STAFF PAPER

22 – 23 January 2013

IFRS Interpretations Committee Meeting

Project	**New items for initial consideration**
Paper topic	**IAS 7 *Statement of Cash Flows*—identification of cash equivalents**

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Introduction

1. In September 2012, the IFRS Interpretations Committee (the Interpretations Committee) received a query regarding the classification of cash equivalents at the date of the acquisition of the investment in accordance with IAS 7 *Statement of Cash Flows.*

2. More specifically, the submitter thinks that the classification of investments as cash equivalents based on the remaining period to maturity as at the balance sheet date would lead to a more consistent classification than the current focus on the instrument's maturity from its acquisition date.

3. We performed outreach with national accounting standard-setters (ie the International Forum of Accounting Standard Setters (IFASS)) and securities regulators (IOSCO and ESMA) on this topic in order to find out whether the issue raised by the submitter is widespread and whether significant diversity in practice exists. The results of this outreach are included as part of our analysis of this issue.

4. The submission is reproduced in full in **Appendix B** to this paper.

Purpose of the paper

5. The purpose of this paper is to:

   (a) provide background information on the issue raised in the submission;

   (b) provide an analysis of the issue, including a summary of the outreach responses received;

   (c) present an assessment of the issue against the Interpretations Committee's agenda criteria;

   (d) make a recommendation that the Interpretations Committee should not take this issue onto its agenda (we have set out our proposed wording for the tentative agenda decision in **Appendix A** of this paper**)**; and

   (e) ask the Interpretations Committee whether it agrees with the staff recommendation.

Background information

6. Paragraph 7 of IAS 7 defines cash equivalents as follows (emphasis added):

> **7 Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition**. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example in the case of preferred shares acquired within a short period of their maturity and with a specified redemption date.”

7. The submitter thinks that the present definition of cash and cash equivalents needs to be updated because it does not properly reflect the current business practice for classifying cash equivalents.

8. From the submitter's perspective, a cash equivalent should be judged from the date of the balance sheet and not from the date of the original investment. This is because the submitter claims that this classification is more relevant for cash management purposes. We reproduce below an extract of the original submission containing the submitter's rationale (emphasis added):

> Suppose a deposit is made on 1st Jan for 13 months and another deposit is made on 1st November for 2 months. Both are maturing on the same day namely 31st January of next year. **On the balance sheet date namely 31st December, the first deposit is treated as a bank deposit not qualifying for Cash and cash equivalent while the second deposit will qualify as cash and cash equivalent which is not correct.**
>
> **The issue assumes importance as how to classify a bank deposit on the date of the Balance Sheet. Classification of cash and Cash equivalent is from the date of the original investment and current and non current classification is from the date of the balance sheet**. Hence in the example given above one deposit will get classified as Cash and Cash equivalent and other deposit as bank balance even though both are maturing on the same day .HENCE THIS PROBLEM IS WIDESPREAD AND PRACTICAL

Staff analysis and view

9. We observe that, on the basis of paragraph 7 of IAS 7, cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. Consequently, it is our view that the purpose for

which an investment is held is the core principle in IAS 7 for determining whether a particular investment qualifies for classification as a cash equivalent.

10. Paragraph 7 further states that for an investment to be held for the 'short term', it will normally have a maturity of three months or less from the date of acquisition. We think that this criterion is an additional factor in assessing the purpose of the investment held.

11. It is also our view that the three-month limit is not arbitrary, because we think that the intention of this criterion is to promote consistency between entities in the classification of cash equivalents.

12. In respect to the example provided by the submitter, we think that the first deposit described (the one with a 13-month maturity and residual term shorter than 3 months from the date of the balance sheet) is not an investment held for meeting a short-term cash commitment and consequently does not meet the definition of a cash equivalent. Consequently, it should not be classified as a cash equivalent.

Outreach request

13. We asked national accounting standard-setters and securities regulators to provide us with information on whether the issue raised in the submission:

    (a) is widespread and has practical relevance; and

    (b) indicates that there are significant divergent interpretations (either emerging or existing in practice).

14. We asked the following question:

    (a) In your jurisdiction, how is the guidance in paragraph 7 of IAS 7, regarding the definition of cash and cash equivalents, applied in practice in the classification of investments as cash and cash equivalents? Please explain how the "three months or less" guidance is applied.

Responses from national accounting standard-setters and securities regulators

15. We received responses from the following 14 jurisdictions: Europe (5), Asia (3), Latin America (2), Americas (1), Oceania (1), Middle East (1) and Africa (1).

16. We also received responses from two regulators (ESMA and IOSCO). The response provided by ESMA reflects the views of 7 European jurisdictions.

Responses from national accounting standard-setters

17. Standard-setters who responded to our outreach request, broadly agree that the “three months or less” criterion in the definition of cash and cash equivalents is applied based on the term to maturity at the date of acquisition as required by IAS 7. They note that this requirement is clear, well understood and consistently applied in practice.

