

## STAFF PAPER

March 2012

## IFRS Interpretations Committee Meeting

Project	IAS 7 <i>Statement of Cash Flows</i>		
Paper topic	Review of requests in relation to IAS 7		
CONTACT(S)	Denise Durant	ddurant@ifrs.org	+44 (0)20 7246 6469

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

## Introduction

1. At its January 2012 meeting, the Board discussed the recommendations from the IFRS Interpretations Committee (the Committee) regarding the classification under IAS 7 *Statement of Cash Flows* of:
  - (a) cash payments for deferred and contingent consideration arising from a business combination within the scope of IFRS 3 *Business Combinations*; and
  - (b) cash flows for an operator in a service concession arrangement within the scope of IFRIC 12 *Service Concession Arrangements*.
2. The Board determined that before it could decide on whether or not these issues should be addressed through the annual improvements project, it would direct the staff to ask the Committee to look collectively at these two issues, as well as at all of the previous IAS 7 issues that the Committee has discussed regarding the classification of cash flows and to consider whether these issues could be dealt with collectively.
3. This paper:
  - (a) lists all the issues that the Committee has been asked to consider on IAS 7 since 2004;

- (b) describes the reasons why the Committee believed that the issues should not be taken onto its agenda at the time and/or why the Committee proposed an annual improvement;
- (c) provide our view on the best way in which we think the Committee can achieve the Board's request; and
- (d) obtain input from the Committee to help us develop papers for a future Committee meeting regarding classification issues relating to IAS 7.

### List of issues considered by the Committee on IAS 7

4. The staff identified six issues and the different reasons why the issues were not taken into the Committee's agenda. The table below:

- (a) shows the list of issues discussed;
- (b) shows the date of the Committee meeting when the issue was last discussed; and
- (c) indicates the Committee's decision regarding the issue (ie propose a rejection note or propose an annual improvement).

Date when last discussed	Issue discussed by the Committee	Committee's decision
November 2004	1. Cash flow statement—classification of value added tax	Rejection note
March 2008	2. Classification of expenditure on unrecognised assets	Annual Improvements (April 2009)
May and July 2009	3. Guidance on cash equivalents as defined by IAS 7	Rejection notes <sup>1</sup>
May 2011	4. Classification of interest paid that is capitalised	Annual Improvements (2010-2012 cycle)
November 2011	5. Classification in the statement of cash flows of the flows arising from the settlement of contingent consideration in a business combination	Rejection note
January 2012	6. Classification of cash flows relating to construction services under service concession arrangements	Annual Improvements (2011-2013 cycle)

<sup>1</sup> The Committee analysed two different fact patterns as explained in subsequent paragraphs.

5. The following section contains a description of each issue and the reasons behind the Committee's decisions.

### **Description of the issues considered by the Committee<sup>2</sup> on IAS 7**

6. The content of this section is a summary of past deliberations as reflected in previous agenda papers and the content of the *IFRIC Update*. We have indicated in each section links to relevant agenda papers, when applicable.

#### ***Issue 1: Cash-flow statement: Value Added Tax (November 2004)***

7. The following is a summary of the analysis presented to the Committee in November 2004. The full analysis of this issue set out in Agenda Paper A2<sup>3</sup>.

#### *Description of the issue*

8. The Committee was asked to clarify the requirements for the treatment of Value Added Tax (VAT) in the statement of cash flows. VAT is a sales tax that is levied in many countries. In some countries, it is referred to as Goods and Services Tax (GST). A business charges VAT on sales to customers and pays VAT on purchases from suppliers. It pays (or recovers) the net of the two to (or from) the tax authority.
9. IAS 7 *Statement of Cash Flows* includes general requirements for gross cash receipts to be reported separately from gross cash payments, permitting a net treatment only in specific circumstances as shown in paragraph 22<sup>4</sup> of IAS 7 below:

22 Cash flows arising from the following operating, investing or financing activities may be reported on a net basis:

(a) cash receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the entity; and

---

<sup>2</sup> In this section, we will use the term 'the Committee' to refer to both the IFRIC and to the IFRS Interpretations Committee (IFRS IC).

<sup>3</sup> The link to this paper is not available in the IASB's website.

<sup>4</sup> Additional exceptions are given for financial institutions in paragraph 24 of IAS 7.

