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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IFRIC meeting: **January 2008, London**

Project: **Classification of cash flows (Agenda Paper 7B)**

INTRODUCTION

1. In November 2007, the IFRIC received a request for it to issue guidance on the classification of some types of expenditure in the statement of cash flows. The request focussed on exploration and evaluation expenditure in extractive industries but could also apply to other types of expenditure, including that on advertising and promotional activities, research and development activities, and staff training. In all such cases, the expenditure is intended to enhance entities' future income or cash flows but does not give rise to an asset that meets the recognition criteria in IFRSs. The expenditure is therefore recognised in profit or loss as an expense as it is incurred.

2. The request asked for guidance as to whether such expenditure should be classified as arising from operating or investing activities in the statement of cash flows.

3. The submission stated that divergence had developed in this area with some entities believing that all such cash flows should be treated as arising from

operating activities and others believing that entities had a choice between presenting the cash flows as either operating or investing activities.

4. This paper sets out the staff's analysis of whether this issue should be taken on to the IFRIC's agenda.

Differing Interpretations

5. The submission to the IFRIC contained two different views:

   - **View 1**: Cash flows from investing activities include any cash flows that are intended to generate future income or enhance future cash flows. Cash flows may therefore be recognised within investing activities even if they do not give rise to an asset that may be recognised in the statement of financial position.

   - **View 2**: For an expenditure to be included as an investing activity, it must give rise to an asset that meets the recognition criteria in IFRS. In other words, even if the expenditure is intended to enhance future income or cash flows, if it is recognised as an expense as incurred, it should be treated as an operating cash flow.

6. The submission focussed on exploration and evaluation expenditure in extractive industries as the argument for classifying such expenditure as an investing activity is stronger than for other similar items (due to the unique treatment of this expenditure in IFRS 6). For the purpose of this discussion, the staff has also focussed on extractive industries. Before concluding, the staff considers the extent to which the arguments put forward can be extended to other types of expenditure.

View 1: All expenditure intended to enhance future cash flows or income may be presented as investing activities

7. Paragraph 6 of IAS 7 defines investing activities:

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

8. IAS 7.16 states:

   > 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.

9. Supporters of view 1 note that many types of expenditure are incurred almost exclusively to generate future income and cash flows but do not give rise to assets that may be recognised in the statement of financial position. Examples include:

- advertising and promotional expenditure which may enhance customer intangibles that do not qualify for recognition;
- training expenditure which may enhance employee-related intangibles; and
- exploration and evaluation expenditure which is discussed in IFRS 6.

10. Supporters of view 1 believe that the treatment of such expenditure as investing activities is consistent with the principle set out in paragraph 16 of IAS 7.

11. Supporters of this view believe that it is further supported by IAS 7.13 which states:

> 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. [Emphasis added]

12. They argue that this type of expenditure is intended to enhance the operating capability of the entity rather than just maintain it. As such, treating the cash flows as investing activities is consistent with IAS 7.13.

13. Furthermore, they argue that this classification is consistent with the principle in IAS 7.11 that an entity should classify cash flows ‘in a manner that is most appropriate to its business’.

14. Supporters of this view believe that, in the case of exploration and evaluation expenditure, there are additional arguments that support the classification of the expenditure as an investing activity. They argue that, because IAS 7 does not provide specific guidance on extractive industries and IFRS 6 gives a specific exemption from IAS 8 for exploration and evaluation expenditure, entities may

chose how to present cash flows related to extractive industries in the statement of cash flows.

15. The accounting for exploration and evaluation expenditures under IFRS 6 represents an unusual situation in which entities have an option of initially capitalising or expensing costs. Given this unusual situation, entities should focus on the underlying objectives in IAS 7 in determining the most appropriate presentation in the statement of cash flows.

16. Supporters of this view note that, even if the exploration and evaluation expenditure was initially expensed, IAS 7.11 would not prohibit the classification of that expenditure as investing if presenting it in that manner was appropriate to the business.

17. Furthermore, since the expenditure is intended to generate future cash flows and not to maintain operating capability, IAS 7.13 and IAS 7.16 would dictate that it should be classified as investing.

