STAFF PAPER

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IASB Meeting

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Project	**Annual Improvements 2012–2014 cycle** **Issues recommended by the Interpretations Committee not to lead to amendments within the scope of the Annual Improvements process**
Paper topic	IAS 7 *Statement of Cash Flows*—Definitions of operating, investing and financing activities

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Introduction

1. At its January 2012 meeting (refer to *IASB Update* of January 2012) the IASB asked the IFRS Interpretations Committee (the Interpretations Committee) to review requests that it had received in relation to IAS 7 *Statement of Cash Flows* with a view to determining whether it could look collectively at issues that the Interpretations Committee had recently discussed regarding the classification of cash flows under IAS 7. These requests were:

    (a) cash payments for deferred and contingent consideration arising from a business combination within the scope of IFRS 3 *Business Combinations* (Recommendation not to be added to annual improvements at the November 2011 IFRS IC meeting);

    (b) cash flows for an operator in a service concession arrangement within the scope of IFRIC 12 *Service Concession Arrangements* (discussed at the November 2011 IFRS IC meeting);

    (c) cash flow statement—classification of value added tax (Agenda decision, discussed at the November 2004 IFRIC meeting);

(d) classification of expenditure on unrecognised assets (*Annual Improvements*, April 2009);

(e) guidance on cash equivalents as defined by IAS 7 (Agenda decision, May and July 2009);

(f) classification of interest paid that is capitalised (*Annual Improvements, 2010-2012 cycle*);

(g) classification in the statement of cash flows of the flows arising from the settlement of contingent consideration in a business combination (Agenda decision, January 2012); and

(h) classification of cash flows relating to construction services under service concession arrangements (*Annual Improvements, 2011-2013 cycle*).

2. At its March 2012 meeting (refer to *IFRIC Update* of March 2012), the Interpretations Committee noted that two 'principles of classification' in IAS 7 have been used to support the Committee's decisions (either for issuing an agenda decision or for proposing an annual improvement), as follows:

(a) cash flows in IAS 7 should be classified in accordance with the nature of the activity to which they relate, following the definitions of operating, investing and financing activities in paragraph 6 of IAS 7; and

(b) cash flows in IAS 7 should be classified consistently with the classification of the related or underlying item in the statement of financial position. This approach could also lead, in some circumstances to splitting transactions into their different operating, investing and financing components.

3. At its March 2012 meeting the Interpretations Committee observed that the primary principle behind the classification of cash flows in IAS 7 is that, based on paragraph 11 of IAS 7, cash flows should be classified in accordance with the nature of the activity in a manner that is most appropriate to the business of the entity, in accordance with the definitions of *operating*, *investing* and *financing* activities in paragraph 6 of IAS 7.

4. At its July 2012 meeting (refer to *IFRIC Update* of July 2012), the Interpretations Committee directed the staff to consider how the definitions of operating, investing

and financing cash flows in IAS 7 could be made clearer so that greater consistency could be achieved in the application of the primary principle that was identified by the Interpretations Committee at the March 2012 meeting.

5. In this analysis, the Interpretations Committee asked the staff to consider the comments received on the IASB's 2011 Agenda Consultation that relate to IAS 7 and the views received through the outreach that was performed on the Financial Statement Presentation Project that also relate to IAS 7. All of these views were summarised in Appendix A of Agenda Paper 7, which was discussed in March 2013.

6. At its March 2013 meeting, after discussing the staff proposals on the definitions of operating, investing and financing cash flows in IAS 7, the Interpretations Committee determined that clarifying the application of the primary principle for the classification of cash flows is a matter that is too broad for the Interpretations Committee to address and tentatively decided to recommend that the IASB should not proceed with a staff proposal to amend those definitions within the context of an annual improvement or a narrow scope amendment.

7. In addition, the Interpretations Committee determined that it could not take a comprehensive approach to the specific fact patterns that had been discussed regarding the classification of cash flows under IAS 7 (refer to the list of requests received in paragraph 1 above) . Consequently, it also does not recommend the IASB to amend:

   (a) paragraph 14 of IAS 7 to clarify that an operator that provides construction or upgrade services in a service concession arrangement should present all of the cash flows relating to this activity as operating cash flows. This proposal had been discussed by the Interpretation Committee's at its November 2011 meeting (refer to Agenda Paper 11) and had not yet been discussed by the IASB. See original proposal to amend IAS 7 in **Appendix D** of this paper.

   (b) a proposal to amend paragraphs 16(a) and 33 and the addition of paragraph 33A of IAS 7 regarding the classification of interest that is capitalised. This proposed amendment was included in the Exposure Draft (ED) on *Annual Improvements to IFRSs 2010 –2012 Cycle* (ED/2012/1) published in May

2012. The comments received on this proposal are discussed in Agenda Paper 16C which will be discussed at the IASB's April 2013 meeting. The Interpretations Committee recommends the IASB to refrain from proceeding with the proposed amendment. See original proposal to amend IAS 7 in **Appendix D** of this paper.

Objective of the paper

8. The objective of this paper is to:

   (a) give an overview of the proposal to amend paragraph 6 of IAS 7 to clarify the application of the primary principle behind the classification of cash flows;

   (b) explain the rationale for the Interpretations Committee's decision not to recommend the IASB to amend paragraph 6 of IAS 7 or to proceed with previous proposals to amend IAS 7;

   (c) explain the rationale for the Interpretations Committee's decision to recommend the IASB to amend paragraph 16 of IAS 7 and

   (d) ask for the IASB agreement with the Interpretations Committee's recommendations.

9. A summary of the staff analysis is described in the paragraphs that follow.

10. For a detailed description of the comments received and the source of those comments, the IASB should refer to Agenda Paper 7 of March 2013, which was presented to the Interpretations Committee.

Summary of the analysis of the current definitions and recommendations

Operating activities

11. In IAS 7 the operating category is a residual category that includes all of the entity's transactions other than investing and financing transactions, as defined in paragraph 6 of IAS 7 (emphasis added):

> **Operating activities** are the **principal revenue-producing activities** of the entity **and other activities that are not investing or financing activities**.

