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Project **Annual Improvements—2010-2012 cycle**

Topic **IAS 7 *Statement of Cash Flows*—classification of interest paid that is capitalised as part of the cost of an asset**

Purpose of this paper

1. In March 2011 the IFRS Interpretations Committee (the Committee) 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. IAS 7.16 might be interpreted to require interest paid that is capitalised to be classified as an investing cash flow. However, this might seem inconsistent with IAS 7.32 and 33 which appears to require interest paid to be classified only as an operating or a financing cash flow.

2. The Committee discussed this issue at the May 2011 meeting and made a recommendation to the Board to propose an improvement through the annual improvements project.

3. This paper:

   (a) provides background information and explains the issue;

   (b) makes a recommendation to amend paragraphs 16(a) and 33 of IAS 7 and add paragraph 33A to clarify that the classification of payments of interest that are capitalised should follow the classification of the underlying asset to which those payments were capitalised.

   (c) asks the Board whether they agree with the recommendation.

4. This paper contains a summary of the analysis presented to the Committee in May 2011. Our full analysis was set out in Agenda Paper 6, which can be found on the public website, and includes the text of the original submission.

Background information

Interest and dividends

5. IAS 7 *Statement of Cash Flows* does not prescribe how interest and dividends received and paid should be classified. Instead, paragraph 31 of IAS 7 requires cash flows from interest and dividends received and paid to be disclosed separately and classified in a consistent manner from period to period as operating, investing or financing activities.

6. Paragraph 32 refers explicitly to interest paid that has been capitalised in accordance with IAS 23 *Borrowing Costs.*

7. Paragraph 33 further explains that interest paid and interest and dividends received are usually classified as operating cash flows for a financial institution. However, for other entities, the guidance in paragraph 33 states that interest paid may be classified as either operating or financing, thus implying that the investing classification should not be used as the following extract from IAS 7 explains (emphasis added):

> 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, interest paid and interest and dividends received **may be classified as financing cash flows and investing cash flows respectively, because they are costs of obtaining financial resources or returns on investments.**

Investing activities – expenditures that result in a recognised asset

8. On the other hand, paragraph 16 in IAS 7 is clear that expenditures that result in the recognition of an asset should be classified as cash flows from investing activities as highlighted below (emphasis added):

> 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) (...)

Staff analysis

9. We think that interest paid that is capitalised into the cost of an asset is eligible for classification as an investing activity in accordance with paragraph 16 of IAS 7, as it results in a recognised asset in the statement of financial position. However such classification seems to contradict the guidance in paragraphs 32 and 33 in IAS 7 for the following reasons:

    (a) paragraph 33 allows for interest paid to be classified as either part of operating or financing activities . However, it 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.

    (b) paragraph 32 refers that interest paid that is capitalised according to IAS 23 should be reflected in the statement of cash flows. However, neither IAS 23 nor IAS 7 specify where such capitalised interest should be classified in the statement of cash flows.

10. Consequently, there appears to be a conflict between paragraph 16 and paragraphs 32 and 33 of IAS 7.

The staff's conclusion

11. We proposed that the example guidance in paragraph 16(a) of cash flows arising from investing activities should explicitly include interest paid that is capitalised into the cost of property, plant and equipment.

12. We also proposed clarifying the guidance in paragraphs 32 and 33 in IAS 7 to avoid a contradiction with the guidance in paragraph 16 (refer to Appendix A in Agenda Paper 6 of May 2011) by:

    (a) indicating in paragraph 32 that interest paid that has been capitalised in accordance with IAS 23 should be classified in accordance with paragraph 16; and

    (b) excluding from the guidance in paragraph 33, the interest paid that has been capitalised in accordance with IAS 23 *Borrowing Costs* and referring instead to paragraph 16.

13. Also, on the basis of the assessment under the existing annual improvements criteria (refer to the staff's assessment in paragraph 13 of Agenda Paper 6 of May 2011), we proposed the Committee to recommend the Board to proceed with amendments to paragraphs 16(a), 32 and 33 of IAS 7.

Interpretations Committee's recommendation

14. The Interpretations Committee agreed with the staff's proposed clarification to paragraph 16(a) of IAS 7.

15. However the Committee disagreed with the proposed amendments to paragraphs 32 and 33 of IAS 7 and thought that an easier way to clarify the classification of interest paid that is capitalised in accordance with IAS 23 would be to:

    (a) explicitly exclude the classification of interest paid that is capitalised in accordance with IAS 23 from paragraph 33 of IAS 7; and

    (b) clarify in a new paragraph (ie paragraph 33A) that the classification of interest paid that is capitalised in accordance with IAS 23 should be in conformity with the classification of the underlying asset to which those payments were capitalised. The Committee noted that the staff's proposed amendment to paragraph 16(a) of IAS 7 regarding the classification of payments of interest capitalised as part of the cost of property, plant and equipment in investing activities is consistent with the proposed guidance in paragraph 33A. This modification also addresses the classification of payments of interest capitalised into the cost of inventory as part of an entity's operating activities.

16. If the Board agrees with the Committee's recommendation, we propose amendments to paragraphs 16(a) and 33 and we also propose adding paragraph 33A. These draft amendments are shown in Appendix A to this paper.

Question to the Board

Question 1—proposed changes to IAS 7
1. Does the Board agree with the Committee's recommendation that the Board should make an amendment to paragraphs 16(a) and 33 and add paragraph 33A in IAS 7, as part of the 2010-2012 annual improvements project? 2. Does the Board have any comments on the proposed wording for the amendment to IAS 7 in Appendix A?

Appendix A – Proposed changes

A1. The staff proposes amendments to paragraphs 16(a) and 33 are presented below. The staff also proposes adding paragraph 33A.

Amendment to IAS 7 *Statement of Cash Flows*

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

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, as well as payments of interest capitalised as part of the cost of those assets. These payments include those relating to capitalised development costs and self-constructed property, plant and equipment.

(b) cash receipts from sales of property, plant and equipment, intangibles and other long-term assets;

(c) cash payments to acquire equity or debt instruments of other entities and interests in joint ventures (other than payments for those instruments considered to be cash equivalents or those held for dealing or trading purposes);

(d) cash receipts from sales of equity or debt instruments of other entities and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes);

(e) cash advances and loans made to other parties (other than advances and loans made by a financial institution);

(f) cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a financial institution);

(g) cash payments for futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and

(h) cash receipts from futures contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

When a contract is accounted for as a hedge of an identifiable position the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

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 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 (<u>except for payments of interest that are capitalised, which shall be classified in accordance with paragraph 33A),</u> 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.

<u>33A Payments of interest that are capitalised in accordance with IAS 23 shall be classified in conformity with the classification of the underlying asset to which those payments were capitalised. For example, payments of interest that are 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 are capitalised as part of the cost of inventories shall be classified as part of an entity’s operating activities.</u>

A2. We are proposing adding the following paragraph to the Basis for Conclusions of IAS 7:

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.

Classification of interest paid that is capitalised

BC1 The Board received a request to clarify the classification in the cash flow statement of interest paid that is capitalised into the cost of property, plant and equipment. Paragraph 16 was interpreted as requiring interest paid that has been capitalised to be classified as an investing cash flow. However, the Board was informed that this seemed to be inconsistent with paragraphs 32 and 33 which required interest paid to be classified only as an operating or a financing cash flow. To eliminate a conflict the Board proposes a modification to paragraphs 16(a) and 33 of IAS 7 and proposes adding paragraph 33A to clarify that the classification of payments of interest that are capitalised shall follow the classification of the underlying asset to which those payments were capitalised.