IFRS

STAFF PAPER

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IASB® meeting

Project	**Primary Financial Statements**
Paper topic	Classification of interest and dividends in the statement of cash flows

CONTACT(S)	Kensuke Okabe	kokabe@ifrs.org	+44 (0) 20 7246 6439
	Aida Vatrenjak	avatrenjak@ifrs.org	+44 (0) 20 7246 6456

Purpose of this paper

1. At its December 2017 and February 2019 meetings, the Board made tentative decisions about the classification of interest and dividends in the statement of cash flows. At its February 2019 meeting, one Board member made an alternative suggestion about the classification of these cash flows which some other Board members suggested the staff should explore. This paper analyses this suggestion and discusses whether the Board should amend its tentative decisions.

Staff recommendation

2. The staff recommend that the Board retain its tentative decisions regarding the classification of interest and dividends in the statement of cash flows without amendment.

Structure of this paper

3. This paper is structured as follows:

    (a) Background (paragraphs 4–17); and

    (b) Staff analysis and recommendation (paragraphs 18–22)

(c) Appendix A— summary of classification of interest and dividends

Background

Current IFRS requirements

4. Paragraph 6 of IAS 7 *Statement of Cash Flows* defines the following activities:

   (a) *operating activities* are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities;

   (b) *investing activities* are the acquisition and disposal of long-term assets and other investments not included in cash equivalents; and

   (c) *financing activities* are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

5. Paragraph 14 of IAS 7 states that cash flows from operating activities generally result from the transactions and other events that enter into the determination of profit or loss.

6. Paragraph 33 of IAS 7 states that interest paid and interest and dividends received are normally classified as operating cash flows by a financial institution. However, there is no consensus on the classification of cash flows for non-financial entities and IAS 7 allows the following classifications.

Table 1: Classification for non-financial entities applying IAS 7

Cash flow item	Classification allowed by IAS 7
Interest paid	Operating or Financing
Dividends paid	Operating or Financing
Interest received	Operating or Investing
Dividends received	Operating or Investing

Scope of the project and the Board's tentative decisions for the statement of cash flows

7. Regarding the statement of cash flows, the Board is proposing:

   (a) to eliminate options for the classification of the cash flows from interest and dividends (see paragraphs 10–14); and

(b) to require entities to use the operating profit subtotal as the starting point for the indirect reconciliation of cash flows from operating activities.

8. The Board is not proposing to:

(a) seek full alignment between the operating section of the statement of cash flows and the corresponding sections in the statement(s) of financial performance; or

(b) make further improvements to the statement of cash flows, besides those mentioned above.

9. At its November 2017 meeting[1], the Board tentatively decided to clarify the definition of 'financing activities' in IAS 7 (see paragraph 4(c)) by indicating that 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.

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

Classification of dividends and interest for non-financial entities

10. At its December 2017 meeting, the Board tentatively decided to remove the classification options for interest and dividends (see Table 1) for non-financial entities and require the classifications shown in Table 2.[2]

Table 2: Classification for non-financial entities applying the tentative decisions

Cash flow item	Classification per Board's tentative decisions
Interest paid	Financing
Dividends paid	Financing
Interest received	Investing
Dividends received	Investing

[1] https://www.ifrs.org/news-and-events/updates/iasb-updates/november-2017/

[2] https://www.ifrs.org/news-and-events/updates/iasb-updates/december-2017/

11. This tentative decision:

(a) requires entities to classify each type of cash flow (dividends paid, dividends received, interest paid and interest received) in a single section of the statement of cash flows; and

(b) results in a classification in the statement of cash flows that is generally consistent with the classification of the related income or expense in the statement(s) of financial performance.

Classification of interest and dividends for financial entities

12. At its February 2019 meeting, the Board discussed whether the classification for non-financial entities in Table 2 should be applied to financial entities.[3] The Board noted that the proposed approach to classification for non-financial entities could not be applied to financial entities without modification. This is because such an approach would result in cash flows that are clearly operating in nature being classified as investing or financing (for example, interest paid would be classified as financing by a bank).

13. The Board therefore decided to propose an approach for financial entities that would result in the outcomes described in paragraph 11. Applying this approach, financial entities will apply the following guidance to determine the classification of their interest and dividends cash flows:

(a) if the entity presents related income or expenses in a single section of the statement(s) of financial performance, the entity shall present related cash flows in that section; or

(b) if the entity presents related income or expenses in more than one section of the statement(s) of financial performance, the entity shall make an accounting policy choice regarding the section of the statement of cash flows in which to present related cash flows.

[3] By financial entities we mean entities that provide financing to customers as a main business activity and/or invest in the course of their main business activities in assets that generate a return individually and largely independently of other resources held by the entity.

14. Consequently, financial entities would classify their interest and dividends cash flows as shown in Table 3.[4]

Table 3: Classification for financial entities applying the tentative decisions[5]

Cash flow item	Classification per Board's tentative decisions
Interest paid	Operating or Financing
Dividends paid	Financing
Interest received	Operating, Investing or Financing
Dividends received	Operating or Investing

Alternative approach

15. At the February 2019 meeting, one Board member suggested that both financial entities and non-financial entities should classify dividends received, interest paid and interest received as operating cash flows (dividends paid would remain classified as financing cash flows). Table 4 presents the classification of cash flows applying this approach.