(b) cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

10. IAS 7 includes requirements that specify the presentation of income taxes within a statement of cash flows. For instance, paragraph 14(f) includes as an example of cash flows from operating activities “cash payments or refunds of income taxes, unless they can be specifically identified with financing and investing activities”. However, IAS 7 does not make any specific reference to VAT or other indirect taxes that the entity collects and passes to the tax authorities on behalf of others.
11. The Committee observed at the time that national practices for reporting VAT in cash flow statements vary. Some standard-setters have deemed that cash flows should be shown:
  - (a) net of VAT (eg FRS 10 *Cash Flow Statements* in UK GAAP); but other standard-setters have deemed that cash flows should be:
  - (b) reported gross in line with the general principle in IAS 7, inclusive of GST (ie *UIG Interpretation 1031* from November 2009 issued by the Australian Urgent Issues Group).

*The Committee’s decision not to add this issue to its agenda*

12. At the Agenda Committee meeting held in November 2004, the Committee determined that there was no ambiguity in the requirements of IAS 7 because in accordance with the requirements in IAS 7:
  - (a) VAT *is not* one of the two types of cash flows that IAS 7 permits by exception to be reported on a net basis; and
  - (b) VAT receipts would be reported separately from VAT payments (whether included within the receipts or payments to which the VAT related or as a separate amount).

*An update on this issue*

13. The IASB's [Financial Statement Presentation \(FSP\) project's Staff Draft](http://www.ifrs.org/Current+Projects/IASB+Projects/Financial+Statement+Presentation/Phase+B/Staff+draft+of+proposed+standard.htm)<sup>5</sup> (published in July 2010) addresses the classification of cash flows for taxes collected from customers and remitted to government authorities. Paragraph 189 in this Staff Draft observes that (emphasis added):

189 **Taxes or fees that an entity collects from customers on behalf of government authorities that are not part of the entity's revenue shall be presented separately in the statement of cash flows net of the amounts remitted to the government authority.** However, if a tax or fee collected from the customer is included in the entity's revenue, the collection of that tax or fee shall be included as part of cash from customers and the remittance to the government authority shall be included as a gross cash outflow.

14. This guidance was based on the **cohesiveness principle** that the project had developed as one of its core principles for the presentation of the financial statements. Paragraphs 57–58 of the *Staff Draft* define the cohesiveness principle as follows (emphasis added):

An entity shall present information in its financial statements so that the **relationship among items across the financial statements is clear.**

To present a cohesive set of financial statements, an entity shall present disaggregated information in the sections, categories and subcategory in the statements of financial position, comprehensive income and cash flows **in a manner that is consistent across those three statements.**

---

<sup>5</sup><http://www.ifrs.org/Current+Projects/IASB+Projects/Financial+Statement+Presentation/Phase+B/Staff+draft+of+proposed+standard.htm>

***Issue 2: Classification of expenditure on unrecognised assets (March 2008)***

15. The following is a summary of the analysis presented to the Committee in January 2008 and March 2008. The full analysis was set out in [Agenda Paper 7-B](#) and [Agenda Paper 4B](#), respectively, which can be found on the public website.

*Description of the issue*

16. In November 2007 the IFRIC received a request for guidance on the treatment of exploration and evaluation expenditure in extractive industries (which can be recognised, according to the applicable standard, as an asset or as an expense).
17. Diversity exists in practice because some entities classify expenditures that *are not* recognised as assets under IFRSs as either:
- (a) cash flows from operating activities; or
  - (b) as part of investing activities.

*The Committee's decision to propose an annual improvement*

18. The Committee observed that while paragraphs 14 and 16 of IAS 7 appear to be clear that only expenditure that results in the recognition of an asset would be classified as cash flows from investing activities, the wording was not definitive in this respect.
19. Consequently the Committee recommended that IAS 7 should be amended to make explicit in paragraph 16 of IAS 7 that only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities.
20. The Board agreed with the Committee's recommendation and published the final amendment in *Improvements to IFRS* published in April 2009. The Board determined in its basis for conclusions (par. BC7) that this classification would:

- (a) better align the classification of investing cash flows with the presentation in the statement of financial position (ie consistent with the cohesiveness principle<sup>6</sup>)
- (b) reduce divergence in practice
- (c) results in financial statements that are easier for users to understand.

### ***Issue 3: Guidance on cash equivalents as defined by IAS 7***

21. The Committee analysed two requests to provide guidance, based on the definition of cash equivalents in IAS 7.6 of:

- (a) investments in shares or units of money market or other funds that are redeemable at any time; and
- (b) fixed deposits or similar instruments with an original term longer than three months. The instruments bear interest at a fixed rate determined at the date of deposit and are redeemable on demand, but are subject to a penalty upon early redemption. The amount of the penalty decreases depending upon the period of the instrument's term that is still outstanding. The principal amount is always redeemed in full.