18. In paragraphs below we reproduce some further comments expressed by some of these standard-setters.

19. One standard-setter observes the following:

> we believe that the core principle is that the financial instrument “...must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value.”, as stated in the standard. **The three months is just a rule, and if the IASB standards are truly principle oriented, such rule should be deleted, especially if it seems that some people are paying more attention to the rule than the principle**.

20. One standard-setter further notes that (emphasis added):

> some entities deliberately purchase fixed deposits that will mature within 3 months to ensure that they will get cash equivalent reporting as they will have less than three months to maturity from acquisition. This has had the effect of altering the interest rate profile of the shorter period instruments at times during the year making them a “premium” security if an entity wants to achieve a certain

> balance sheet presentation. **Therefore they would support the proposed change requiring cash equivalent reporting if the instruments has less than three months at balance sheet date to maturity as the current statement appears, in some jurisdictions, to have had an unintended consequence on market forces**.

21. One standard-setter mentioned the following (emphasis added):

> We consider that the requirements of IAS 7 are clear, but in the past have identified that entities have presented such cash equivalents on a 3 months maturity from balance sheet date, but not so much in recent years. **It is noted that the 3 months from acquisition date may not be the way treasury departments manage cash and those preparing the accounts have to be alert to checking the information they get from treasury when preparing the accounts to ensure that the classification complies with the standard**.

Responses from securities regulators

22. Securities regulators who responded to our outreach request[1] noted that no diversity in practice has been observed with regard to the application of the "three months or less" criterion in the definition of cash and cash equivalents.

23. One regulator further noted that this criterion of "three months or less" has always been well understood as three months or less based on the date of acquisition of the instrument rather than three months or less from the reporting date. This regulator also observed that the definition of cash equivalents in IAS 7 should not change from the date of acquisition to the reporting date, as proposed in the submission, because this change would lead to volatility and lack of comparability in the cash equivalents reported.

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[1] The reply from one of these regulators reflects the views received from seven European jurisdictions that sent their answer to our outreach request.

24. Another regulator observed that under the guidance in US GAAP, which the regulator mentions and that is similar to the language in IAS 7, there does not seem to be diversity regarding the application of the guidance on cash equivalents having a maturity of 3 months or less from the date of acquisition.

Agenda criteria assessment

25. The staff's preliminary assessment of the agenda criteria is as follows:

- *The issue is widespread and has practical relevance.*

  No. On the basis of our outreach, we understand that the concerns raised about the current requirements on cash equivalents do not seem to be widespread.

- *The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The Committee will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.*

  On the basis of our outreach, we understand that no diversity in practice exists.

- *Financial reporting would be improved through elimination of the diverse reporting methods.*

  No. We do not think that financial reporting would be improved if the cash equivalents definition in IAS 7 were to be modified.

- *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

  Yes. The requirements in IAS 7 for the classification and identification of cash equivalents are clear and sufficient. The issue raised in the submission is one of disagreement with the current requirements in IAS 7 rather than a concern about a lack of clarity or a need for interpretation.

- *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

  Yes.

- *If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The Committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the Committee requires to complete its due process.*

  Not applicable. The issue does not relate to a current or planned IASB project.

Staff recommendation

26. We think that the issue raised in the submission is one of disagreement with the current requirements in IAS 7 rather than a concern about a lack of clarity or a need for interpretation. We also observe that concerns about current requirements in the identification and classification of cash equivalents in IAS 7 do not seem to be widespread. Consequently, we do not share the concerns raised by the submitter.

27. On the basis of our assessment of the Interpretations Committee's agenda criteria, we recommend that the Interpretations Committee should not take this issue onto its agenda.

28. We have set out proposed wording for the tentative agenda decision in **Appendix A.**

Questions for the Interpretations Committee—identification of cash equivalents
1. Does the IFRS Interpretations Committee agree with the staff recommendation? 2. Does the IFRS Interpretations Committee have any comments on the drafting of the tentative agenda decision?

Appendix A – IAS 7 *Statement of Cash Flows*— Identification of cash equivalents

A1. We propose the following wording for the tentative agenda decision.

> **IAS 7 *Statement of Cash Flows* — identification of cash equivalents**
>
> The IFRS Interpretations Committee received a received a request regarding the basis of classification of financial assets as cash equivalents at the date of the acquisition of the investment in accordance with IAS 7 *Statement of Cash Flows*. More specifically, the submitter thinks that the classification of investments as cash equivalents on the basis of the remaining period to maturity as at the balance sheet date would lead to a more consistent classification rather than the current focus on the investment's maturity from its acquisition date.
>
> The Interpretations Committee noted that that based on paragraph 7 of IAS 7 financial assets held as cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. This paragraph further states that for an investment to be held for the 'short-term', it will normally have a maturity of three months or less from the date of acquisition. The IFRS Interpretations Committee observed that this three-month criterion in paragraph 7 of IAS 7 promotes consistency between entities in the classification of cash equivalents.
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> On the basis of the above, the Interpretations Committee determined that in the light of the existing IFRS guidance, an interpretation or an amendment to IFRSs was not necessary and it did not expect significant diversity in practice to develop regarding their application.
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> Consequently, the IFRS Interpretations Committee [decided] not to add this issue to its agenda.