Table 4: Suggested alternative classification for all entities

Cash flow item	Classification
Interest paid	Operating
Dividends paid	Financing
Interest received	Operating
Dividends received	Operating

16. The Board member suggested this approach because it would:

(a) be consistent with the Board's objective of eliminating options for the classification of interest and dividends cash flows (see paragraph 7(a));

(b) reduce complexity in preparing the statement of cash flows; and

(c) improve comparability between entities applying IFRS Standards and entities applying US GAAP.

[4] https://www.ifrs.org/news-and-events/updates/iasb-updates/february-2019/

[5] Refer to Variant 2 of Approach B of AP21B February 2019

17. This approach was not included in the staff paper nor was discussed in detail at the February 2019 Board meeting. However, a few of Board members asked staff to consider this approach.

Staff analysis and recommendation

Advantages of the alternative approach

18. As with the Board's proposed approach, the alternative approach described in paragraph 15 would achieve the Board's objective of eliminating options for the classification of interest and dividends cash flows. This will reduce diversity in practice making users' analysis of the statement of cash flows simpler and less costly—users would not need to identify where in the statement of cash flows interest and dividends cash flows have been classified.

19. Additional advantages of the alternative approach are that:

    (a) it would be simpler for preparers to apply and easier for users to understand than the Board's proposed approach.

    (b) it would be consistent with the approach to classifying operating cash flows described in paragraph 14 of IAS 7 (see paragraph 5) because dividends received, interest paid and interest received generally result from transactions and other events that enter into the determination of profit or loss.

    (c) it would be less costly for preparers to apply because:

        (i) they would not need to determine how to classify these cash flows; and

        (ii) for many entities this approach would not result in a change to existing practice (our analysis of 85 financial statements of non-financial entities shows that many entities classify cash flows from dividends received, interest paid and interest received in the operating section (see Appendix A)).

    (d) it would be consistent with US GAAP which generally requires dividends received, interest paid and interest received to be classified as operating cash flows.[6] Consequently, this approach would help users compare entities that apply US GAAP with entities that apply IFRS Standards.

Disadvantages of the alternative approach

20. The alternative approach has the following disadvantages:

    (a) it is arguably inconsistent with the definition of operating activities in paragraph 6 of IAS 7 (see paragraph 4). This is because, for non-financial entities, interest paid generally would not arise from the entity's main revenue-producing activities but would meet the definition of financing activities—cash flows from interest paid represent the compensation that an entity pays to the provider of finance. Whilst we could consider changing the definition of operating cash flows, this might go beyond the scope of this project (see paragraph 8(b)).

    (b) if the Board were to change the definition of operating cash flows as suggested in paragraph 20(a), this would result in less alignment between the operating profit section of the statement(s) of financial performance and the operating cash flows section of the statement of cash flows than the Board's proposed approach. We acknowledge that the Board has tentatively decided not to seek full alignment between the statements (see paragraph 8(a)). However, we think that where alignment can be achieved it can increase the understandability of the resulting information.

    (c) if operating cash flows include cash flows arising from income and expenses not included in operating profit, it may seem counter-intuitive to require operating profit as a starting point for the indirect reconciliation of operating cash flows. Entities will need to present additional line items in the operating cash flows section for interest and dividends cash flows.

[6] US GAAP stipulates that:

1. cash receipts from returns on loans, other debt instruments of other entities, and equity securities - interest and dividends are cash inflows from operating activities (ASC 230-10-45-16(b)); and
2. cash payments to lenders and other creditors for interest are cash flows from operating activities (ASC 230-10-45-17(d)).

Staff recommendation

21. Whilst the alternative approach has significant advantages, we think it would require amendments to the definition of operating activities in IAS 7 which would be a fundamental change that could have unintended consequences. It would also be contrary to the Board’s decision to make limited changes to IAS 7. Furthermore, it would be inconsistent with the Board’s proposed definition of operating profit to define cash flows from operating activities such that they include cash flows from income and expenses not included in operating profit.

22. We therefore recommend that the Board retain the current tentative decisions regarding the classification of interest and dividends in the statement of cash flows. We propose to describe the alternative approach and the reasons for rejecting it in the Basis for Conclusions on the Exposure Draft.

Question
Does the Board agree to retain its tentative decisions regarding the classification of interest and dividends in the statement of cash flows without amendment?

Appendix A— summary of classification of interest and dividends

A1. We have analysed how entities classify interest and dividends in the statement of cash flows, using a sample of 85 non-financial entities and a sample of 15 financial entities. The results of this analysis are shown in the following tables:

Non-financial entities

	Operating	Investing	Financing	Not clear
Interest paid	51	0	31	3
Interest received	47	29	1	8
Dividends paid	2	0	78	5
Dividends received	32	38	0	15

Financial entities

	Operating	Investing	Financing	Not clear
Interest paid	8	0	3	4
Interest received	9	1	0	5
Dividends paid	1	0	11	3
Dividends received	6	3	0	6