In both fact patterns the Committee decided not to add this issue to its agenda because it determined that the guidance in IAS 7 was sufficient.

#### ***Investments in shares or units of money market***

22. The following is a summary of the analysis presented to the Committee in March 2009, May 2009 and July 2009. The full analysis was set out in [Agenda Paper 5A](#), [Agenda paper 4](#) and [Agenda Paper 2C](#), respectively, which can be found on the public website.

---

<sup>6</sup> We say “consistent with the cohesiveness principle” because it captures the essence of this principle (as defined in the FSP Staff Draft). However the FSP Staff Draft went beyond on the application of the cohesiveness principle as it suggested a redefinition of the *operating*, *financing* and *investing* sections in the statement of cash flows, as well as including these same sections in the remainder financial statements. It also implied the use of the direct method of cash flows to better align the information of the SCF with the other financial statements.

23. The Committee observed that the issue of the classification of investments in shares or units of money market funds as cash equivalents involves an analysis of the local regulatory requirements against the criteria set out in the cash equivalents definition in paragraphs 6 and 7 of IAS 7. These criteria state that:
- (a) cash equivalents are highly liquid investments that are (paragraph 6):
    - (i) “convertible to known amounts of cash”. This means that the amount of cash that will be received must be known at the time of the initial investment, ie the units cannot be considered cash equivalents simply because they can be converted to cash at any time at the then market price in an active market); and
    - (ii) “subject to insignificant risk of changes in value”. This means that an entity would have to satisfy itself that any investment was subject to an insignificant risk of changes in value for it to be classified as a cash equivalent.
  - (b) the purpose of holding cash equivalents is to meet “short-term cash commitments” (paragraph 7).
24. The Committee observed, based on a strict reading of the definition and criteria in paragraphs 6 and 7 of IAS 7, that units of money market and other readily redeemable funds do not qualify as cash equivalents. This is because they are essentially equity instruments that have no maturity date and because, at the time of the initial investment, they are not convertible into a known amount of cash.
25. Nevertheless, the Committee determined that units that do not have a maturity date, but that are readily convertible into an amount of cash that is known at inception and that are subject to an insignificant risk of future changes in value can be considered to be ‘in substance’ cash equivalents in accordance with paragraph 7 of IAS 7. How an entity makes that determination is a matter of judgement.
26. Given the guidance in IAS 7, the Committee did not expect significant diversity in practice and decided not to add this issue to its agenda.



*Fixed deposits or similar instruments with an original term longer than three months*

27. The following is a summary of the analysis presented to the Committee in May 2009. The full analysis was set out in the [Addendum to Agenda Paper 4](#), which can be found on the public website.
28. The Committee determined that redeemable fixed-term deposits are cash equivalents because they meet the critical criteria in the definition:
- (a) they qualify as cash equivalents because they are instruments that are readily convertible to a known amount of cash, being principal plus accrued interest depending on how long the investments are held; and
  - (b) they are subject to an insignificant risk of change in value assessed against the amount invested at inception.
29. On this basis, the Committee arrived at the conclusion, consistently with the classification of investments in shares or units of money market funds that are redeemable at any time, that redeemable fixed-term deposits are cash equivalents ‘in substance’.
30. Given the guidance in IAS 7, the Committee did not expect significant diversity in practice and decided not to add this issue to its agenda.

***Issue 4: Classification of interest paid that is capitalised as part of the cost of an asset***

31. The following is a summary of the analysis presented to the Committee in May 2011. The full analysis was set out in the [Agenda Paper 6](#), which can be found on the public website.

*Description of the issue*

32. In March 2011 the Committee addressed 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.
33. The Committee observed that 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 appeared to require interest paid to be classified only as an operating or a financing cash flow.

*The Committee's decision to propose an annual improvement*

34. At the May 2011 meeting the Committee noted that interest paid that is capitalised into the cost of an asset should be classified as an investing activity in accordance with paragraph 16, because it results in a recognised asset in the statement of financial position.
35. In addition, the Committee identified the following inconsistencies in the guidance in IAS 7:
  - (a) paragraph 32 states that interest paid that is capitalised in accordance with IAS 23 *Borrowing Costs* should be reflected in the statement of cash flows, but neither IAS 23 nor IAS 7 specifies where such capitalised interest should be classified in the statement of cash flows.
  - (b) paragraph 33 allows for interest paid to be classified as part of either operating or financing activities, but this paragraph 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.
36. To address this apparent conflict, the Committee proposed to the Board that it should modify paragraphs 16(a) and 33 and proposed adding paragraph 33A to clarify that the classification of payments of interest that are capitalised shall follow the same classification of the underlying asset to which those payments were capitalised (this is consistent with the cohesiveness principle that we have described above). This modification would also cover 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.
37. The Board approved the Committee's recommendation at the September 2011 meeting and decided to include as part of the exposure draft of *Improvements to IFRSs* that will be published later this year (that refers to the 2010-2012 cycle).

