STAFF PAPER

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REG IASB Meeting

Project	Conceptual Framework		
Paper topic	Other elements		
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Purpose of this paper

1. This paper discusses whether to define elements for the statement of changes in equity and the statement of cash flows.

Summary of staff recommendation

2. The staff recommend that the *Conceptual Framework* should not define elements for the statement of changes in equity and for the statement of cash flows.

3. Thus, the only elements would continue to be assets, liability and equity, and income and expense.

Background

4. This section covers:

   (a) the existing *Conceptual Framework* (paragraphs 5-6);

   (b) the Discussion Paper (paragraphs 7-8);

   (c) feedback received – general (paragraphs 9-11);

   (d) feedback received – changes in equity (paragraphs 12-13); and

   (e) feedback received – cash flows (paragraphs 14-15).

Existing Conceptual Framework

5. Paragraph 4.2 of the existing *Conceptual Framework* states the following:

> Financial statements portray the financial 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. The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity. The elements directly related to the measurement of performance in the income statement are income and expenses. The statement of changes in financial position[1] usually reflects income statement elements and changes in balance sheet elements; accordingly, this *Conceptual Framework* identifies no elements that are unique to this statement.

6. In its definitions of income and expense, the existing *Conceptual Framework* refers to contributions from equity participants and distributions to equity participants, but it does not describe those contributions and distributions as elements. Those definitions are as follows:

> 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, <u>other than those relating to contributions from equity participants</u>. [emphasis added]
>
> 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, <u>other than those relating to distributions to equity participants</u>. [emphasis added]

[1] Staff comment: a ‘statement of changes in financial position’ was required before the introduction of the requirement to present a statement of cash flows.

Discussion Paper

7. The Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* stated that:

   (a) 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.

   (b) the elements would be:

      (i) in the statement of financial position: assets, liabilities and equity;

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

      (iii) in the statement of changes in equity: contributions of equity, distributions of equity and transfers between classes of equity; and

      (iv) in the statement of cash flows, whether prepared using the indirect method or the direct method: cash inflows (cash receipts) and cash outflows (cash payments).

8. Agenda Paper 10F discusses the notion of primary financial statements, and recommends that the IASB should not introduce this notion in the *Conceptual Framework*. The Discussion Paper:

   (a) stated that it may be helpful for the *Conceptual Framework* to define elements for each primary financial statement. The existing *Conceptual Framework* does not define separate elements for the statement of cash flows and for the statement of changes in equity.

   (b) did not propose definitions for those possible elements. It stated that the IASB did not foresee great difficulties in developing definitions of these elements. It asked respondents whether they had comments on these items, and whether it would be helpful for the *Conceptual Framework* to identify them as elements of financial statements.

Feedback received - general

9. Just over a third of respondents to the Discussion Paper commented on whether the *Conceptual Framework* should define elements relating to changes in equity and to cash flows.

10. Respondents who favoured adding definitions of these items offered the following arguments:

    (a) Defining elements for the statement of cash flows and the statement of changes in equity would indicate more clearly the relationships between these items and profit or loss or other comprehensive income, and so aid understanding by preparers, auditors and users.

    (b) The *Conceptual Framework* should be complete and include definitions of elements of all financial statements, and indicate their relationships. Cash receipts and cash payments, and contributions to equity and distributions of equity, are broad classes of items that share similar characteristics and form the building blocks from which the statement of cash flows and statement of changes in equity are constructed.

    (c) All primary financial statements are important to users. Defining elements for each statement would help to re-balance the focus between the statement of financial position and other statements.

11. Some respondents argued against defining elements relating to changes in equity and to cash flows, giving the following reasons:

    (a) These items are movements in the elements of financial position (assets and liabilities). The statement of cash flows and the statement of changes in equity can be derived at the standards level without identifying and defining new elements.

    (b) Identifying new elements might lead to unintended inconsistency with the definitions of existing elements of financial statements.

    (c) These items are derived from the elements already identified. The *Conceptual Framework* could usefully include some discussion of these items, just as it now identifies categories within the defined elements of income and expense. However, these derived items and subgroups are not separate elements.

(d) Identifying new elements for the statement of cash flows and in the statement of changes in equity is not a priority. These items are already clear and no significant problems have arisen in practice.

Feedback received – changes in equity

12. Some respondents agreed with the suggestion that the *Conceptual Framework* should define contributions of equity and distributions of equity as elements. They stated that this:

(a) would distinguish these movements from income and expenses. This might resolve some problems that arise in practice in deciding how to account for some transactions with equity participants, including loans or other transactions with entities under common control.

(b) would explain why transactions with shareholders do not normally result in the recognition of income or expense.

(c) could clarify conceptually whether share-based payment results in an expense, or in a distribution to equity holders.

(d) may help in discussing the differentiation between equities and liabilities.

(e) would show more clearly how changes in equity articulate with equity at the beginning and end of the period.

(f) would be consistent with the US *Statements of Financial Accounting Concepts*, which include as elements 'investments by owners' and distributions to owners'.[2]

13. Some respondents agreed with the suggestion that contributions of equity and distributions of equity should be identified as elements of financial statements, but

[2] Statement of Financial Accounting Concepts No. 6 *Elements of Financial Statements*, paragraphs 66 and 67

disagreed with treating wealth transfers between classes of equity as an element. They gave the following reasons:

(a) Transfers between categories of equity are a matter of presentation, and hence no elements are needed for these transfers.

(b) Transfers between categories of equity would not be confused with other elements, so there is no advantage in distinguishing transfers from other elements.

(c) The objective of general purpose financial reporting is to provide decision-useful information about economic phenomena that affect the reporting entity, rather than economic phenomena that affect only holders of its equity.

