STAFF PAPER

12 – 13 March 2013

IFRS Interpretations Committee Meeting

IFRS IC May 2011/Jan 2013 (deferred) | IASB September 2011

Project	**Annual Improvements to IFRSs—2010-2012 Cycle (ED/2012/1) comment letter analysis**
Paper topic	IAS 7 *Statement of Cash Flows*—classification of interest paid that is capitalised as part of the cost of an asset

CONTACT(S) Denise Durant ddurant@ifrs.org +44 (0)20 7246 6469

Introduction

1. The Exposure Draft (ED) on *Annual Improvements to IFRSs 2010 –2012 cycle* (ED/2012/1) published in May 2012 includes the IASB's proposal to:

   (a) amend the requirements in paragraphs 16 and 33 of IAS 7 and

   (b) add paragraph 33A to IAS 7.

2. This amendment proposes 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.

Objective of the paper

3. The objective of this paper is to provide an analysis of the comment letters received on the proposal to amend the requirements in paragraphs 16 and 33 of IAS 7 and add paragraph 33A to IAS 7 and to obtain a recommendation from the IFRS Interpretations Committee (the Interpretations Committee).

Structure of the paper

4. This paper:

   (a) provides background information and explains the issue;

   (b) analyses the comments received as part of the Exposure Draft process and recommends to the Interpretations Committee to recommend the IASB to halt this proposed amendment to IAS 7 until the Interpretations Committee finalises its discussions on the clarification of the underlying principle for classifying cash flows; and

   (c) asks the Interpretations Committee to confirm whether they agree with the staff recommendation.

Background information

Current guidance in IFRSs

5. IAS 7 *Statement of Cash Flows* does not prescribe how interest/dividends received and how interest/dividends paid should be classified. Instead, paragraph 31 of IAS 7 requires cash flows from interest/dividends received/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 for a financial institution, interest paid and interest and dividends received are usually classified as operating cash flows. 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 states 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**;
>
> (...)

Issue that led to the proposed amendment

9. In March 2011 the Interpretations 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.

10. Paragraph 16 of IAS 7 might be interpreted to require interest paid that is capitalised to be classified as an investing cash flow. However, this might seem inconsistent with paragraphs 32 and 33 of IAS 7, which appear to require interest paid to be classified only as an operating or a financing cash flow.

11. The Interpretations Committee discussed this issue at the May 2011 meeting (refer to Agenda Paper 6) and made a recommendation to the IASB to propose an improvement through the annual improvements project (refer to the *IFRIC Update* of May 2011).

The IASB's proposal to address the issues raised

12. At the September 2011 meeting (refer to Agenda Paper 7F) the IASB discussed the issue and agreed with the Interpretations Committee's decision to propose an improvement to IAS 7 (refer to the *IASB Update* of September 2011).

13. The amendment:

    (a) proposes 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; and

    (b) clarifies in paragraph 33 (and in the new paragraph 33A) that interest paid that is capitalised in accordance with IAS 23 should be classified in conformity with the classification of the underlying asset to which those payments were capitalised.

14. The proposed amendment is reproduced below for ease of reference **(new text is underlined)**:

> **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 borrowing costs, capitalised development costs and self-constructed property, plant and equipment;

...

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.

Comment letter analysis

15. In this section, we discuss and analyse the comments received from interested parties on the ED (May 2012) during the comment period, which ended on 5 September 2012.

16. The Board received 84 comment letters on the ED. Of these, 71 respondents expressed their views on the proposed amendment to IAS 7 regarding the classification of interest paid that is capitalised.

17. The ED asked two general questions that were answered individually for each proposed amendment:

    (a) **Question 1**: *Do you agree with the Board's proposal to amend the IFRS as described in the exposure draft? If not, why and what alternative do you propose?*

    (b) **Question 2**: *Do you agree with the proposed transitional provisions and effective date for the issue as described in the exposure draft?*

Analysis of Question 1

18. In respect of **Question 1** about the IASB's proposal to amend paragraph 16(a) and paragraph 33 and add paragraph 33A:

    (a) almost **two-thirds** of the respondents **agree** with the proposed amendment.