***Issue 5: Classification in the statement of cash flows of the flows arising from the settlement of contingent consideration in a business combination***

38. The following is a summary of the analysis presented to the Committee in September 2011 and November 2011. The full analysis was set out in [Agenda Paper 9](#) and [Agenda Paper 7](#), respectively, which can be found on the public website.

*Description of the issue*

39. At the September and November 2011 meetings, the Committee addressed a request for guidance on the classification of cash payments for deferred and contingent considerations under IAS 7. The submitter asked the Committee to clarify:
- (a) whether the settlement of contingent consideration for a business combination should be classified as an operating, an investing or a financing activity in the statement of cash flows; and
  - (b) whether the subsequent settlement of a deferred consideration for a business combination should be classified as an investing or a financing activity in the statement of cash flows

*The Committee's decision not to propose an annual improvement*

40. At the September 2011 meeting the Committee observed that cash payments for the contingent/deferred consideration that are recognised at the acquisition date and any adjustment arising during the measurement period (as defined in paragraphs 45-50 of IFRS 3) should be classified as investing activities, because these cash flows arise from the recognition of the acquiree's net assets in a business combination (ie consistent with the cohesiveness principle).
41. The Committee's reasoning was supported by the fact that according to paragraph 16 of IAS 7, only the expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities. In addition, contingent consideration can be viewed as a way of obtaining control of an entity as stated in paragraph 39 of IAS 7, which reinforces the fact that contingent consideration should be classified as an investing activity.

42. The Committee also determined that cash payments in excess of the amount recognised at acquisition date of the contingent consideration should be classified as operating activities, because:
- (a) these cash flows do not result in a recognised asset; and
  - (b) to be consistent with the requirements in paragraph 58 of IFRS 3, which state that changes in the fair value of contingent consideration classified as assets or liabilities that are not ‘measurement period adjustments’ should be recognised in profit or loss or in other comprehensive income, because they are not recognised as part of the consideration transferred in a business combination at acquisition date.
43. The Committee also concluded that cash payments relating to interest resulting from accretion of the discount on the contingent consideration liability balance should be classified as financing or operating cash flows in accordance with other interest expenses, as stated in paragraphs 31–34 of IAS 7.
44. A majority of Committee members however, judged that the issue raised by the submitter was too broad to be resolved through the annual improvements process because it might be relevant to circumstances other than business combinations (for example, consistency with the classification of contingent payments in financial liabilities has not been sufficiently discussed) and decided to propose that the Board should not add this issue to the Annual Improvements project.

***Issue 6: Classification of cash flows relating to construction services under service concession arrangements (November 2011)***

*Description of the issue*

45. In November 2011 the Committee addressed an issue related to classification of cash flows for an operator in a service concession arrangement within the scope of IFRIC 12 (refer to [Agenda Paper 11](#)). More specifically the Committee was asked to clarify whether:
- (a) cash inflows relating to construction services under a service concession arrangement should be classified as operating or investing cash flows or a combination of both; and

- (b) whether cash outflows relating to construction services under a service concession arrangement should be classified as operating or investing cash flows.

46. The Committee observed that:

- (a) neither IFRIC 12 nor IAS 7 provide explicit guidance for the classification of cash flows relating to service concession arrangements; and
- (b) the recognition of either an intangible asset or financial asset, could affect the classification of the related cash flows.

*The Committee's decision to propose an annual improvement*

- 47. The Committee noted that the principle in IAS 7 is to classify the cash flows in a manner that is consistent with the nature of the activity that generated the cash flow. In the case of construction services in a service concession arrangement, the Committee noted that operators who engage in construction services do so because this is their operating activity, and hence it is more appropriate to present the cash flows as operating cash flows.
- 48. Consequently, the Committee determined that *all* the cash flows from construction or upgrade services in a service concession arrangement should be classified as *operating* cash flows.
- 49. The Committee decided to recommend that the Board should propose an amendment, through Annual Improvements, to paragraph 14 of IAS 7 to clarify that an operator that provides construction or upgrade services in a service concession arrangement should present all of the cash flows relating to this activity as operating cash flows.

