise. • In the case of the balance sheet (or statement of financial position): o Assets o Liabilities o Ownership interest[5] • In the case of the profit and loss account (or statement of financial performance): o Gains (includes all forms of income and revenue as well as all recognised gains (realised and unrealised) on non-revenue items) o Losses (incorporates all forms of expenses, sometimes referred to as revenue expenditure, and all recognised losses (realised and unrealised) on non-revenue items) • Contributions from owners • Distribution to owners
CFA Institute	Not mentioned	• Does not discuss what are elements of financial statements • Does provide definitions of assets, liabilities and equity

[5] There is footnote that says that this element is given various descriptions in financial statements including, for example, equity, owners' equity, shareholders' equity, equity capital, capital, capital and reserves, partners' capital, shareholders' funds, proprietorship and ownership.

Standard-setter/ Body	No of Elements of Financial Statements	Explanation
International Public Sector Accounting Standards Board	5	• No explanation of what is an element of financial statement. But, identifies what they are: ○ Assets ○ Liabilities ○ Net assets/equity ○ Revenues ○ Expenses
Oxford online dictionary	N/A	• **1** a basic constituent part. **2** (also chemical element) each of more than one hundred substances that cannot be chemically interconverted or broken down. **3** any of the four substances (earth, water, air, and fire) regarded as the fundamental constituents of the world in ancient and medieval philosophy. **4** a distinct group within a larger group: *right-wing elements in the army*.