12. We observe that if *operating activities* are defined in paragraph 6 as the "principal revenue-producing activities", then the objective of the operating section of the statement of cash flows should be to provide a cash-based measure of operating income.

13. However, paragraph 14 of IAS 7 states that operating activities result from transactions that enter into the determination of 'profit or loss' rather than from those that enter into the determination of 'operating income'. In this respect some other guidance in IAS 7 permits a closer alignment with profit or loss than with operating income. For instance:

    (a) Interest paid can be classified as either an operating or a financing activity on the basis of the guidance in paragraphs 33–34 of IAS 7.

    (b) Cash payments or cash refunds of income taxes are primarily identified as operating cash flows in accordance with paragraph 14(f), but they can also be identified with financing and investing activities.

14. Even more, paragraph 33 of IAS 7 justifies the classification of interest paid and the interest and dividends received as part of the operating section on the grounds that their accrual-basis equivalents enter into the determination of profit or loss.

15. We think that the definition of operating activities could be improved if IAS 7 clarifies whether the objective of the operating section of the statement of cash flows is to provide a cash-basis measurement of:

(a) the entity's profit or loss; or

(b) the entity's operating income.

16. We think that, on the basis of the current guidance in IAS 7, operating cash flows are the cash-basis equivalent of transactions that enter into the determination of profit or loss. The Interpretations Committee did not reach any conclusion in this respect.

17. Another shortcoming that we observe in the current definition of operating activities is that it is a residual category. Consequently, this category might include activities that cannot be clearly distinguished as *investing activities*, *financing* or *operating activities* and thus by default are considered *operating activities*.

18. An alternative to the proposal for eliminating activities that are not, in a strict sense, 'operating' in nature from the definition of *operating activities* would be for the section on operating activities in the statement of cash flows to segregate 'other activities' that do not represent principal-revenue-producing activities of the entity and that remain undefined. Consequently, the statement of cash flows would show other activities as a subsection of the operating activities section.

19. In addition we observe that IAS 7 does not clarify why some cash flows that are primarily derived from the principal-revenue-producing activities of the entity are considered 'investing' in nature, instead of 'operating'. For example, the cash outflows associated with the purchase of property, plant and equipment (PPE), intangibles and other long-term assets are classified as investing cash flows in accordance with paragraph 16(a) of IAS 7, However, some argue that because depreciation and amortisation charges are included in the determination of profit or loss (and operating profit), cash outflows associated with the purchase of PPE should be classified as operating cash flows rather than as investing cash flows.

20. We think, however, that a proposal to remove the investing activities section from the statement of cash flows and classify a portion of these activities as part of an entity's operating activities (for example, the cash flows derived from an entity's acquisitions or disposals of long-term assets) and another portion as part of an entity's financing activities (for example, the cash flows derived from financial assets) is too broad and beyond the Annual Improvements project.

Staff proposal to clarify the definition of operating activities

21. Based on our analysis above, we observe that the definition of **operating activities** in paragraph 6 could clarify that:

    (a) operating cash flows are the cash-basis equivalent of transactions that enter into the determination of 'profit or loss'; and

    (b) 'operating activities' would be maintained as a residual, but 'other activities' that do not represent principal-revenue-producing activities of the entity and that remain undefined could be segregated and the statement of cash flows could show 'other activities' as a subsection of the 'operating activities' section.

The Interpretations Committee view

22. The Interpretations Committee did not reach any conclusion in respect on whether, based on the current guidance in IAS 7, operating cash flows are the cash-basis equivalent of transactions that enter into the determination of profit or loss or operating income.

23. The Interpretations Committee disagreed with the proposal of isolating other activities from operating activities because it would represent a change in practice on how cash flows are presented in the statement of cash flows under either the direct or indirect method for determining cash flows. The Interpretations Committee also considered that this proposal is beyond the scope of the Annual Improvements project.

Financing activities

24. Paragraph 6 in IAS 7 defines *financing activities* as (emphasis added):

> **Financing activities** are activities that result in changes in the size and composition of the **contributed equity**[1] **and borrowings** of the entity.

25. In addition, paragraph 17 of IAS 7 states that (emphasis added):

> The separate disclosure of cash flows arising from financing activities **is important because it is useful in predicting claims on future cash flows by providers of capital to the entity**.

26. A major shortcoming that we observe in the definition of financing activities is that the term 'borrowings' in paragraph 6 of IAS 7 has not been defined.

27. We note that paragraph 5 of IAS 23 *Borrowing Costs* describes the meaning of 'borrowing costs'. However, this definition is unclear because it provides a circular definition as follows (emphasis added):

> **Borrowing costs are** interest and other costs that an entity incurs **in connection with the borrowing of funds**.

28. We observe that 'to borrow'[2] means:

> The action of taking and using (something belonging to someone else) under agreement to pay it back later.

29. From looking at the above definition we think that the nature of a financing activity could involve one or all of the following three elements:

    (a) the receipt or use of a resource from a provider of finance (for example, an entity receives money from the bank; or an entity receives cash in return for issuing equity instruments);

    (b) the expectation that the resource will be returned to the provider of finance (for example, an entity repays the money borrowed);

[1] In our view the term 'contributed equity' in the definition of 'financing activities' does not need further clarification. The term 'equity' is defined as an element of the financial statements in section 4.4 of the *Conceptual Framework for Financial Reporting* (Conceptual Framework) as "a residual interest in the assets of the entity after deducting all its liabilities". Paragraph 4.20 further explains that 'funds contributed by shareholders' (ie contributed equity) could be shown as a sub classification in the balance sheet.

[2] *Oxford English Dictionary* (10th ed).

(c) the expectation that the provider of finance will be appropriately compensated (for example, the bank charges interest to the entity as compensation for lending the funds).

Are cash flows arising from/associated with financial liabilities/assets, "financing cash flows"?

30. We think that cash flows arising from/associated with financial liabilities meet the first and second elements that we have identified when defining financing activities, because financial liabilities represent the receipt or use of a resource from a provider of finance and the expectation that the resource will be returned to the provider of finance.