## **Staff analysis**

### ***A quick glance at the issues considered by the Committee***

- 50. We observe that of the six issues considered by the Committee under IAS 7 (as analysed in the previous section):

- (a) one issue refers to a request for interpreting the meaning of ‘cash equivalents’; and
- (b) five involve queries on the classification of specific items in the financial statements, as either, operating, investing or financing.

#### *Room for improvement*

51. For three of the issues considered (out of six) the Committee recommended an improvement to IAS 7. These issues were:
- (a) classification of expenditure on unrecognised assets
  - (b) classification of interest paid that is capitalised; and
  - (c) classification of cash flows relating to construction services under service concession arrangements.
52. The Committee gave the following reasons for supporting an improvement to IAS 7:
- (a) either the wording in IAS 7 is unclear; or
  - (b) the guidance in IAS 7 is inconsistent.

#### *No improvement needed*

53. For two of the issues considered (out of six), the Committee did not recommend the Board to take these issues into its agenda or to add the issues to the Annual improvements project. These issues are:
- (a) classification of value added tax; and
  - (b) classification in the statement of cash flows of the flows arising from the settlement of contingent consideration in a business combination.
54. The Committee gave the following reasons for the rejection notes:
- (a) there is no ambiguity in the requirements of IAS 7; or
  - (b) the existent guidance in IAS 7 is sufficient; or
  - (c) the issues are not widespread or do not have practical relevance; or
  - (d) the issues are too broad.

## ***Principles behind IAS 7***

55. We observe that two different ‘principles of classification’ were used to support the Committee’s decisions (either for issuing a rejection note or for proposing an annual improvement):

- (a) View A: cash flows in IAS 7 should be classified in accordance with the nature of the activity to which they relate; or
- (b) View B: cash flows in IAS 7 should be classified consistently with the classification of the related or underlying item in the statement of financial position (ie consistent with the cohesiveness principle).

### *View A: Classification of cash flows by the nature of the activity*

56. This view relies on the definitions of investing activities, operating activities and financing activities in paragraph 6 of IAS 7, as follows:

*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.”]

*Financing activities* are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity

57. We observe that in only one instance (ie: ‘classification of cash flows for service concession arrangements’), the Committee decide that cash flows should be classified in accordance with the nature of the activity to which they relate.

58. Paragraph 8(c) of Agenda Paper 11(November 2011) summarises the basis for this decisions:

The different accounting models in IFRIC 12 (intangible asset or financial asset) are not the relevant factor in determining cash flow presentation. The different accounting models, for construction services, are a consequence of the different types of arrangements and definitions of a financial asset versus an intangible asset. **However this does not change the activity to which the construction services relate. In other words, regardless of whether the cash inflows will be obtained contractually from the government (financial asset model) or through services to the public (intangible asset model), the activity of satisfying a service concession arrangement is expected to be a principal revenue producing activity of an entity which undertakes such arrangements i.e. an operating cash flow.**

*View B: Classification of cash flows consistently with the cohesiveness principle*

59. In the remaining cases (excluding the classification of VAT and the request for guidance on cash equivalents), the Committee decided that cash flows should be classified consistently with the classification of the related or underlying item in the statement of financial position. Consequently, it appears to us that this view dominated the Committee's rationale for determining the classification of specific items.
60. The Committee followed this view when it analysed the classification of expenditure on unrecognised assets and proposed an amendment to paragraph 16 of IAS 7 to clarify that only expenditures that resulted in recognised assets should be presented as cash investing cash flows (refer to Agenda Paper 4B, March 2008). This same rationale was used when the Committee proposed an amendment to paragraphs 16(a) and 33 (and added paragraph 33a) of IAS 7 to clarify that "interest paid that is capitalised into the cost of property, plant and equipment is part of an entity's investing activities" (refer to Agenda Paper 6 of May 2011).



61. A majority of Committee members also supported this rationale when they discussed the classification of contingent and deferred consideration payments. The table below summarises their conclusions in this respect<sup>7</sup>:

Description	Proposed classification	Rationale behind
Cash payments for the contingent consideration that are recognised at the acquisition date and any adjustment arising during the measurement period (as defined in IFRS 3, paragraphs 45-50)	<b>Investing activities</b>	(IAS 7.16) Only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities.
Cash payments for increases in fair value of contingent consideration arising after the measurement period	<b>Operating activities</b>	In accordance with IFRS 3.58, the changes in the fair value of contingent consideration classified as assets or liabilities that are not 'measurement period adjustments' should be recognised in profit or loss or in other comprehensive income (ie not recognised as part of the consideration transferred in a business combination at acquisition date). If the cohesiveness principle is followed then these cash flows would be presented as part of operating activities.
Cash payments relating to interest resulting from accretion of the discount on the contingent consideration liability balance.	<b>Financing or operating activities</b>	Will follow the classification for interest paid in accordance with paragraphs 31–34 of IAS 7.

