STAFF PAPER

April 2013

IASB Meeting

IFRS IC March 2013/Jan 2013 (deferred) May 2011/ |IASB September 2011

Project	**Annual Improvements 2010–2012 cycle Issues recommended by the Interpretations Committee not to lead to amendments within the scope of the Annual Improvements process**
Paper topic	IAS 7 *Statement of Cash Flows*—classification of interest paid that is capitalised as part of the cost of an asset

CONTACT(S) Denise Durant ddurant@ifrs.org +44 (0)20 7246 6469

Introduction

1. The Exposure Draft (ED) on *Annual Improvements to IFRSs 2010 –2012 cycle* (ED/2012/1) published in May 2012 included the IASB's proposal to:
   (a) amend the requirements in paragraphs 16 and 33 of IAS 7; and
   (b) add paragraph 33A to IAS 7.
2. This amendment proposed to clarify that the classification of payments of interest that is capitalised shall follow the same classification as the cash flows for the underlying asset into which those payments were capitalised. This proposed amendment also covers 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.
3. After considering the comments received from respondents to the ED, the Interpretations Committee decided to recommend to the IASB that it should refrain from proceeding with the proposed amendment to paragraphs 16(a) and 33 and with

the proposed addition of paragraph 33A to IAS 7 because of the concerns raised about the implementation of the amendment.

Objective of the paper

4. The objective of this paper is to:

   (a) give an overview of the proposed amendment and the comments received;

   (b) explain the rationale for the Interpretations Committee's decision not to recommend that the IASB to amend IAS 7; and

   (c) ask for the IASB agreement with the Interpretations Committee's recommendation.

Summary of the proposed amendment and the comments received

5. A summary of the proposed amendment and the comments received is described in the paragraphs that follow.

6. For a detailed description of the comments received and the source of those comments, the IASB should refer to Agenda Paper 9C of March 2013, which was presented to the Interpretations Committee.

Proposed amendment

7. The IASB received 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. This is because paragraph 16 of IAS 7 might be interpreted to require interest paid that is capitalised to be classified as an investing cash flow. However, this may seem inconsistent with paragraphs 32 and 33 of IAS 7, which appear to require interest paid to be classified only as an operating or a financing cash flow.

8. The proposed amendment:

   (a) proposed that the example guidance in paragraph 16(a) on cash flows arising from investing activities should explicitly include interest paid that is capitalised into the cost of property, plant and equipment; and

(b) proposed to clarify in paragraph 33 (and in the new paragraph 33A) that interest paid that is capitalised in accordance with IAS 23 should be classified in conformity with the classification of the underlying asset to which those payments were capitalised.

9. The proposed amendment is reproduced below for ease of reference **(new text is underlined)**:

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. These payments include those relating to <u>capitalised borrowing costs,</u> capitalised development costs and self-constructed property, plant and equipment;

...

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.

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 <u>(except for payments of interest that is capitalised, which shall be classified in accordance with paragraph 33A),</u> 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 (except for payments of interest that is capitalised, which shall be classified in accordance with paragraph 33A), and interest and dividends received, may be classified as financing cash flows and investing cash flows respectively, because they are either costs of obtaining financial resources or returns on investments.

33A Payments of interest that is capitalised in accordance with IAS 23 shall be classified in accordance with the classification of the underlying asset to which those payments were capitalised. For example, payments of interest that is capitalised as part of the cost of property, plant and equipment shall be classified as part of an entity's investing activities, and payments of interest that is capitalised as part of the cost of inventories shall be classified as part of an entity's operating activities.

Summary of the comments received

10. In this section, we discuss and analyse the comments received from interested parties on the ED (May 2012) during the comment period, which ended on 5 September 2012.

11. The IASB received 84 comment letters on the ED. Of these, 71 respondents expressed their views on the proposed amendment to IAS 7 regarding the classification of interest paid that is capitalised.

12. In respect to the IASB's proposal to amend paragraph 16(a) and paragraph 33 and add paragraph 33A:

    (a) almost **two-thirds** of the respondents **agree** with the proposed amendment;

    (b) **fewer than a dozen** of the respondents **agreed in principle** (not included as part of those who agree) with the proposed amendment but noted additional issues that the IASB should look at before finalising the proposed amendment; and

(c) **fewer than one-third** of the respondents disagreed with the proposed amendment.

13. We observe that respondents who **agreed** did so because they think that the proposed amendment will allow more consistent classification of interest that is capitalised.

14. Respondents who **agreed in principle** or **disagreed** with the proposed amendment mainly gave the following arguments:

(a) The proposals may be difficult to implement in practice.

(b) The proposed amendment may not be consistent with the conclusion that the IFRS Interpretations Committee will reach after reviewing the underlying principle for classifying cash flows in IAS 7.

The proposed amendment may be difficult to implement in practice

15. A few respondents think that the proposed amendment may be difficult to implement in cases where interest expense occurs in a period different from the actual payment of interest. For example, some point out that interest presented as expense under the effective interest method is not always recognized in the same period as the period in which the corresponding actual interest payments (i.e. cash outflows) occur (e.g. interest expense for zero coupon financial debt). Therefore some think that reconciling interest capitalised to actual interest paid will be a very challenging exercise in practice.

16. In another example one respondent points out that in situations where issued debt has a long maturity, some payments for borrowing costs will be made long after the costs have been recognised, and there would be a significant difference from the amount capitalised as borrowing costs and interest payments in any one year.

(a)

17. Other respondents have pointed out that implementing the proposed amendment would ‘force’ an entity to make an arbitrary calculation to decide how much of the interest capitalised in the period has been paid in the period to acquire underlying assets (operating and/or investing assets), especially:

(a) when the construction of a qualifying asset is financed by general borrowings; or

(b) in the cases mentioned in paragraph 11 of IAS 23. This is for example when, among other possible situations, the financing activity of an entity is co-ordinated centrally; or a group uses a range of debt instruments to borrow funds at varying rates of interest, and lends those funds on various bases to other entities in the group. In such cases this paragraph states that “it may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided”.