31. We observe, however, that stating in the definition of financing activities that cash flows associated with all financial liabilities represent cash flows from financing activities would not be appropriate because some cash flows associated with some financial liabilities are considered operating activities in accordance with IAS 7.

32. Take, for example, the case of a cash payment to a supplier for goods and services to settle a trade accounts payable. The trade accounts payable is considered to be a financial liability in accordance with paragraph AG4(a) of IAS 32. However the cash payments to settle this payable are considered to be operating cash outflows in accordance with paragraph 14(c) of IAS 7.

33. We think that a similar logic applies for some financial assets. For instance, take the case of a cash receipt from the repayment of loans made to other parties to settle a loan receivable. The loan receivable is considered to be a financial asset in accordance with paragraph AG4(c) of IAS 32. However the cash receipts from the repayment of this loan receivable are considered investing cash inflows in accordance with paragraph 16(f) of IAS 7.

Are cash flows derived from the issue of an entity's own equity instruments part of an entity's financing activities?

34. Even though the second element that we have identified (ie the expectation that the resource will be returned to the provider of finance) is not present in the issue of an entity's own equity instruments, we think that such transactions should still be

considered ‘financing’ by nature because they are providing finance to an entity. Consequently, we think that the definition of financing activities should clearly state so. Consequently we think that financing activities include obtaining resources derived from the issue of an entity’s own equity instruments (as defined in IAS 32 *Financial Instruments: Presentation*).

Does the nature of a cash flow change if the credit terms change?

35. We think that the third element that is present in some financing activities (ie the expectation that the provider of finance will be appropriately compensated throughout the period that the financing is outstanding (for example, by charging interest)) is important for differentiating financing activities from operating activities.

36. For instance, take the case of a purchase of materials from a supplier. If an entity decides to buy the materials directly from the supplier, it will receive the goods and in return agrees to pay a certain amount at a future date.[3] The entity would classify this activity as an operating activity in accordance with paragraph 14(c) of IAS 7. However, if in turn the supplier had not granted such credit, the entity would have had to have borrowed the funds in order to pay for the goods on the date of delivery, and then repay the lender at a future date, including the payment of compensation to the lender. The borrowing of funds and the payment of compensation <u>to a lender</u> would have indicated that the purchase of materials represents a borrowing activity. We observe, however, that the definition of financing activities does not focus on the type of counterparty that provides finance to the entity as a basis for the classification of cash flows.

37. In addition, under the current guidance in IAS 7 the nature of the cash outflows to purchase some items (ie goods or services or long-term assets) appears to remain the same irrespective of whether the credit terms change. For instance, we observe that on the basis of paragraph 17(c) of IAS 7 a borrowing activity would always be classified as a financing activity irrespective of its short- or long-term nature.

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[3] This is assuming that this transaction is under normal credit terms (ie the entity has a moderate length of time to settle the transaction).

38. We, however, observe that an operating activity that involves a payment to a supplier for goods or services on extended credit terms (ie beyond normal credit terms) or deferred terms would also qualify for classification as a financing activity. This is because the supplier in this case might have built into the pricing of the goods or services provided a finance charge (ie interest) that would have changed the nature of the activity from being operating to financing.

39. Consequently, we think that another relevant element in defining financing is the notion of time for repaying finance. In line with this we think that financing activities should include purchase transactions with suppliers who have provided extended credit.

Staff proposal to clarify the definition of financing activities

40. Based on our analysis above, we observe that the definition of **financing activities** in paragraph 6 could clarify that the nature of a financing activity involves:

    (a) the receipt or use of a resource from a provider of finance (or provision of credit);

    (b) the expectation that the resource will be returned to the provider of finance; and

    (c) the expectation that the provider of finance will be appropriately compensated through a finance charge payment. The finance charge is both dependent on the amount of the credit and the duration (time of the credit).

41. The definition of financing activities could also state that cash flows that provide finance to an entity are:

    (a) those that are derived from the issue of an entity's own equity instruments (as defined in IAS 32) are considered financing by nature; and

    (b) include those purchase transactions that have been negotiated on extended credit terms.

The Interpretations Committee view

42. Some members thought that it would help to add clarity to IAS 7 in respect to the classification of cash flows when the timing of payables extend beyond the normal credit terms.

43. However, a majority of the members objected to the staff conclusions on the proposal to amend the definition of financing activities because they consider it to be a matter that is too broad for the Interpretations Committee to address and beyond the scope of the Annual Improvements project.

Investing activities

44. Paragraph 6 in IAS 7 defines investing activities as (emphasis added):

> ***Investing activities*** are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

45. In addition, reporting the amount of cash flows that arise from investing activities is important according to paragraph 16 in IAS 7 because (emphasis added):

> The separate disclosure of cash flows arising from investing activities is important **because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows**.

46. We observe that the definition of investing activities in IAS 7 is more prescriptive (than the definitions of financing and operating activities) about the cash flow activities that should be included in this section. But as we have noted above, we think that part of the rationale behind segregating certain activities in the investing section is because, from a finance perspective, operating activities involve the acquisition of short-term assets, which some view as a working capital operating decision, whereas some investing activities involve the acquisition of long-term assets, which some view as long-term investing decisions. Consequently, we are not proposing to modify the guidance in this respect.

Investing activities – Classification of expenditures

47. We note that the indication in paragraph 16 of IAS 7 that "only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities" leads to misunderstandings about the classification of cash flows. This is because some think that this classification seems to give precedence to the classification of cash flows consistently with the classification of the related or underlying item (ie the asset) in the statement of financial position[4] instead of giving precedence to the nature of the activity in a manner that is most appropriate to the business of the entity (based on paragraph 11 of IAS 7).

48. We observe that the reference "only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities" was included as an amendment to paragraph 16 in *Improvements to IFRS* published in April 2009. The objective of this amendment was to address a request for guidance on the treatment of exploration and evaluation expenditure in extractive industries (which can be recognised, according to the applicable Standard, as an asset or an expense) and reduce existing diversity in practice in the classification of expenditures that *are not* recognised as assets under IFRS as either:

    (a) cash flows from operating activities; or

    (b) as part of investing activities.