(d) Measurements of equity instruments should not be updated. Thus, there is no need for the notion of transfers of wealth between classes of equity.

(e) The notion of wealth transfers may only become useful if these transfers are presented in the statement of comprehensive income. This would require rethinking the definitions of income and expense.

Feedback received – cash flows

14. Some respondents commented that cash inflows and cash outflows should be defined as elements, for the following reason, in addition to the reasons given in paragraph 10:

(a) the cash flow statement is becoming increasingly important for decision-making by investors, to help them understand the differences between actual cash generated and economic value created (based on potential cash flows). Thus, this statement should have more prominence in the *Conceptual Framework*.

15. Some other respondents stated that cash inflows and cash outflows should not be defined as elements, for the following reasons, in addition to the general reasons given in paragraph 11:

(a) It is not necessary to define cash payments and cash receipts, as they are straightforward. The definition of cash receipts and cash payments can be considered in a standard on the statement of cash flows.

(b) Cash is not an element, it is only a sub-set of another element (that is, assets). Thus, movements in cash cannot be an element.

(c) Defining cash inflows (or cash receipts) and cash outflows (or cash payments) as elements of the statement of cash flows could imply that the IASB wishes to move from the indirect method to the direct method. Indirect cash flow statements provide useful information to users of financial statements. Direct cash flow statements would cause significant costs and implementation issues.

(d) Total cash received and total cash paid are never reported in a cash flow statement. If a cash flow statement can have elements, the most likely candidates are operating, investing and financing.

(e) As currently required, cash flow statements are of little value for financial institutions, including banks and insurers. Instead of defining cash receipts and cash payments as elements, the IASB should consider what information the statement of cash flows should convey, including whether all types of entities should provide the same type of cash flow information.

(f) To be consistent with the objective of financial reporting, the elements of financial statements should be limited to items that provide information about the entity's financial position and financial performance.

(g) The US *Statements of Financial Accounting Concepts* do not define elements for the cash flow statements.

Staff analysis

16. This section covers:

(a) contributions to equity and distributions of equity (paragraphs 17-19);

(b) cash receipts and cash payments (paragraph 20);

(c) other matters (paragraph 21); and

(d) staff recommendation (paragraph 22).

Contributions to equity and distributions of equity

17. In the staff's view, the following are arguments in favour of introducing contributions to equity and distributions of equity as new elements:

    (a) The existing definitions of income and expense refer to changes in assets and liabilities, excluding those resulting from contributions from equity participants and distributions to equity participants. It may be confusing, and arguably is conceptually inconsistent, to define one type of movement as an element if that definition refers to another type of movement that is not identified explicitly as an element.

    (b) Some respondents to the Discussion Paper suggested that there is lack of clarity about the distinction between income /expense and contributions / distributions. Explicit clarification in the *Conceptual Framework* might help.

    (c) Defining these items as elements is consistent with the US conceptual framework.

18. The staff view the following as arguments against introducing contributions to equity and distributions of equity as new elements:

    (a) It may be difficult to create a clear definition without making significant amendments to the definitions of income and expense.

    (b) The absence of a definition of contributions of equity and distributions of equity has not caused major problems.

    (c) The Discussion Paper suggested making the statement of changes in equity more prominent. Defining these elements was one part of this. However, it now seems questionable whether that statement will acquire sufficient prominence to play a major role in solving some of the problems of distinguishing liabilities from equity instruments.

Thus, defining contributions and distributions may not provide great benefits.

19. Arguably, the list of elements need not be a complete list of all possible elements. Indeed, in the US, Concepts Statement 6 (CON 6) takes this approach, stating that:

    (a) CON 6 defines a related group of basic elements with a particular focus—on assets, liabilities, equity, and other elements directly related to measuring performance and status of an entity. These are not the only elements of financial statements. Other statements or focuses may require other elements.

    (b) Variations of possible statements showing the effects on assets and liabilities of transactions or other events and circumstances during a period are almost limitless, and all of them have classes of items that may be called elements of financial statements. For example, a statement showing cash flows during a period may include categories for cash provided by (i) operations, (ii) borrowing, (iii) issuing equity securities, (iv) sale of assets, and so forth. Other projects may define additional elements of financial statements as needed.[3]

Cash receipts and cash payments

20. Defining elements of the cash flow statement would emphasise the importance of cash flow information. Nevertheless, this would have the following disadvantages:

    (a) Defining elements of cash flows may have unintended consequences, and would not solve any known practical problem.

    (b) Defining elements of cash flows would imply that all entities should produce a statement of cash flows. Some argue that, as currently structured, cash flow statements do not provide useful information in the case of financial institutions. The research project on principles of disclosure is researching, among other things, the usefulness of the

[3] Statement of Financial Accounting Concepts No. 6 *Elements of Financial Statements*, paragraphs 3 and 4

statement of cash flows, for entities in general and for financial institutions in particular. Until that research is complete, it would be premature to consider whether to define elements for cash flow statements.

(c) The most obvious definitions of elements of cash flows might imply a preference for the direct method. In the staff's view, it would not be appropriate to consider embedding such a preference in the *Conceptual Framework* without conducting further research.

Other matters: capital maintenance

21. One respondent suggested that capital maintenance adjustments should be defined as an additional element. However, as approved by the IASB in April 2014, the staff will not discuss capital maintenance with the IASB unless work on the measurement section of the Exposure Draft highlights a need to discuss the issue further. Accordingly, the staff do not recommend identifying capital maintenance adjustments as an additional element.

Staff recommendation

22. In the staff's view, the disadvantages of defining elements for the statement of changes in equity and for the statement of cash flows outweigh the advantages. Accordingly, the staff recommends not introducing such elements.

Question
Does the IASB agree that the *Conceptual Framework* should not define elements for the statement of changes in equity and for the statement of cash flows?