Appendix B—IAS 7 *Statement of Cash Flows*— Identification of cash equivalents

A discussion on Cash and Cash Equivalents

THE ISSUE : The present definition of cash and cash equivalent do not properly represent the current day business practice It needs to be updated as the definition etc continues to be same from 1992

CURRENT PRACTICE :

(A) DEFINITION : PARA 6 OF IAS 7 DEFINES ;

Cash **comprises cash on hand and demand deposits.**

Cash equivalents **are short-term, highly liquid investments that are readily**

convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

IAS 7 further says

Cash and cash equivalents

7 Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example in the case of preference shares acquired within a short period of their maturity and with a specified redemption date.

8 Bank borrowings are generally considered to be financing activities. However, where bank overdrafts which are repayable on demand form an integral part of an entity's cash management, bank overdrafts are included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn.

9 Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an entity rather than part of its operating, investing and financing activities. Cash management includes the investment of excess cash in cash equivalents

(B) CURRENT PRACTICE ;

1.As a part of Cash management the entities put their money in Fixed deposit with Banks. The banks give the right to the entities to withdraw these amounts at very short notice and sometimes across the counter . However a rider is put that it is subject to approval by the bank even though no approval is denied. However adjustment to actual interest paid is adjusted for the actual period it is run and based on the applicable rates for the period run. This results in refund of interest originally earned. The deposit is in tact and full amount is refunded.

2.Such deposits are not treated as demand deposits and hence not qualified as Cash

3.Such deposits are treated as Cash equivalent and treated as Investment of Cash management in terms of para 9 as stated above

4 Once it is treated as cash equivalent, then the question arises whether it is a cash equivalent or bank deposit on the date of the balance sheet . The definition of cash equivalent recognizes an item as Cash equivalent only if the investment is fro the period of 3 months or less from the date of original deposit . Other wise it only a bank deposit

5. Suppose a deposit is made on 1st Jan for 13 months and another deposit is made on 1st November for 2 months. Both are maturing on the same day namely 31st January of next year. On the balance sheet date namely 31st December, the first deposit is treated as a bank deposit not qualifying for Cash and cash equivalent while the second deposit will qualify as cash and cash equivalent which is not correct .

6. Hence to qualify for cash equivalent, it should be judged from the date of the balance Sheet and not from the date of the original investment

7. Further the definition of Cash to be amended to *Cash* **comprises cash on hand and free bank deposits from the narrow definition of** *Cash* **comprises cash on hand and demand deposits**

8 Bank Deposits are the mode of modern cash management and to take advantage of interest differential one selects a particular period but retaining in substance the right to withdraw at any time with no loss or insignificant loss

9. Similarly the explanation to of cash and cash equivalent in para 7 of IAS 7 reading : Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition., should be amended to read :an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of Balance Sheet

10. The cash Flow statement as per IAS 7 prepared between two balance Sheet date and measurement of Cash and Cash equivalent is more relevant from the balance sheet date rather than the date of investment as this forms part of cash management rather than investment

REASON FOR THE INTERPRETATION COMMITTEE TO ADDRESS THIS ISSUE

1. The issue assumes importance as how to classify a bank deposit on the date of the Balance Sheet. Classification of cash and Cash equivalent is from the date of the original investment and current and non current classification is from the date of the balance sheet. Hence in the example given above one deposit will get classified as Cash and Cash equivalent and other deposit as bank balance even though both are maturing on the same day .HENCE THIS PROBLEM IS WIDESPREAD AND PRACTICAL
2. Definition of cash to be amended to include free bank deposits as the word demand is narrow in interpretation . All Bank deposits are generally demand deposits but not all demand deposits are cash and deposits may be made with other entities also . Only on paper it will remain as demand deposits but generally not paid immediately. On the other hand all bank deposits except where lien is marked are demand deposits only. Hence the definition should be amended. HENCE THIS PROBLEM IS WIDESPREAD AND PRACTICAL
3. In the example given above two deposit maturing on the same day , one is treated as cash and cash equivalent and other is treated as bank deposits . HENCE THIS ISSUE INVOLVE SIGNIFICANTLY DIVERGENT INTERPRETATION AS PRACTICE AND RULES OF CNTRAL BANK DIFFER FROM COUNTRY TO COUNTRY For example In India, banks have a technical right of approval early with drawl where as in Australia a mall penalty is levied
4. The Financial reporting will definitely improved and Cash Flow will show the facts .
5. The issue involves change of definition or an interpretation can issued by IFRIC
6. The issue does involve cash Flow which is currently planned by IASB
7. KINDLY CONSIDER IN THE FORTH COMING INTERPRETATION COMMITTEE METTING.