The Interpretations Committee view

49. During its deliberations in March 2013, the Interpretations Committee agreed that making explicit in paragraph 16 of IAS 7 that "only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities" might lead to some misinterpretations that expenditures that give rise to recognised assets are, by default, investing activities.

[4] In fact this guidance led the Interpretations Committee to identify a second principle in the classification of cash flows in IAS 7; this is that cash flows in IAS 7 should be classified consistently with the classification of the related or underlying item in the statement of financial position.

50. The Interpretations Committee concluded that:

(a) an expenditure that gives rise to a recognised asset should be classified as an investing activity when it meets the definition of an investing activity; and

(b) an expenditure that does not give rise to a recognisable asset can also meet the definition of an investing activity to the extent that this expenditure has been made for resources that are intended to generate future income and cash flows.

51. Consequently, the Interpretations Committee agreed to recommend that the IASB amend paragraph 16 of IAS 7 to delete the reference that “only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities” as it seems clear that this reference has introduced inconsistencies in the classification principle in paragraph 11 of IAS 7 and has led to some confusion.

52. Based on the above, the Interpretations Committee proposes the IASB to include the following amendment to paragraph 16 (deleted text is struck through).

> 16 The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. **~~Only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities.~~** Examples of cash flows arising from investing activities are:
>
> (a) cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalised development costs and self-constructed property, plant and equipment;
>
> (b) …

Agenda criteria assessment for the proposed annual improvement

53. We think that the current wording of paragraph 16 of IAS 7 is not sufficiently clear and it is leading to misinterpretations. We think that the proposed amendment set out

in paragraph 52 above meets the agenda criteria established by the *Due Process Handbook* issued in February 2013, because in our view:

(a) this issue could potentially have a widespread effect;

(b) we expect to reduce potential divergence in practice;

(c) the issue can be resolved efficiently within the confines of existing IFRSs and the Conceptual Framework for Financial Reporting.

(d) the issue is sufficiently narrow in scope and it is cost-effective for the Interpretations Committee, the IASB and interested parties to undertake the due process that would be required; and

(e) clarifying the existing wording of paragraph 16 maintains consistency with the main classification principle of cash flows in IAS 7 in paragraph 11.

54. An extract from the *Due Process Handbook* issued in February 2013 is provided in **Appendix B** of this paper.

Other considerations

55. We observe that in IAS 7 there is no consensus on the classification of interest paid/received and dividends paid/received (for non-financial institutions). At present, in accordance with paragraph 31 of IAS 7, cash flows from interest and dividends should be classified in a consistent manner from period to period as either part of operating, investing or financing activities. In addition, as stated in paragraphs 33–34:

(a) cash outflows from interest paid and dividends paid may be classified as **either** operating or financing cash flows; and

(b) cash inflows from interest received and dividends received may be classified as **either** operating or investing cash flows.

56. Based on our analysis in previous paragraphs for each one of the categories in the statement of cash flows (operating, financing, investing), we think that cash outflows for interest paid and dividends paid are not operating cash flows and should instead

(other than for financial institutions) be classified as financing cash flows because they represent the cost of obtaining financial resources.

57. We also think that cash inflows for interest received and dividends received are not investing cash flows investing activities because they do not represent:

(a) cash received from the disposal of long-term assets that are expected to generate future economic benefits, nor

(b) cash received from the disposal of debt or equity instruments of other entities (that do not meet the definition of cash and cash equivalents)

58. Moreover, we reflected on the view that cash inflows for interest received and dividends received should be classified as operating cash flows. This is because cash inflows for interest received and dividends received could be viewed as the operating returns obtained from an investment. This view considers that operating returns from an investment are excluded from the current definition of investing activities.

59. In relation to this topic we should mention that the IASB has proposed a modification to paragraph 16(a) and 33 (and has proposed adding paragraph 33A) to clarify that the classification of payments of interest that is capitalised shall follow the same classification as the underlying asset into which those payments were capitalised. This proposal was included in the Exposure Draft on *Annual Improvements to IFRSs 2010–2012 Cycle* (ED/2012/1) published in May 2012.

60. The IASB has received comments on the proposal to clarify the classification of payments of interest that is capitalised, that we have analysed in Agenda Paper 16C of April 2013.

61. The Interpretations Committee recommends the IASB not to proceed with the proposed amendment to paragraphs 16(a) and 33 of IAS 7 and the proposal to add paragraph 33A to IAS 7 due to:

(a) the concerns raised about the implementation of this amendment; and

(b) the Interpretations Committee’s conclusion at the March 2013 meeting that clarifying the application of the primary principle for the classification of cash flows in IAS 7 is a matter that is too broad for the Interpretations

Committee to address and as a consequence, the Interpretations Committee (refer to IFRIC Update of March 2013):

(i) determined that it could not take a comprehensive approach to the specific fact patterns recently discussed regarding the classification of cash flows under IAS 7; and

(ii) observed that several specific requests regarding the classification of cash flows had been considered individually but it thought that amendments to IAS 7 on a piecemeal basis would not be appropriate unless the classification is evident from the current guidance in IAS 7 and an amendment to IAS 7 would make that classification clearer.

62. The Interpretations Committee also does not recommend the IASB to modify the classification of interest paid or dividends paid or of interest received or dividends received for the reasons explained above.

Summary of the Interpretations Committee's recommendations

63. The Interpretations Committee's recommendations to the IASB are:

(a) *not to amend* the definitions of operating, investing and financing in IAS 7;

(b) *not to amend* IAS 7 on a piecemeal basis except when the cash flows classification is evident from the current guidance in IAS 7 and an amendment to IAS 7 would make that classification clearer; and

(c) *to amend* paragraph 16 of IAS 7 regarding the classification of expenditures

Proposal not to amend the definitions of operating, investing and financing in IAS 7

64. Some of the Interpretations Committee members found merit on the staff findings and ways to improve the current definitions of operating, investing and financing activities in paragraph 6 of IAS 7, particularly the flow chart that the staff had included summarising its views on the classification of cash flows (refer to **Appendix C** of this agenda paper to see the staff proposed amendments as well as the staff flow chart).