View 2: Expenditure that is immediately expensed should be recognised in the statement of cash flows as an operating activity

18. Paragraph 6 of IAS 7 defines investing activities and operating activities:

> *Investing activities* are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.
>
> *Operating activities* are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities. [Paragraph 14 of IAS 7 also states that cash flows from operating activities "…generally result from the transactions and other events that enter into the determination of profit or loss."]

19. Supporters of view 2 note that expenditure that is recognised as an expense as incurred is included in the determination of profit or loss. IAS 7.14 therefore implies that such expenditure is an operating activity.

20. This view is further supported by IAS 7.16 which gives examples of cash flows from investing activities. Paragraph 16(a) states that cash flows from investing activities include:

> 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. [Emphasis added]

21. Supporters of view 2 argue that the Board would not have restricted the wording in paragraph 16(a) to <u>capitalised</u> costs if it intended entities to classify expenditure that does not give rise to a recognised asset to be included as an investing cash flow.

22. Supporters of view 2 do not accept that exploration and evaluation expenditure is a special case. They note that the exemption in IFRS 6 refers only to recognition and measurement not to cash flow classification. Neither IFRS 6 nor IAS 7 refer to an exemption in the case of the statement of cash flows.

STAFF ANALYSIS

23. The staff first considered whether exploration and evaluation activities were a special case or whether the same arguments should apply to all expenditure that does not give rise to a recognised asset.

24. In the staff's view, the arguments that exploration and evaluation expenditure are a 'special case' for the purposes of determining how such expenditure should be classified in the statement of cash flows fall into two categories:

    - the exemption in IFRS 6 may exempt such expenditure from the requirements of IAS 7, and
    - such expenditure is unusual as entities may decide to capitalise it or not.

25. The staff notes IFRS 6.7 which states that:

> Subject to paragraphs 9 and 10 below, this IFRS exempts an entity from applying [paragraphs 11 and 12 of IAS 8] to its accounting policies for the **recognition and measurement** of exploration and evaluation assets. [Emphasis added]

26. The staff considers that this paragraph is explicit in providing an exemption from certain recognition and measurement principles. However, it does not convey an exemption from any other requirements, for example classification requirements in the statement of cash flows. The staff does not therefore

consider that arguments that exploration and evaluation expenditure is a special case because of the provisions of IFRS 6 are valid.

27. Similarly, the staff does not consider that the fact that entities may chose whether to capitalise exploration and evaluation expenditure is a valid reason for a different treatment. The staff considers that, whilst there may be cause for a distinction between the treatment of costs that are capitalised and those that are not, the fact that an entity has an option to capitalise or not should not give rise to a choice as to how expenditure that is not capitalised is treated in the statement of cash flows.

28. The staff therefore concludes that exploration and evaluation expenditure should not receive a different treatment from other similar types of expenditure in this respect.

29. IAS 7.16(a) sets out a number of examples of investing cash flows. It states that payments to acquire property, plant and equipment, intangible assets, or capitalised development costs should be treated as investing cash flows. The staff therefore concludes that, in situations in which exploration and evaluation expenditure is capitalised, it is clear that the related cash flows must be treated as investing activities.

30. The staff then considered the treatment of cash flows for expenditure (including exploration and evaluation expenditure) that is not capitalised.

31. The definition of investing activities in IAS 7.6 states that investing activities are the acquisition and disposal of 'long-term assets and other investments not included in cash equivalents'. The staff believes it is clear that, to qualify as investing activities, expenditures must be made to acquire or dispose of long-term assets or investments.

32. However, the staff considers that there may be an argument that expenditure that gives rise to unrecognised assets also meets this definition.

33. The staff next considered the examples of investing activities in IAS 7.16. The staff notes that the paragraph is clear that only capitalised development costs are investing activities. All of the items discussed in paragraph 16 as being investing activities result in the recognition or derecognition of assets. As with the definition of investing activities, the staff considers that this paragraph gives

a good indication that the intention of the Board when IAS 7 was written was that only expenditure that resulted in recognised assets should be presented as investing cash flows.

