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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IFRIC meeting:	**March 2008, London**
Project:	**IAS 7 Statement of cash flows- Classification of expenditures (Agenda Paper 4B)**

Background

1. In January 2008, the IFRIC considered whether to add an issue to its agenda on the classification of expenditure in the statement of cash flows. The issue arose from a submission discussing the classification of expenditure on exploration and evaluation activities in extractive industries but could also apply to other types of expenditure including that on advertising and promotional activities, staff training and research and development. Diversity has arisen in practice with some entities believing that such expenditure must be classified within operating activities and others believing that it can be classified within investing activities.

2. The IFRIC tentatively decided not to add the issue to its agenda but instead to refer the issue to the Board. Its tentative agenda decision included a recommendation that IAS 7 be amended to state that expenditure may only be classified as arising from investing activities if it results in an asset that is recognised in the statement of financial position.

3. Two comment letters were received. The first agreed with the IFRIC's decision not to add the issue to its agenda. It also agreed with the recommendation that the Board should amend IAS 7 as part of the annual improvements process. However, the commentator disagreed with the IFRIC's recommendation as to how the standard should be changed.

4. The second letter agreed with the IFRIC's tentative decision not to add the issue to its agenda but disagreed with referring it to the Board. The letter argued that there was no need to refer the issue to the Board since there was no divergence in practice. Instead, the commentator argued, 'the issue appears to be raised as a result of a single divergent view'. The respondent also argued that it would be incorrect to amend IAS 7 in the way proposed by the IFRIC.

5. This paper considers whether the IFRIC should:

   - finalise its tentative agenda decision and recommendation to the Board published in January 2008;
   - finalise its tentative agenda decision but remove the recommendation to the Board; or
   - finalise its tentative agenda decision and not refer the issue to the Board.

6. Since both commentators agree with not adding the issue to the IFRIC's agenda, this paper does not reconsider that question.

Differing views

Rationale for tentative decision

7. In the staff paper presented to the January 2008 IFRIC meeting (paper 7B), the staff argued that IAS 7 should be amended to make clear that expenditure that does not give rise to an asset that is recognised in the statement of financial position may not be included in investing cash flows.

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

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

10. The staff next considered the examples of investing activities in IAS 7.16. The staff noted that the paragraph is clear in requiring 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 considered that this paragraph gives a good indication that the intention of the Board when IAS 7 was written was that only expenditure that results in recognised assets should be presented as investing cash flows.

11. However, 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.

12. The staff concluded that, whilst IAS 7 appears to require the classification of expenditure that is 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 the expenditure gives rise to an asset that is not recognised.

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

14. Furthermore, in January 2008, the staff expressed concerns that, if expenditure that gives rise to an unrecognised asset can be classified as investing then a whole range of cash flows may be 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 with US GAAP.

15. At the January 2008 meeting, the IFRIC agreed with the staff's analysis and decided to recommend to the Board that it should amend IAS 7 to state that only expenditure that results in an asset that may be recognised can be included in investing activities.

No significant divergence

16. The comment letters disagree with the IFRIC's recommendation for two reasons. One argues that there is little diversity in practice in this area and, as such, there is no need to change the standard. Instead, the issue has arisen because of a single divergent view:

> *'We do not believe there is a significant divergence in practice which warrants this issue being considered by the IFRIC and requiring resolution by either the IFRIC or the IASB. In addition to BHP Billiton classifying exploration expenditure as investing cash flows regardless of how that expenditure is dealt with in the income statement or balance sheet, Rio Tinto and Total (as further examples) also classified exploration expenditure as investing prior to intervention by the Securities and Exchange Commission (SEC). Rio Tinto changed their presentation to classify exploration expenditure as operating only after the SEC disagreed with this presentation and sought a change in policy. The SEC also disputed BHP Billiton's classification of exploration expenditure in the cash flow when it reviewed the 2006 BHP Billiton Form 20F. After lengthy discussions, the SEC recognised the merit of BHP Billiton's position on the issue in the context of the requirements of the standard and therefore agreed that it had no basis to object to the treatment adopted by BHP Billiton. It was evident, however, that the SEC was not comfortable with the interpretation required to apply the standard. As a result, we believe the presentation of exploration expenditure as investing cash flows has been consistently applied by major participants in the extractive industries and is not seen as a matter of significant divergent practice. Rather, we believe there is a divergent view from the SEC.*
>
> *In addition, from our knowledge of industry practice, analyst expectations and experience in the Australian mining community which has applied the Australian equivalent of this standard for an extended period prior to IFRS transition, the classification of exploration expenditure in the cash flow has been accepted and understood as appropriate on a consistent basis for many years.'*

The IFRIC's recommendation should be changed

17. Both respondents argue that the IFRIC should not recommend to the Board that expenditure should be included in investing only if it results in an asset that is recognised in the statement of financial position.