65. However, a majority of the members objected to the staff conclusions on the proposal to amend the current definitions because they consider it to be a matter that is too broad for the Interpretations Committee to address and beyond the scope of the Annual Improvements project. Some members also noted that, derived from the views gathered from the agenda consultation, the need for an amendment to IAS 7 was not regarded by many respondents as a high priority..

Proposal not to amend IAS 7 on a piecemeal basis

66. The Interpretations Committee also determined that it could not take a comprehensive approach to the specific fact patterns recently discussed regarding the classification of cash flows under IAS 7 because clarifying the application of the primary principle for the classification of cash flows in IAS 7 is a matter that is too broad for the Interpretations Committee to address.

67. It also observed that several specific requests regarding the classification of cash flows had been considered individually but it thought that amendments to IAS 7 on a piecemeal basis would not be appropriate unless the cash flows classification is evident from the current guidance in IAS 7 and an amendment to IAS 7 would make that classification clearer.

68. In line with the above, the Interpretations Committee also recommends the IASB to:

(a) halt the previous proposed amendment to paragraphs 16(a) and 33 of IAS 7 as well as the addition of paragraph 33A to clarify that the classification of payments of interest that is capitalised shall follow the same classification as the underlying asset into which those payments are capitalised (refer to Agenda Paper 16C of April 2013).

(b) not to proceed with the staff proposal to amend paragraph 14 of IAS 7 to clarify that an operator that provides construction or upgrade services in a service concession arrangement should present all of the cash flows relating to this activity as operating cash flows. This proposal had been discussed by the Interpretation Committee's meeting at its November 2011 meeting (refer to Agenda Paper 11) and presented to the IASB for discussion at the January 2012 meeting (refer to agenda paper 7C) but the IASB decided that before it could decide on whether or not this issue should be addressed through the annual improvements project, it would direct the staff to ask the Committee to look collectively at these two issues, as well as all of the previous IAS 7 issues that the Committee has discussed regarding the classification of cash flows and consider whether these issues could be dealt with collectively.

Proposal to amend paragraph 16 of IAS 7 regarding the classification of expenditures

69. The Interpretations Committee proposes the IASB to delete the guidance in paragraph 16 that states: “only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities”. We think that this proposed amendment is appropriate because it would make the classification of investing activities in IAS 7 clearer as explained in our assessment of the agenda criteria.

70. This proposed amendment to IAS 16 is shown in **Appendix A** of this agenda paper.

Question to the IASB

1. Does the IASB agree with the Interpretations Committee's recommendation not to amend the definitions in paragraph 6 of IAS 7 of operating, investing and financing within annual improvements?

2. Does the IASB agree with the Interpretations Committee's recommendation:

   (a) to halt the previously proposed amendment to paragraphs 16(a) and 33 of IAS 7 as well as the addition of paragraph 33A to clarify that the classification of payments of interest that is capitalised, as well as

   (b) not to proceed with the staff proposal to amend paragraph 14 of IAS 7 to clarify that an operator that provides construction or upgrade services in a service concession arrangement should present all of the cash flows relating to this activity as operating cash flows?

3. Does the IASB agree with the Interpretations Committee's recommendation to amend paragraph 16 of IAS 7 to delete the guidance that states: "only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities" as part of annual improvements?.

Appendix A
Proposed changes (IAS 7)

Paragraph 16 is amended. Deleted text is struck through.

Investing activities

16 The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. ~~Only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities.~~ Examples of cash flows arising from investing activities are:

(a) cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalised development costs and self-constructed property, plant and equipment;

(b) ...

…

Effective date

58 *Annual Improvements* [2012–2014] issued in [date] amended paragraph 16. An entity shall apply that amendment retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after [date]. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

Basis for Conclusions on the proposed amendments to IAS 7 *Statement of Cash Flows*

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Presentation of a statement of cash flows

BC1 The IASB noted that the primary principle for classification of cash flows on the basis of paragraph 11 of IAS 7 is that cash flows shall be classified in accordance with the nature of the activity in a manner that is most appropriate to the business of the entity in accordance with the definitions of operating, investing and financing activities in paragraph 6 of IAS 7.

BC2 The IASB observed that the guidance in paragraph 16 leads to the misinterpretation that expenditures that give rise to recognised assets are, by default, investing activities. In addition the IASB observed that the guidance in paragraph 16 of IAS 7 is giving precedence to the fact that cash flows should be classified consistently with the classification of the related or underlying item in the statement of financial position, being that cash flows shall be classified in accordance with the nature of the activity in a manner that is most appropriate to the business of the entity in accordance with the guidance in paragraph 11 of IAS 7.

BC3 The IASB proposes to clarify that an expenditure that gives rise to a recognised asset should be classified as an investing activity when it meets the definition of an investing activity and that expenditures that do not give rise to a recognisable asset could also meet the definition of investing activities to the extent to which these expenditures have been made for resources intended to generate future income and cash flows.

BC4 Consequently, the IASB proposes to amend the guidance in paragraph 16 by deleting the reference “only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities”.

Appendix B—Extract from the Due Process Handbook (February 2013)

5.16 …The Interpretations Committee should address issues:

(a) that have widespread effect and have, or are expected to have, a material effect on those affected;

(b) where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and

(c) that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.

5.17 The issue should be sufficiently narrow in scope that it can be addressed in an efficient manner by the Interpretations Committee, but not so narrow that it is not cost-effective for the Interpretations Committee and interested parties to undertake the due process that would be required when making changes to IFRSs.

5.21 The solution developed by the Interpretations Committee should be effective for a reasonable period of time. Accordingly, the Interpretations Committee would not normally develop an Interpretation if the topic is being addressed in a forthcoming Standard. However, this does not prevent the Interpretations Committee from acting on a particular matter if the short-term improvements can be justified.