### ***Which principle of classification in IAS 7 should be applied?***

62. We have noted in the previous section the different principles that can be found in IAS 7. The question that arises is: which is the principle that should be followed?
63. We think that both principles (ie, classification by the nature of the underlying activity and classification according to the cohesiveness principle) exist in IAS 7 and could both be applied. However, when applied, they can sometimes give different answers.
64. For instance, different answers would have been obtained if:

<sup>7</sup> This discussion is included in Agenda Paper 7 from November 2011.

- (a) the cohesiveness principle had been employed as the basis for classification of the issue raised on service concession arrangements; or
- (b) classification based on the nature of the activity had been used to classify payments for contingent consideration.

65. The table below illustrates our observation in this respect:

Description	Classification based on the nature of the activity	Classification consistent with the cohesiveness principle
Cash payments for the contingent consideration	<p>Three options could be used:</p> <p><b>Option 1</b> <i>Investing activity</i>, because they are cash flows arising from obtaining control of a business (IAS 7.39);</p> <p><b>Option 2</b> <i>Financing activity</i>, because the vendor is providing finance to the acquirer; or</p> <p><b>Option 3</b> <i>Operating activity</i>, because it is a payment linked to the performance of the acquired business.</p>	<p>Split components into:</p> <p>Payments at acquisition date (including payments for the liability) and adjustments arising during measurement period: <i>investing</i>, based on IAS 7.16:</p> <p>Payments for increases in fair value after measurement period: <i>operating</i>, based on IFRS 3.58.</p> <p>Classification for interest paid: <i>financing or operating</i> based on IAS 7.31–34.</p>
Cash flows for relating to construction services under a service concession arrangement	<b>Operating activities</b> , because the activity of satisfying a service concession arrangement is a principal revenue producing activity.	<p>a) <u>Intangible asset model</u>: Cash inflows: operating Cash outflows; investing (in accordance with IAS 7.16).</p> <p>b) <u>Financial asset model</u>: - cash outflows: operating - cash inflows (investing): represent a repayment of a financial instrument (IAS 7.16). Distinguish interest component (that could be either financing or operating based on IAS 7.31–34.)</p>

66. We think that the principle behind the classification of cash flows in IAS 7 is that cash flows should be classified in accordance with the nature of the activity type

in a manner which is most appropriate to the business of the entity. This conclusion is based on paragraph 11 of IAS 7 which states that (emphasis added):

**An entity presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the entity** and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.

67. Alternatively if the Committee's view is that the cohesiveness principle should have primacy over the nature of the activity principle when classifying cash flows, then this principle should be made clear in IAS 7. For example, for transactions having different components (as we have illustrated for the case of contingent consideration) we think that the standard could have clearer general principles that would guide the classification for each component.
68. As a final observation, we would like to mention that the *Leases* project was caught in a similar discussion when trying to distinguish the main principle guiding the classification of cash flows in IAS 7.
69. For example, when considering the classification of cash inflows related to leases by lessors in a discussion with the Board in September 2011 (refer to [agenda paper 2C](#)), the staff identified some possibilities for classification. Two of them are described as follows:
- (a) all cash receipts from lease payments should be classified as operating activities in the SCF because leasing activities are the operating activities of the lessor.
  - (b) all cash receipts from lease payments should be classified as investing in parallel with the accounting among lessors and lessees. That is, if the lessee has been provided with financing of the right-of-use asset it would be reasonable to see the provision of that financing by the lessor as an investing activity.

70. According to the September 2011 *IASB Update* the first classification was favoured:

The boards tentatively decided that a lessor should classify the cash inflows from a lease as operating activities in the statement of cash flows.

71. In other words, the Board decided that classification according to the nature of the activity should be followed, rather than the application of the cohesiveness principle.

### **Staff recommendation for the approach to address the Board's request**

72. As we have mentioned above it is our view that the primary principle behind the classification of cash flows in IAS 7 is that cash flows should be classified in accordance with the nature of the activity type in a manner which is most appropriate to the business of the entity.
73. We also think that a review of IAS 7 could be performed to identify how the principle could be clarified. Such a review could also consider whether there is conflicting guidance within the standard, and if so, propose amendments to it. If such a review were to be undertaken, we suggest that any proposed amendments to the standard be tested against the issues already identified in this paper, plus the additional issues set out in **Appendix A**. However we would like to hear the Committee's views in this respect.
74. We think that in addressing the issues raised in relation to IAS 7, the Committee members could answer the following questions:
- (a) **Question 1**—What is the underlying principle in IAS 7 regarding the classification of cash flows?
  - (b) **Question 2**—Is the principle identified in IAS 7 sufficient to guide the classification of cash flows or should specific guidance be developed for certain transactions? (for example, if there is a need to include exceptions to the principle)

- (c) **Question 3**—What is the best way in which the Committee can help the Board to address this issue in the short term?