18. They argue that the IFRIC's proposals would change practice and may mislead investors. The principle in IAS 7 is that cash flows should be classified by activity type. Items such as expenditure on exploration and evaluation in extractive industries is undertaken to generate future income and cash flows – not to support current activities. The principles in IAS 7 and the needs of users require entities to separate this expenditure and display it as part of investing activities. Classifying the expenditure in operating cash flows would mislead investors and lead to additional pro-forma disclosure.

19. The respondents highlighted some additional items of expenditure that would be required to be classified as operating if the Board followed the IFRIC's tentative recommendation, including:

    - initial expenditure on development that does not qualify for recognition as an asset; and
    - acquisition-related expenditure in a business combination that is expensed immediately under the revised version of IFRS 3 *Business Combinations*.

20. They concluded that, in determining the classification of expenditure, judgement should be applied to the principle that expenditure to enhance future income and cash flows is investing.

Staff analysis

Should the issue be referred to the Board?

21. One respondent argues that there is no diversity in practice in this area. The only entity sharing the view proposed by the IFRIC is one regulator.

22. Whilst this may be true the staff notes that, according to the commentator, one entity has already changed its accounting policy as a result of dialogue with that regulator. In the staff's view, this could be seen as evidence that divergence

may develop in this area if further clarity is not provided by the IFRIC or the IASB.

23. Furthermore, the staff believes that this issue could affect a range of other types of expenditure (outside of extractive industries). The fact that diversity in extractive industries may be limited does not mean that diversity does not exist in other areas. The staff therefore believes that obtaining clarification from the Board would be a useful exercise as it would reduce the risk of future diversity developing.

24. The staff concludes that it would be helpful for the IFRIC to recommend that the Board clarify whether expenditure that results in an asset that is not recognised in the statement of financial position should be classified as operating or whether it may be classified as investing.

What should the IFRIC recommend?

25. The staff notes that, regardless of what the IFRIC does or doesn't recommend, the Board will form its own conclusion in deciding how to amend the standard. Whilst the IFRIC's recommendation may have some persuasive power, it has no authority. It may not be what the Board finally decides to propose.

26. The staff continues to believe that it may be extremely hard to draw a line between what may be included in investing activities and what is included in operating activities if expenditure that does not result in an asset that may be recognised is allowed to be treated as investing. For example, under this approach, it could be argued that staff training that results in a staff related intangible asset that may not be recognised could be included in investing activities. The staff also believes that the Board's intention in developing IAS 7 was that such expenditure should be classified as operating.

27. The staff therefore believes that the IFRIC should finalise its draft recommendation as published in its tentative agenda decision in IFRIC *Update* in January 2008.

28. As the IFRIC has received comment letters arguing that this view may not be supported in practice and suggesting that a different treatment may be prevalent in some industries, the IFRIC may decide that it does not wish to recommend to the Board that it amend IAS 7 in this way. If IFRIC members believe that the

arguments in the comment letter have merit then the staff proposes that the recommendation be dropped from the agenda decision.

29. [Paragraph omitted from observer note].

Conclusions and recommendation

30. The staff notes that neither of the comment letters proposed changing the IFRIC's decision not to add the issue to its agenda. In the staff's view, the only questions to be decided are therefore:

- whether the issue should be referred to the Board; and
- whether the final agenda decision should include a recommendation to the Board and, if so, what it should say.

31. As discussed above, the commentator that argues that there is not divergence in this area accepts that there are divergent views between a regulator and constituents in respect of one type of expenditure. Whilst this is not, in itself, sufficient evidence that divergence exists in this area, the staff believes that it suggests that significant divergence may develop. The staff concludes that it would be helpful for the IFRIC to refer the issue to the Board for clarification.

32. The staff notes that, whatever the IFRIC decides can only be a recommendation. Whilst it may be influential, the Board is not committed to acting upon it.

33. The staff continues to believe that, when IAS 7 was written, the Board intended that only items that give rise to an asset that may be recognised should be included in investing activities. Furthermore, if IAS 7 is not amended in that way, it will be difficult to draw a line between what is operating and what may be classified as investing activities.

34. The staff therefore recommends that the IFRIC finalise its decision as published in IFRIC *Update* in January 2008.

35. If the IFRIC supports the view discussed in the comment letters, the staff proposes that the IFRIC refer the issue to the Board with no recommendation as to which action it should take.

Attachment 1: Tentative Agenda Decision

IAS 7 *Statement of Cash Flows*—Classification of expenditures

The IFRIC received a request for guidance on the treatment of some types of expenditure in the statement of cash flows. In practice some entities classify expenditures that are not recognised as assets under IFRSs as cash flows from operating activities while others classify them as part of investing activities. Examples of such expenditures are those for exploration and evaluation activities (which can be recognised, according to the applicable standard, as an asset or an expense). Advertising and promotional activities, staff training and research and development could also raise the same issue.

The IFRIC concluded that the issue could be best resolved by referring it to the Board with a recommendation that IAS 7 should be amended to make explicit that only an expenditure that results in a recognised asset can be classified as a cash flow from investing activity. The IFRIC therefore [decided] not to add the issue to its agenda.