34. However, as with the definition of investing activities, the staff considers that, because paragraph 16 only includes a list of examples, it could be read as not prohibiting the classification of expenditure that gives rise to an unrecognised asset as investing activities.

Conclusions

35. The staff concludes that, whilst IAS 7 appears to require the classification of expenditure that must be expensed as incurred as operating activities, it does not specifically prohibit the classification of such expenditure as investing activities if it can be argued that it gives rise to an asset that it not recognised.

36. From the wording in IAS 7, the staff believes that it was the Board's intention that such expenditure should be classified as operating.

37. Furthermore, the staff has concerns that, if expenditure that gives rise to an unrecognised asset can be classified as investing then a whole range of cashflows may reclassified from operating to investing. This kind of reclassification may result in an overstatement of operating inflows and an overstatement of investing activities. This treatment would also lead to divergence developing with US GAAP.

CONSIDERATION OF WHETHER THE ISSUE SHOULD BE ADDED TO THE IFRIC'S AGENDA

38. The staff considered whether the issue should be added to the IFRIC's agenda with regard to the conditions set out in the IFRIC's due process handbook.

Widespread and practical relevance

39. The staff considers that, whilst the issue submitted to the IFRIC focussed on exploration in extractive industries, it has wider implications. In particular, similar issues are likely to exist in other situations in which expenditure is incurred on assets that do not qualify for recognition under IFRS. Examples of such expenditure may include advertising and promotional costs, staff training costs, research and development costs and costs of repairs or maintenance.

40. The staff therefore considers that the issue is of widespread relevance.

41. Furthermore, the staff considers that any guidance issued in this area would be of practical benefit to entities with these types of expenditure in applying IAS 7.

Significantly divergent interpretations

42. The staff is aware of divergent interpretations existing in the way that that entities in extractive industries apply the existing literature in this area. Whilst the staff has not carried out further detailed research, the staff has heard anecdotal evidence that divergence may also exist in other areas. The staff is also aware that classifying such expenditure as investing introduces as difference between IFRS and US GAAP.

43. Whilst the divergence relates only to the classification of items in the statement of cash flows, the staff considers that the fact that it results in an increase in operating cash flows as well as an increase in investing flows could be seen as enhancing entities' cash flows. Given that many investors and regulators place a heavy emphasis on operating cash flows, particularly in the extractive industries, this is significant divergence.

Improvements in financial reporting

44. The staff considers that, if the IFRIC agrees that the divergence in this area is significant, then it may conclude that eliminating this divergence will improve the consistency and comparability of financial reporting and so will result in an improvement to financial reporting.

Efficient resolution within the confines of existing IFRSs

45. As discussed above the staff considers that, whilst IAS 7 clearly implies that cash flows that are deducted in determining profit or loss should be included in operating cash flows, the current standard is not sufficiently prescriptive to make this the only possible interpretation of the wording.

46. Whilst the staff considers that the IFRIC could develop an Interpretation based on the current literature, it would be more efficient to recommend that the Board amend the current standard to make clear that only expenditure that gives rise to recognised assets should be classified as investing activities.

47. The staff considers that this could be achieved relatively easily by amending the definition of investing activities in IAS 7.6 and the description of investing activities in paragraph 16 of IAS 17. For example, the definition of investing activities could be reworded to state:

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

And paragraph 16 of IAS 17 could be reworded:

> 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. Expenditures for such resources can be identified because they give rise to assets that are recognised in the statement of financial position of the entity.

Can the IFRIC resolve the issue on a timely basis?

48. As discussed above, whilst the staff considers that the issue could be resolved by the IFRIC on a timely basis, it could be resolved in a more efficient manner by referring it to the Board to be addressed as part of the Annual Improvements project.

Relationship with current IASB projects

49. The issue will be resolved by the IASB's joint project on Financial Statement Presentation. However, that project will not be completed for several years.

Conclusions

50. The staff considers that, whilst the current literature is reasonably clear that only expenditure that results in an asset that may be recognised should be classified within investing activities, the wording of the standard is not definitive in this respect.

51. The staff considers that the issue could most efficiently be resolved by referring it to the Board to be addressed as part of the annual improvements process. [Sentence omitted from observer note].