### Other requests on the classification of cash flows

75. We recently received other requests on the classification of cash flows. We have not performed a full analysis of these requests. A summary of these requests is shown in **Appendix A** and **Appendix B**. If further work is performed on the classification of cash flows, we propose that these additional issues be used to test any proposed amendments.

#### Questions for the Committee

1. Does the Committee agree that the questions identified by the staff are the appropriate ones?
  
2. Does the Committee think that there are additional questions that we need to consider in order to address the Board's request to address the issues raised on IAS 7 in a collective way?
  
3. Does the Committee agree with the proposal to review conflicting guidance in IAS 7 and as part of this proposal deal with additional issues on classification with a view to test any proposed amendment?

## Appendix A

This Appendix identifies some informal requests for classification of cash flows (ie we have not received a formal submission except for the first issue on the classification of payments to a long-term employee benefit fund. **This submission is shown in Appendix B**). The table below provides a brief description of the issue along with some potential fact patterns that we have been advised could be considered.

Topic	Issue	Possible fact patterns
<b>Cash payments to employee benefit fund</b>	<p><i>How should payments made to an employee benefit fund (accounted for as defined benefit plan as per IAS 19) such as annual contributions (voluntary or required by law), special contributions (to remedy a funding deficit) or contributions to fund past service costs, be classified in the statement of cash flows?</i></p> <p><i>Should they be classified as operating cash flows or may, in certain circumstances be classified as investing or financing cash flows?</i></p>	<p><b>1.</b> Cash flows are comparable to service cost for the period.</p> <p><b>2.</b> Cash flows significantly exceed the service cost for the period. However, the defined benefit plan shows a deficit.</p> <p><b>3.</b> Cash flows significantly exceed the service cost for the period. The defined benefit plan shows a surplus and part or all of the additional contribution results in an increase in the net asset recognised in the statement of financial position.</p>
<b>Proceeds from insurance company (recovery)</b>	<p>As a result of a natural disaster, significant amounts of property, plant &amp; equipment (PP&amp;E) were damaged. The entity holds an insurance policy covering such losses.</p> <p><i>How should the proceeds from the insurance company (recovery) be classified in the statement of cash flows?</i></p>	<p><b>1.</b> The entity is purchasing new items of PP&amp;E in the same reporting period.</p> <p><b>2.</b> The entity is purchasing new items of PP&amp;E, however the insurance recovery is only received in a subsequent reporting period.</p> <p><b>3.</b> The entity decides not to replace the damaged items of PP&amp;E.</p>

Topic	Issue	Possible fact patterns
<b>Cash flow from government grants</b>	<i>How are cash flows from government grants related to investing in fixed assets classified in the statement of cash flows?</i>	<p><b>1.</b> The entity is investing in fixed assets, the construction of which takes place over several reporting periods. The entity receives a government grant up front equivalent to the expected spending (ie, the cash flow pattern of the investing and the government grant differ).</p> <p><b>2.</b> The entity is investing in fixed assets, the construction of which takes place over several reporting periods. The entity is entitled to receive payments from a government grant as it is investing (ie, the cash flow pattern of the investing and the government grant match).</p> <p><b>3.</b> The entity is continually investing in fixed assets, all of which qualify for receiving a government grant. However, instead of receiving the government grant as the entity is investing, the annual grant received is equivalent to the annual depreciation recorded on qualifying assets.</p>