…

6.12 Clarifying a Standard involves either replacing unclear wording in existing Standards or providing guidance where an absence of guidance is causing concern. Such an amendment maintains consistency with the existing principles within the applicable Standard and does not propose a new principle or change an existing principle.

6.13 Resolving a conflict between existing requirements of Standards includes addressing oversights or relatively minor unintended consequences that have arisen as a result of the existing requirements of Standards. Such amendments do not propose a new principle or a change to an existing principle.

6.14 Proposed Annual Improvements should be well defined and narrow in scope. The IASB assesses proposed Annual Improvements against the criteria set out above before they are published in an Exposure Draft. As a guide, if the IASB takes several meetings to reach a conclusion it is an indication that the cause of the issue is more fundamental than can be resolved within the Annual Improvements process.

Appendix C—Proposed staff changes to IAS 7 [not approved by the Interpretations Committee]

C1. The proposed amendments to IAS 7 are presented below

Amendment to IAS 7 *Statement of Cash Flows*

Paragraph 11A and 13A are added. Paragraph 11 is not proposed for amendment but is included here for ease of reference. Paragraphs 6, 13, 14, 16, 31, 33 and 34 are amended. New text is underlined and deleted text is struck through.

Presentation of a statement of cash flows

11 An entity presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the entity and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities

11A When classifying cash flows by activity an entity shall focus on the nature of the transaction that gave rise to the cash receipt or the cash payment. This principle of classification takes precedence if other guidance conflicts with it. The definitions of operating, investing and financing activities in paragraph 6 (and subsequent descriptions in IAS 7 for each activity) describe the nature of each of these activities.

Definitions

6 *Operating activities* are the cash effects of the transactions and other events that enter into the determination of profit or loss ~~principal revenue-producing activities of the entity~~ and include other activities that are not investing or financing activities.

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents (such as the making and collecting of loans and acquiring and disposing of debt or equity instruments of other entities).

Financing activities are activities for raising (or repaying) capital. These activities ~~that~~ result in changes in the size and composition of the contributed equity and borrowings of the entity.

Financing activities include obtaining resources derived from the issue of an entity's own equity instruments (as defined in IAS 32 *Financial Instruments: Presentation*).

A financing activity involves (a) the receipt or use of a resource from a provider of finance; (b) the expectation that the resource will be returned to the provider of finance; and (c) the expectation that the provider of finance will be appropriately compensated through a payment of a finance charge.

Financing activities include purchase transactions with suppliers who have provided extended credit.

Operating activities

13 The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the entity have generated sufficient cash flows to repay loans, maintain the operating capability of the entity, pay dividends and make new investments without recourse to external sources of financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows. The information provided within operating activities enables users to assess the reasons for differences between profit or loss and associated cash receipts and payments.

13A Cash effects of activities that do not represent principal revenue-producing activities should be segregated in a subsection within the operating activities section in the statement of cash flows.

14 ~~Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity.~~ Cash flows from operating activities are the cash effects of ~~Therefore, they generally result from~~ the transactions and other events that enter into the determination of profit or loss.

Investing activities

16 The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. ~~Only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities.~~ Examples of cash flows arising from investing activities are:

(a) cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalised development costs and self-constructed property, plant and equipment;

(b) (...)

(h) (...)

Interest and dividends

31 Cash flows from interest and dividends received and paid shall each be disclosed separately. ~~Each shall be classified in a consistent manner from period to period as either operating, investing or financing activities.~~

33 Interest paid and interest and dividends received are usually classified as operating cash flows for a financial institution. ~~However, there is no consensus on the classification of these cash flows for other entities. Interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of profit or loss. Alternatively,~~ However for a non-financial institution, interest paid is classified as a financing cash flow because it is a cost of obtaining financial resources. ~~and~~ I~~i~~nterest and dividends received ~~may be~~ are classified as ~~financing cash flows and investing~~ operating cash flows because they do not meet the definitions of investing or financing cash flows.~~because they are costs of obtaining financial resources or returns on investments.~~

34 Dividends paid ~~may be~~ are classified as a financing cash flow because they are a cost of obtaining financial resources. ~~Alternatively, dividends paid may be classified as a component of cash flows from operating activities in order to assist users to determine the ability of an entity to pay dividends out of operating cash flows.~~

Effective date

58 *Annual Improvements* [cycle] issued in [date] added paragraph 11A and 13A and amended paragraphs 6, 13, 14, 16, 31, 33 and 34. An entity shall apply those amendments retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after [date]. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

Basis for Conclusions on proposed amendments to IAS 7 *Statement of Cash Flows*

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Presentation of a statement of cash flows

BC1 The IASB noted that two 'principles of classification' in IAS 7 have been used to guide the classification of cash flows. The first principle, based on paragraph 11 of IAS 7, is that cash flows shall be classified in accordance with the nature of the activity in a manner that is most appropriate to the business of the entity in accordance with the definitions of operating, investing and financing activities in paragraph 6 of IAS 7. The second principle, based on paragraph 16 of IAS 7, is that cash flows should be classified consistently with the classification of the related or underlying item in the statement of financial position. The IASB considered it important to clarify that that the primary principle for classification of cash flows on the basis of paragraph 11 of IAS 7 is the classification of cash flows based on their nature. The IASB thinks that this principle of classification takes precedence if other guidance conflicts with this principle.

BC2 The IASB also considered adding more guidance on the application of the primary principle behind the classification of cash flows, to address existing diversity in practice regarding the classification of cash flows by activity. This can occur when transactions can be viewed as having aspects of operating, investing or financing activities and the appropriate classification might not be clear.

BC3 The IASB noted that the definitions of operating, investing and financing activities are too ambiguous to be applied consistently and uniformly in practice. Consequently, the IASB tentatively proposes some amendments to the definitions to give management more elements that can be used to identify the nature of a transaction.

BC4 The IASB proposes that the operating section should include the cash effects of transactions that enter into the determination of profit or loss. In this respect, the IASB observes that the main objective for presenting an operating section in the statement of cash flows is to align profit or loss items with cash receipts and payments so that the operating section provides a cash-basis measure of the entity's profit or loss.