    (b) **fewer than a dozen** of the respondents **agreed in principle** (not included as part of those who agree) with the proposed amendment but noted additional issues that the IASB should look at before finalising the proposed amendment; and

(c) **fewer than one third** of the respondents disagreed with the proposed amendment.

19. We observe that respondents who **agreed** did so because they think that the proposed amendment will allow more consistent classification of interest that is capitalised.

20. Respondents who **agreed in principle** or **disagreed** with the proposed amendment gave mainly the following arguments:

(a) The proposals may be difficult to implement in practice[1]

(b) The proposed amendment may not be consistent with the conclusion that the IFRS Interpretations Committee will reach after reviewing the underlying principle for classifying cash flows in IAS 7[2]

(c) The proposed amendment is not needed[3]

Proposed amendment may be difficult to implement in practice

Differences in timing of recognition

21. A few respondents think that the proposed amendment may be difficult to implement especially in those cases in which:

(a) interest expense incurred in the period is different from the amount capitalised in the same period;

(b) interest expense occurs in a period different from the actual payment of interest; and also if

(c) the payment of interest occurs in a period different from the period in which the underlying asset is purchased.

22. The following comments illustrate the points mentioned above (emphasis added):

[1] Roche Group, ACCA, MASB, SAICA, BP, British Tobacco, Business Europe, Lin, National Grid, Institute of Professional Accountants of Russia, Shell International, Swiss Holdings, The Hundred Group and VMEBF.

[2] BDO UK, Ernst & Young, EFRAG, Grant Thornton, PWC, Deloitte, IDW, KPMG, Mazars and ICAEW.

[3] CRUF and FAR.

British American Tobacco

Interest is charged and capitalised on an accruals basis / effective interest rate method, **whereas interest paid is recognised in the cash flow statement on an actual cash paid basis.** In many cases it will add an unnecessary **layer of complexity with arbitrary adjustments to reflect a non-cash approach through to the cash flow statement**; for example, **identifying the actual interest paid in respect of the funding of qualifying assets, particularly where borrowing costs have been estimated and capitalised using a capitalisation rate.** We do not agree that splitting the actual cash number between more sections of the cash flow statement on an estimated basis would provide better quality information to users of financial statements than the current treatment.

National Grid

Many companies, including National Grid, issue index-linked debt. Under the terms of such debt, a lower annual coupon is paid whilst the amount to be paid on maturity increases according to an index (e.g. UK RPI). Under the effective interest method this indexation is incorporated into borrowing costs. **Consequently, there can be a significant difference borrowing costs and interest payments in any one year. Where issued debt has a long maturity, some payments for borrowing costs will be made long after the costs have been recognised.**

Swiss Holdings

However, we believe that **the suggested change, although conceptually sound, could be very complex to implement**. It could require the use of **arbitrary assumptions about the relationship of interest expense and the related cash flows** which are inappropriate for certain facts and circumstances. This is

> due to the fact that **interest presented as expense under the effective interest method is not always recognized in the same period as the period in which the corresponding actual interest payments (i.e. cash outflows) occur** (i.e. interest expense for zero coupon financial debt). **Therefore reconciling capitalized to actual interest paid will be a very challenging exercise in practice**. We therefore suggest classifying the expenses as interest expense in line with the nature of the cash flow.

23. The above respondent (National Grid) includes the following example to illustrate its views (emphasis added):

> Assume that an entity issues a 100 bond to fund a single asset. The bond has a 3 year term, an annual interest payment of 2% and an increase in the amount to be paid on maturity based on inflation (assumed to be stable at 3% per annum). Borrowing costs are eligible for capitalisation in year 1 only.
>
> Under these assumptions and in accordance with IAS 23, the entity would capitalise a total borrowing cost of 5 in year 1 (100 x 2% interest + 100 x 3% indexation).
>
> **As the two elements of this borrowing cost are settled in different periods,** under the proposals, the interest payment will be shown in investing activities in year 1 whereas the payment of the indexation will be recorded in investing activities in year 3 when the bond is repaid.

