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 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 submitter suggests that this clarification should be included as part of the annual improvements project (AIP). The submission is reproduced in full in Appendix B to this paper.

3. This paper:

   (a) provides background information on the issue;

   (b) includes the staff analysis and recommendation to add this issue as part of the annual improvements project; and

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

Background information

Interest and dividends

4. 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. Paragraph 31 is reproduced below (emphasis added):

> 31 Cash flows from interest and dividends received and paid shall each be **disclosed separately**. Each shall be **classified in a consistent manner** from period to period **as either operating, investing or financing activities**.

5. Paragraph 32 refers explicitly to interest paid that has been capitalised in accordance with IAS 23 *Borrowing Costs*. Paragraph 32 is reproduced below (emphasis added):

> 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***.

6. 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

7. On the other hand, paragraph 16 in IAS 7 appears to be clear that expenditures that result in the recognition of an asset should be classified as cash flows from investing activities as highlighted below:

> 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) 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.

Staff analysis

8. 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, 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.

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

Staff recommendation

10. We think that classifying as investing activities interest paid that is capitalised in the cost of an asset, would result in useful and relevant information. Consequently, we think that the example guidance in paragraph 16 of cash flows arising from investing activities, should explicitly include interest paid that is capitalised into the cost of property, plant and equipment:

11. We also think that paragraphs 32 and 33 in IAS 7 could be clarified to avoid a contradiction with the guidance in paragraph 16, 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.

(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.

12. Our proposed changes to paragraphs 16, 32 and 33 are presented in Appendix A of this paper.

Assessment against the new annual improvements criteria

13. We have assessed the proposed amendment to paragraphs 16(a), 32 and 33 against the enhanced annual improvements criteria, which are reproduced in full below:

> In planning whether an issue should be addressed by amending IFRSs within the annual improvements project, the IASB assesses the issue against the following criteria. All criteria (a)–(d) must be met to qualify for inclusion in annual improvements.
>
> (a) The proposed amendment has one or both of the following characteristics:
>
> (i) clarifying–the proposed amendment would improve IFRSs by:
>
> - clarifying unclear wording in existing IFRSs, or
> - providing guidance where an absence of guidance is causing concern.
>
> A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs. It does not propose a new principle, or a change to an existing principle.
>
> (ii) correcting–the proposed amendment would improve IFRSs by:
>
> - resolving a conflict between existing requirements of IFRSs and providing a straightforward rationale for which existing requirement should be applied, or.
> - addressing an oversight or relatively minor unintended consequence of the existing requirements of IFRSs.
>
> A correcting amendment does not propose a new principle or a change to an existing principle.

[Staff analysis—this criterion is satisfied. To avoid inconsistent guidance, there is a need for clarification of the requirements in paragraphs 16(a), 32 and 33 regarding the classification of interest paid that is capitalised as part of the cost of an asset]

(b) The proposed amendment is well-defined and sufficiently narrow in scope such that the consequences of the proposed change have been considered.

[Staff analysis—this criterion is satisfied. The issue is sufficiently narrow to ensure that the proposed change has been considered sufficiently and identified.]

(c) It is probable that the IASB will reach conclusion on the issue on a timely basis. Inability to reach a conclusion on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within annual improvements.

[Staff analysis—this criterion is satisfied. We think that the Committee will be able to address these issues on a timely basis and we think that the Board should be in a position to also reach a conclusion on a timely basis. The issue can be sufficiently tackled by a clarification to the current wording of paragraphs 16(a), 32 and 33 in IAS 7, which will provide increased clarity where diversity currently exists, while not significantly affecting the primary accounting treatment that exists in practice for this issue.]

(d) If the proposed amendment would amend IFRSs that are the subject of a current or planned IASB project, there must be a need to make the amendment sooner than the project would.

[Staff analysis—this criterion is satisfied. There is no current IASB project on IAS 7 and none is planned for the near future.]

Staff conclusion

14. On the basis of the assessment under the existing annual improvements criteria, we think that the Committee should recommend to the Board that the changes proposed to paragraphs 16(a), 32 and 33 in IAS 7 (refer to Appendix A of this paper) should be included in the **2010-2012 annual improvements** cycle.

Question to the Interpretations Committee

Question 1—proposed changes to IAS 7
Does the Committee agree with the staff recommendation in paragraphs 10–11 and the proposed changes in Appendix A?

Appendix A – Proposed changes

A1. The proposed amendments to paragraphs 16, 32 and 33 are presented below.

Amendment to IAS 7 *Statement of Cash Flows*

Paragraphs 16(a), 32 and 33 are amended (new text is underlined and deleted text is struck through).

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, <u>as well as payments of interest capitalised as part of the cost of those assets</u>. 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*; <u>if interest paid has been capitalised in accordance with IAS 23, it should be classified as part of investing activities in accordance with paragraph 16(a).</u>

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 interest paid that has been capitalised and classified as part of investing activities in accordance with paragraph 16(a)),</u> 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.

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 to require interest paid that is capitalised to be classified as an investing cash flow. However, the Board was informed that this seemed 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, 32 and 33 of IAS 7 to clarify the classification of interest paid that is capitalised into the cost of property, plant and equipment as an investing cash flow.

Appendix B – Request for Annual Improvements

B1 The staff received the following request. All information has been copied without modification, except for details that would identify the submitter of the request and details that are subject to confidentiality.

REQUEST FOR ANNUAL IMPROVEMENTS

The issue:

IAS 7.16 might be interpreted to require that interest paid that is capitalised into the cost of property, plant and equipment should be treated as an investing cash flow because it is a capitalised development cost. This might be inconsistent with IAS 7.32 and 33, which suggest that interest paid can only be an operating or a financing cash flow.