BC5 The IASB also observed that operating activities involve the acquisition of short-term assets (which are part of working capital); whereas some investing activities involve long-term asset acquisitions. The IASB noted that this distinction is useful for users in making decisions.

BC5 The IASB also proposes to clarify that the financing section should reflect an entity's capital-raising activities. These activities fund an entity's general business activities, capital expenditures and acquisition activities. The IASB identified some elements that can generally be found in financing activities:

(a) the receipt or use of a resource from a provider of finance (or provision of credit); (b) the expectation that the resource will be returned to the provider of finance; and (c) the expectation that the provider of finance will be appropriately compensated through a payment of a finance charge. The finance charge is both dependent on the amount of the credit and the duration (time of the credit).

BC6 The IASB also proposes to clarify that if the credit term for the purchase of any item is extended beyond normal credit terms, the nature of the transaction changes and becomes a financing transaction. The IASB observes that this information is significant and useful for an investor.

BC6 The IASB also proposes to amend the guidance in paragraph 16 regarding the fact that “only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities”. The IASB noted that this guidance is leading to the misinterpretation that expenditures that give rise to recognised assets are by default investing activities. The IASB observed that an expenditure that gives rise to a recognised asset should be classified as an investing activity when it meets the definition of an investing activity and that expenditures that do not give rise to a recognisable asset could also meet the definition of investing activities to the extent to which these expenditures have been made for resources intended to generate future income and cash flows.

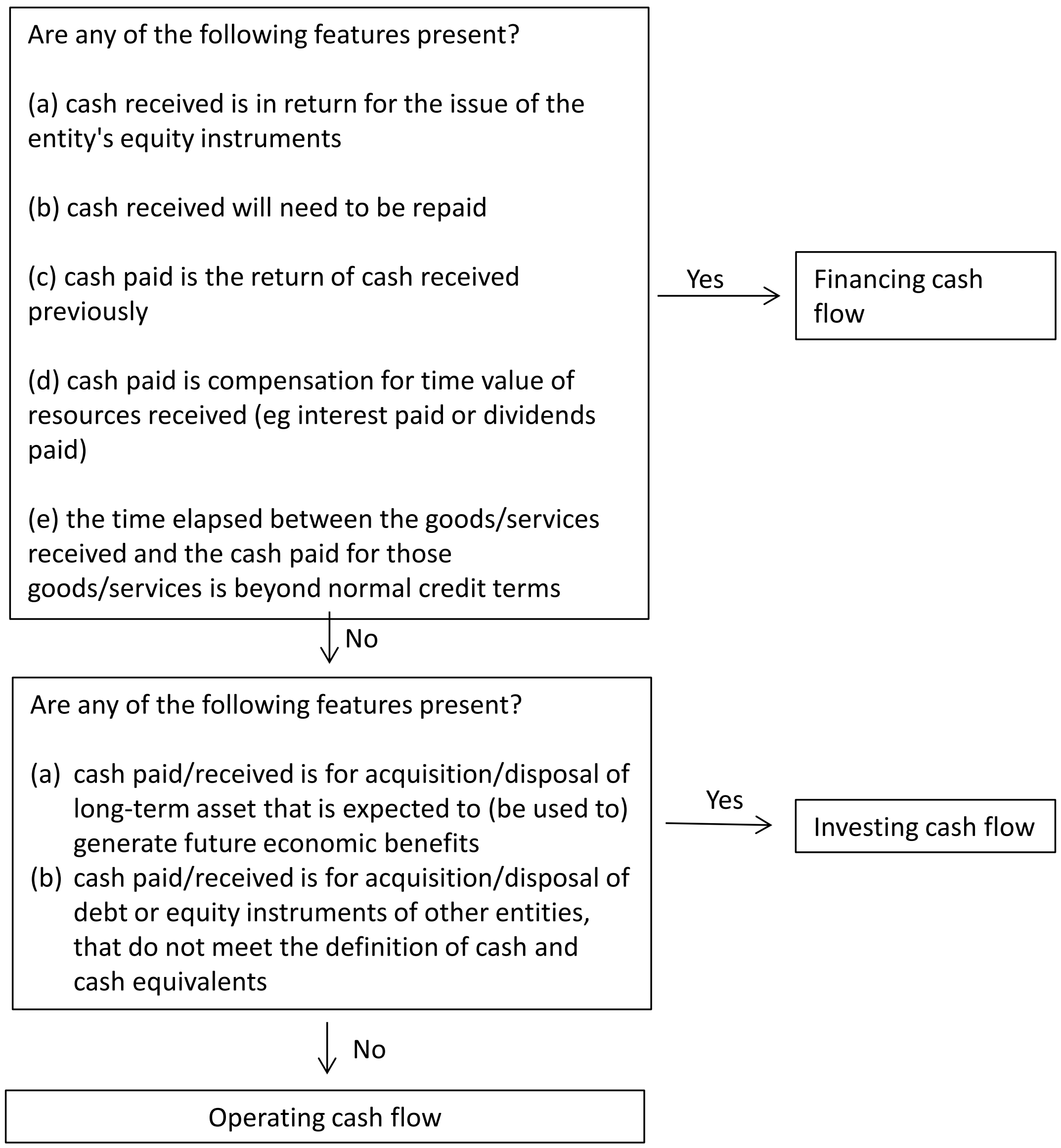
BC6 The IASB also proposes to amend the guidance in paragraphs 31, 33 and 34 to promote a consistent classification of cash flows from interest and dividends. The IASB proposes that cash flows from interest/dividends paid should not be classified as operating activities; instead they should be classified as financing activities. The IASB also proposes that cash flows from interest/dividends received should be classified as operating activities.

Guidance on implementing IAS 7 *Statement of Cash Flows*

This guidance accompanies, but is not part of, IAS 7

The following flow chart provides guidance on the identification of operating, investing and financing activities on the basis of the definitions in paragraph 6 of IAS 7.