Would involve arbitrary calculations

24. Other respondents have pointed out that implementing the proposed amendment would 'force' an entity to make an arbitrary calculation in determining how much of the interest capitalised has been paid to acquire underlying assets (operating and/or investing assets), especially:

(a) when the construction of a qualifying asset is financed by general borrowings; or

(b) in the cases mentioned in paragraph 11 of IAS 23. This is, for example when, among other possible situations, the financing activity of an entity is co-ordinated centrally; or a group uses a range of debt instruments to borrow funds at varying rates of interest, and lends those funds on various bases to other entities in the group.

25. The following comments illustrate some of the views explained above:

Business Europe

Any attempt to "shoehorn" the IAS 23 accounting outcome into the cash flow statement **will inevitably involve an arbitrary allocation of cash paid for the period, particularly if IAS 23.14** is the appropriate accounting whereby an entity applies a weighted average interest rate to determine the interest to be capitalised for that period **and is limited as to the amount that can be capitalised**. Another example that would require such allocation is "interest free" loans issued at a discount, requiring the calculation of an interest element for accounting purposes. The problem is exacerbated because (as is proposed in IAS 7.33A) an entity's interest paid could potentially have to be classified between all three activities (operating, investing and financing).

Lin

At the same time, it is worried about that the proposed approach need subjective judgement, especially when the outstanding interest hasn't been fully paid. **For example, one entity incurred interest of 10 million and capitalised 6 million during a month, but paid only 7 million. How can the financial statement preparer know the amount to be allocated among investing or financing in case of interest arising from general borrowing in IAS 23**?

26. Moreover, one respondent points out that the allocation of interest paid that has been capitalised to different activities would be made more difficult, because according to the guidance in paragraph 14 of IAS 23, the amount of borrowing costs eligible for capitalisation is limited. Paragraph 14 of IAS 23 states that (emphasis added):

> To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, **the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset. The capitalisation rate shall be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period**, other than borrowings made specifically for the purpose of obtaining a qualifying asset. **The amount of borrowing costs that an entity capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period**.

27. We think that the determination of the amount of interest paid that would be capitalised into the cost of the underlying asset is difficult and would involve the use of judgement. We note that in this respect, paragraph 11 of IAS 23 notes a similar difficulty when trying to identify a direct relationship between particular borrowings and a qualifying asset, as follows (emphasis added):

> **11 It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided.** Such a difficulty occurs, for example, when the financing activity of an entity is co-ordinated centrally. Difficulties also arise when a group uses a range of debt instruments to borrow funds at varying rates of interest, and lends those funds on various bases to other entities in the group. Other complications arise through the use of loans denominated in or linked to foreign currencies, when the group operates in highly inflationary economies,

> and from fluctuations in exchange rates. **As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and the exercise of judgement is required.**

28. We observe that in the view of respondents, the proposed amendments would add another layer of complexity in terms of allocating the cash payments in addition to the difficulties and the judgement needed in accordance with paragraph 11 of IAS 23.

The presentation of interest paid that is capitalised is not clear

29. Another respondent observes that it is not clear whether the presentation of the interest paid can be aggregated (or not) into a single line item on the face of the statement of cash flows with the related cash flows of the underlying capital asset. This respondent gives the following example:

> **<u>SAICA</u>**
>
> If an entity constructed an asset for CU110m which included interest capitalised (and paid) of CU10m. Can a single outflow of CU110m be shown under Investing Activities or should the CU10m be shown separately from the CU100m on the face of the statement of cash flows?

30. In our discussion of the proposed amendment this point was not specifically deliberated upon by the IASB. However, in our view, interest paid that is capitalised would be disaggregated if this amount is material.

The amendment should refer to 'borrowing costs' and not to 'interest capitalised' only

31. A few other respondents point out that the proposed amendment should refer to 'borrowing costs' rather than only to 'interest' in paragraphs 33 and 33A of the proposed amendment, because 'interest' is only one of the elements of borrowing costs as defined in paragraph 6 of IAS 23 (others are, for example, other finance charges and some exchange differences).

32. We agree with these respondents that 'interest expense' is one of the components of borrowing costs. However, the focus of the proposed amendment is on interest paid (which is a cash-basis concept and not an accrual-basis concept) and as such we think that the proposed amendment, if finalised, should refer only to the total amount of interest paid that is capitalised.