18. The Interpretations Committee agreed that the proposed amendment would add another layer of complexity in terms of allocation of the cash payments.

The proposed amendment may not be consistent with the underlying principle for classifying cash flows in IAS 7

19. These respondents suggested to the IASB that it should hold back its proposed amendment to IAS 7 until the Interpretations Committee issues a recommendation to the IASB based on the outcome of its discussions regarding the underlying principle that should guide the classification of cash flows.

20. The Interpretations Committee concluded at the March 2013 meeting that clarifying the application of the primary principle is a matter that is too broad for the Interpretations Committee to address. In this respect we will present a separate paper to the IASB at the April 2013 meeting (refer to agenda paper 11B) describing the Interpretations Committee’s discussions and conclusions.

Transition and effective date of the proposed amendment

21. Respondents who agreed with the proposed amendment **broadly agree** with the transition and effective date of the proposed amendment, ie that the proposed amendment would apply in annual periods beginning on or after 1 January 2014 with earlier application permitted.

Interpretations Committee recommendation

22. The Interpretations Committee recommends the IASB not to proceed with the proposed amendment to paragraphs 16(a) and 33 of IAS 7 and the proposal to add paragraph 33A to IAS 7 due to:

    (a) the concerns raised about the implementation of the amendment on the basis of our analysis in the previous section; and

    (b) the Interpretations Committee's conclusion at the March 2013 meeting that clarifying the application of the primary principle for the classification of cash flows in IAS 7 is a matter that is too broad for the Interpretations Committee to address and as a consequence, the Interpretations' Committee (refer to IFRIC Update of March 2013):

        (i) determined that it could not take a comprehensive approach to the specific fact patterns recently discussed regarding the classification of cash flows under IAS 7; and

        (ii) observed that several specific requests regarding the classification of cash flows had been considered individually but it thought that amendments to IAS 7 on a piecemeal basis would not be appropriate unless the classification is evident from the current guidance in IAS 7 and an amendment to IAS 7 would make that classification clearer.

23. For reference purposes we are including in **Appendix A** the proposed amendment as published in the *Annual Improvements* ED of May 2012.

Question to the IASB
Does the IASB agree with the Interpretations Committee's recommendations on not finalising the proposed amendment to IAS 7 on the classification of interest paid that is capitalised as part of the cost of an asset?

Appendix A—proposed amendment as published in *Annual Improvements to IFRSs* (2010-2012 Cycle)[1]

A1. The proposed amendments to paragraphs 16(a) and 33 and the addition of paragraphs 33A and 58 are presented below. Paragraph 32 is not proposed for amendment but is included here for ease of reference.

Amendment to IAS 7 *Statement of Cash Flows*

Paragraphs 33A and 58 are added. Paragraph 32 is not proposed for amendment but is included here for ease of reference. Paragraphs 16(a) and 33 are amended. New text is <u>underlined</u> and deleted text is ~~struck through~~.

Presentation of a statement of cash flows

…

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. These payments include those relating to <u>capitalised borrowing costs</u>, capitalised development costs and self-constructed property, plant and equipment;

(b) ...

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*.

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 <u>(except for payments of interest that is capitalised, which shall be classified in accordance with paragraph 33A),</u> and interest and dividends received, may be

[1] This proposed amendment was included in the Exposure Draft (ED) on *Annual Improvements to IFRSs 2010 -2012 cycle* (ED/2012/1) published in May 2012

classified as operating cash flows because they enter into the determination of profit or loss. Alternatively, interest paid (except for payments of interest that is capitalised, which shall be classified in accordance with paragraph 33A), and interest and dividends received, may be classified as financing cash flows and investing cash flows respectively, because they are either costs of obtaining financial resources or returns on investments.

33A Payments of interest that is capitalised in accordance with IAS 23 shall be classified in accordance with the classification of the underlying asset to which those payments were capitalised. For example, payments of interest that is capitalised as part of the cost of property, plant and equipment shall be classified as part of an entity's investing activities, and payments of interest that is capitalised as part of the cost of inventories shall be classified as part of an entity's operating activities.

Effective date

58 *Annual Improvements to IFRSs 2010–2012 Cycle* issued in [date] amended paragraphs 16(a) and 33 and added paragraph 33A. An entity shall apply that amendment for annual periods beginning on or after 1 January 2014. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.

Basis for Conclusions on the proposed amendment to IAS 7 *Statement of Cash Flows*

This Basis for Conclusions accompanies, but is not part of, the proposed amendment.

Interest paid that is capitalised

BC1 The Board received 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. Paragraph 16 of IAS 7 was interpreted as classifying interest paid that has been capitalised as an investing cash flow. However, the Board was informed that this seemed to be inconsistent with paragraphs 32 and 33, which require interest paid to be classified only as an operating or a financing cash flow.

BC2 The Board observed 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. Paragraph 32 states that interest paid that is capitalised according to IAS 23 *Borrowing Costs* should be reflected in the statement of cash flows; however, the Board noted that neither IAS 23 nor IAS 7 specifies where such capitalised interest should be classified in the statement of cash flows. Paragraph 33 allows for interest paid to be classified as part of either operating or financing activities. However, the Board noted that 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.

BC3 To address this lack of guidance, the Board proposes to modify paragraphs 16(a) and 33 and proposes adding paragraph 33A to clarify that the classification of payments of interest that is capitalised shall follow the same classification as the underlying asset into which those payments were capitalised. This modification also covers 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.