Classification of cash flows



Appendix D—Proposed amendments to IAS 7 that the Interpretations Committee does not recommend to the IASB

Issue on service concession arrangements

D1. The Interpretations Committee recommends the IASB not to proceed with the proposal to amend paragraph 14 of IAS 7.

Amendment to IAS 7 *Statement of Cash Flows*

Paragraph 14 is amended as follows (new text is underlined):

Operating activities

14 Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events that enter into the determination of profit or loss. Examples of cash flows from operating activities are:

(a) cash receipts from the sale of goods and the rendering of services;

…

(f) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; ~~and~~

(g) cash receipts and payments from contracts held for dealing or trading purposes~~.~~<u>; and</u>

<u>(h) cash receipts and payments from construction or upgrade services related to service concession arrangements within the scope of IFRIC 12.</u>

Basis for Conclusions on proposed amendments to IAS 7 *Statement of Cash Flows*

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Cash payments for contingent and deferred considerations

BC1 The IASB received a request to clarify how an operator, in a service concession arrangement within the scope of IFRIC 12 *Service Concession Arrangements*, should classify the cash inflows and cash outflows resulting from construction or upgrade services.

BC2 The IASB thinks that the different accounting models in IFRIC 12 (intangible asset or financial asset) are not the relevant factor in determining cash flow presentation. The different accounting models, for construction or upgrade services, are a consequence of the different types of arrangements and definitions of a financial asset versus an intangible asset. However the IASB noted that this does not change the activity to which the construction services relate. In other words, regardless of whether the cash inflows will be obtained contractually from the grantor (financial asset model) or through services to the public (intangible asset model), the activity of satisfying a service concession arrangement is expected to be a principal revenue producing activity of an entity which undertakes such arrangements, ie an operating cash flow. For this reason, the IASB proposes to include these types of arrangements in IAS 7 paragraph 14(h) to clarify that the cash inflows and cash outflows resulting from construction or upgrade services should be classified as operating cash flows.

Appendix D (*Continued*)— Proposed amendments to IAS 7 that the Interpretations Committee does not recommend to the IASB

Interest that is capitalised[5]

D2. The Interpretations Committee recommends the IASB that it should halt the following proposed amendments to paragraphs 16(a) and 33 and the addition of paragraphs 33A and 58.

Amendment to IAS 7 *Statement of Cash Flows*

Paragraphs 33A and 58 are added. Paragraph 32 is not proposed for amendment but is included here for ease of reference. Paragraphs 16(a) and 33 are amended. New text is underlined and deleted text is struck through.

Presentation of a statement of cash flows

…

Investing activities

16 The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities. Examples of cash flows arising from investing activities are:

(a) cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to <u>capitalised borrowing costs</u>, capitalised development costs and self-constructed property, plant and equipment;

(b) ...

[5] This proposed amendment was included in the Exposure Draft (ED) on *Annual Improvements to IFRSs 2010 – 2012 cycle* (ED/2012/1) published in May 2012. The IASB has received comments on this proposal that we have analysed in Agenda paper 9C of March 2013.

Interest and dividends

32 The total amount of interest paid during a period is disclosed in the statement of cash flows whether it has been recognised as an expense in profit or loss or capitalised in accordance with IAS 23 *Borrowing Costs*.

33 Interest paid and interest and dividends received are usually classified as operating cash flows for a financial institution. However, there is no consensus on the classification of these cash flows for other entities. Interest paid (except for payments of interest that is capitalised, which shall be classified in accordance with paragraph 33A), and interest and dividends received, may be classified as operating cash flows because they enter into the determination of profit or loss. Alternatively, interest paid (except for payments of interest that is capitalised, which shall be classified in accordance with paragraph 33A), and interest and dividends received, may be classified as financing cash flows and investing cash flows respectively, because they are either costs of obtaining financial resources or returns on investments.

33A Payments of interest that is capitalised in accordance with IAS 23 shall be classified in accordance with the classification of the underlying asset to which those payments were capitalised. For example, payments of interest that is capitalised as part of the cost of property, plant and equipment shall be classified as part of an entity's investing activities, and payments of interest that is capitalised as part of the cost of inventories shall be classified as part of an entity's operating activities.

Effective date

58 *Annual Improvements to IFRSs 2010–2012 Cycle* issued in [date] amended paragraphs 16(a) and 33 and added paragraph 33A. An entity shall apply that amendment for annual periods beginning on or after 1 January 2014. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.

Basis for Conclusions on the proposed amendment to IAS 7 *Statement of Cash Flows*

This Basis for Conclusions accompanies, but is not part of, the proposed amendment.

Interest paid that is capitalised

BC1 The IASB received a request to clarify the classification in the statement of cash flows of interest paid that is capitalised into the cost of property, plant and equipment. Paragraph 16 of IAS 7 was interpreted as classifying interest paid that has been capitalised as an investing cash flow. However, the IASB was informed that this seemed to be inconsistent with paragraphs 32 and 33, which require interest paid to be classified only as an operating or a financing cash flow.

BC2 The IASB observed that interest paid that is capitalised into the cost of an asset should be classified as an investing activity in accordance with paragraph 16, because it results in a recognised asset in the statement of financial position. Paragraph 32 states that interest paid that is capitalised according to IAS 23 *Borrowing Costs* should be reflected in the statement of cash flows; however, the IASB noted that neither IAS 23 nor IAS 7 specifies where such capitalised interest should be classified in the statement of cash flows. Paragraph 33 allows for interest paid to be classified as part of either operating or financing activities. However, the IASB noted that this paragraph does not specify whether interest paid that is capitalised as part of the cost of an asset should be classified in the same way or not.

BC3 To address this lack of guidance, the IASB proposes to modify paragraphs 16(a) and 33 and proposes adding paragraph 33A to clarify that the classification of payments of interest that is capitalised shall follow the same classification as the underlying asset into which those payments were capitalised. This modification also covers the classification of payments of interest that have been capitalised into the cost of operating assets (such as inventory), which should be classified as part of an entity’s cash flows from operating activities.