The proposed amendment may not be consistent with the underlying principle for classifying cash flows in IAS 7

33. One-third of the respondents who disagreed or agreed only in principle (and not necessarily in detail) with the proposed amendment note that the IASB should first conclude its discussions on the clarification of the underlying principle in classifying cash flows before attempting to fix individual issues on a piecemeal basis.

34. In line with this, several respondents also pointed out that the proposed amendment seems to be based on the alternative classification principle 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.

bearing in mind that in March 2012 (refer to *IFRIC Update* of March 2012) the IFRS Interpretations Committee expressed the following preference:

> 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

35. These respondents suggest to the IASB that it should hold back its proposed amendment to IAS 7 until the Interpretations Committee has completed this project. They think that the outcome of these discussions should be taken into account when redeliberating this proposed amendment.

36. We agree with these respondents that the IASB should keep this proposed amendment on hold until the IFRS Interpretations Committee issues a

recommendation to the IASB based on the outcome of its discussions regarding the underlying principle that should guide the classification of cash flows.

37. In this respect we think that whenever the proposed amendment is re-deliberated, the IASB could take into account, among others, some of the following suggestions proposed by respondents to address some of the concerns expressed by them:

(a) provide additional guidance on how the proposed amendment would be implemented;

(b) avoid arbitrary allocations by clarifying that the nature of interest paid (whether capitalised or not) is always financing. Consequently, payments of interest that are capitalised shall be classified in the financing section and the split between operating or investing activities would not be required[4];

(c) classify interest paid that is capitalised in accordance with IAS 23 in accordance with the underlying asset only if this is practical; or

(d) make the proposed amendment more specific by only amending paragraph 16(a) of IAS 7 to specify the classification of cash paid in relation "to capitalised development costs and self-constructed property, plant and equipment".

The proposed amendment is not needed

38. One of the respondents to the ED (CRUF) provides some reasons of why this respondent thinks that the amendment is not needed (emphasis added):

> **CRUF**
>
> **We do not believe that the proposed amendment is necessary. We believe that rather than this classification, a reconciliation of the cash flow statement with the income statement charge would add more value for users**. Users often struggle to

[4] This suggestion is in line with our proposal to eliminate the alternative for the classification of interest/dividends paid within 'operating activities' in our Agenda Paper 7 of March 2013.

> understand exactly how the income statement financial items relate to the liabilities on the balance sheet and cash expenditure including the unwinding of the discount rate on long-term liabilities in addition to capitalised interest. We are not convinced that a split as proposed would help solve this bigger issue.

Analysis of Question 2

39. With respect to Question 2, respondents who agreed with the proposed amendment **broadly agree** with the transition and effective date of the proposed amendment, ie that the proposed amendment would apply in annual periods beginning on or after 1 January 2014 with earlier application permitted.

Staff recommendation

40. On the basis of the analysis in the previous section, we think that the Interpretations Committee should refrain from recommending to the IASB that it should proceed with the proposed amendment to paragraphs 16 (a) and 33 of IAS 7 and add paragraph 33A to IAS 7 due to the concerns raised about the implementation of the amendment.

41. We also think that the Interpretations Committee should recommend the IASB that it should halt the proposed amendments to IAS 7 until the Interpretations Committee finalises its discussions on the clarification of the underlying principle for classifying cash flows. The Interpretations Committee will discuss the underlying principle for classifying cash flows at the March 2013 meeting (refer to **Agenda Paper 7**).

42. For reference purposes we are including in **Appendix A** the proposed amendment as published in the *Annual Improvements* ED of May 2012.

Question to the IFRS Interpretations Committee
Does the Committee agree to recommend to the IASB that it should not proceed with the amendment until the discussions about the underlying principle for classifying cash flows are concluded?

Appendix A—Changes for finalising the amendment

A1. The proposed amendments to paragraphs 16(a) and 33 and the addition of paragraphs 33A and 58 are presented below. Paragraph 32 is not proposed for amendment but is included here for ease of reference[5].

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 <u>underlined</u> 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) ...

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

[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

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.