Topic	Issue	Possible fact patterns
<b>Purchase of an asset on deferred terms</b>	<p>The entity is purchasing an asset on deferred terms.</p> <p><i>How is the cash flow from the deferred payment classified in the statement of cash flows?</i></p>	<p><b>1.</b> The payment is only deferred as a result of payment terms common in the industry (e.g. invoice due after 45 days).</p> <p><b>2.</b> The parties agree to a substantial deferral; however, the agreement does not specify any interest payable on the amount outstanding.</p> <p><b>3.</b> The parties agree to a substantial deferral and also agree on interest payable on the amount outstanding (ie clear reference to a financing element).</p>
<b>Rehabilitation obligation</b>	<p><i>How are cash flows related to the rehabilitation of a surface mine classified in the statement of cash flow?</i></p>	<p><b>1.</b> A mining company has an obligation for rehabilitation of the land at the end of the operations for a specific (surface) mine. At initial recognition, the rehabilitation obligation is recognised as liability with a corresponding asset recorded.</p>
<b>Cash flows in a reverse factoring agreement</b>	<p>The entity enters into reverse factoring arrangement with a bank.</p> <p><i>How are cash flows related to a reverse factoring agreement classified in the statement of cash flow?</i></p>	<p>The terms and conditions of the arrangement are as follows:</p> <ul style="list-style-type: none"> <li>- The trade payable has a normal 45-day due date.</li> <li>- At the due date the bank pays the amount due to the supplier.</li> <li>- The loan receivable of the bank is paid after a maximum of 90 days.</li> </ul> <p>The entity has a policy of derecognising the trade payable upon payment by the bank of the amount due under the payable to the supplier.</p>



## Appendix B – Request for the IFRS Interpretations Committee

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

**Suggested agenda item: Classification of payments made to a long-term employee benefit fund in the statement of cash flows**

It has come to our attention that there are divergent views on the classification of payments made to a long-term employee benefit fund in the statements of cash flows.

We are seeking clarification of this issue by the Committee.

**The Issue**

IAS 7 does not provide explicit guidance on the classification of payments made to a long-term employee benefit fund. Such payments may be made in a variety of circumstances, including:

- annual contributions (voluntary or required by law) to fund the increased defined benefit obligation arising from employees' service provided in the year;
- special contributions made to remedy a funding deficit in the defined benefit plan; or
- contributions to fund past service costs arising from service provided to the entity or to a previous sponsoring employer (in the case of a defined benefit plan acquired as part of a business combination).

**Alternative views**

***Payments made to a long-term employee benefit fund should always be classified as operating cash flows***

Proponents of this view consider that, as the sole purpose of a long-term employee benefit fund used as part of a defined benefit plan is the provision of benefits to current and past employees, all payments made to the fund should be considered to be 'on behalf of employees' [IAS 7.14] and as such classified as operating cash flows.

Proponents also believe that the requirements of IAS 7.16 preclude such a payment from classification as an investing cash flow as it does not lead to a recognised asset in the statement of financial position. They note that assets held by a long-term employee benefit fund are recognised only as a deduction from the present value of the defined benefit obligation and are not controlled by the entity as they are available only to pay or fund employee benefits.

***Payments made to a long-term employee benefit fund may, in certain circumstances, be classified as investing or financing cash flows***

Proponents of this view consider that, as reflected by the split between service cost, net interest and remeasurements required by IAS 19(2011) and the separate elements of accounting for a defined benefit plan identified by IAS 19, the funding of a long-term employee benefit fund is more complex than a simple arrangement to pay employees for service to the entity and that this should be considered in the classification of related cash flows. In this respect, proponents note that:

- payments may be made to invest in assets held by a long-term employee benefit fund, with the intent of generating a return over a number of years prior to use of those assets (i.e., funding payments to plan members); and
- a special contribution made to remedy a funding deficit might be considered to be similar to financing cash flows made on settlement of other long-term liabilities.

Proponents of this view also believe that classification as an investing cash flow is not precluded by IAS 7.16 as payments to a long-term employee benefit fund may lead to a recognised asset as the requirement of IAS 19 to show plan assets as a deduction from the present value of the defined benefit obligation affect only the presentation of plan assets, not their recognition.

Proponents of this view would also refer to the Board's discussions on the Financial Statement Presentation in December 2009 which did not result in a conclusion that long-term employee benefit funds should be considered wholly operating in nature.

**Reason for IFRIC to Address the Issue**

We believe that this issue should be addressed in a timely manner as payments to long-term employee benefit funds are a common feature of businesses in many jurisdictions and we are aware of diversity in practice in the classification of such cash flows. We are also aware of a regulatory view in a specific jurisdiction that payments made to a long-term employee benefit fund should be classified as operating cash flows. Whilst this view would necessarily have been based on a specific set of circumstances, it is indicative of the widespread nature of the issue.

Furthermore, we note the Board's request in January 2012 for the Interpretations Committee to look at the classification of cash flows in other circumstances (payments of deferred and contingent consideration arising from a business combination and cash flows for an operator in a service concession arrangement). We believe that payments to a long-term employee benefit fund could usefully be considered alongside these issues.

If you have any questions concerning our comments, please contact [ ].

Yours sincerely,