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STAFF PAPER

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Project	Primary Financial Statements		
Paper topic	Definition of finance income/expenses		
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Purpose of this paper

1. This Agenda Paper seeks the Board's views on the staff's proposals to define finance income/expenses for the purposes of an EBIT (or profit before financing and income tax) subtotal for a straightforward non-financial entity. We will consider at a future meeting how our proposals could be applied or adapted to more complex scenarios.

Summary of staff recommendations in this paper

2. The staff recommend:

    (a) using 'cash and cash equivalents' as a proxy for cash and temporary investments of excess cash ('excess cash') in our definition of finance income/expenses.

    (b) that finance income/expenses consist of the following five line items:

        (i) interest income from cash and cash equivalents calculated using the effective interest method;

        (ii) other income from cash, cash equivalents and financing activities;

        (iii) expenses from financing activities;

        (iv) other finance income; and

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(v) other finance expenses.

(c) clarifying the current description of ‘financing activities’ in IAS 7 *Statement of Cash Flows* using the wording recommended to the IFRS Interpretations Committee by the staff in March 2013.

Overview

3. This paper is structured as follows:

   (a) background (paragraphs 4-10)

   (b) what decisions has the Board made about the EBIT subtotal so far? (paragraphs 11-13)

   (c) are we happy with the outcome of our discussions so far or should we consider other approaches? (paragraphs 14-36)

   (d) outstanding issues:

      (i) determining a reasonable and comparable proxy for ‘excess cash’ (paragraphs 37-41)

      (ii) clarification of the term ‘financing activities’ (paragraphs 42-51)

   (e) Appendix—Current IFRS requirements for financing activities

Background

Why are we exploring requiring an ‘EBIT’ (or profit before financing and income tax) subtotal?

4. We have received feedback that investors would like additional required subtotals in the statement(s) of financial performance, especially ones that provide relatively comparable measures of performance between entities.

5. Our objective in introducing an additional comparable subtotal in the statement(s) of financial performance is to provide a comparable measure of performance further up the statement(s) of financial performance than profit before tax. We think EBIT would be a useful subtotal for investors in the statement(s) of financial performance, in

addition to profit before tax, because it is commonly used in practice to facilitate comparisons between entities that have different capital structures and different tax situations. This characteristic of EBIT enables it to be used by investors in different types of analyses (see Appendix A of June 2017 Agenda Paper 21A for more detail on these analyses).

6. Capital structure is not defined in IFRS Standards. However, based on our research, an entity's capital structure is most commonly viewed by preparers and investors as:

   (a) an entity's equity and debt financing, with debt comprising some subset of the entity's liabilities (possibly including related assets such as derivative assets); together with

   (b) excess cash and temporary investments of excess cash (we will refer to both collectively as 'excess cash' in this paper). Excess cash that is not used in operations can be used to pay dividends, repay debt, buy back shares etc. Therefore, the way an entity manages excess cash is often considered to be interrelated with its decisions on debt and equity financing. For example, an entity might choose to invest cash temporarily rather than repay debt because of disadvantages in repaying debt at a particular time. Or a treasury function might gather the cash within a group and use it to offset borrowings through agreed bank facilities.

Why do we need to define finance income/expenses?

7. Many entities currently present EBIT or an EBIT-type operating profit calculated as profit before finance income/expenses and income tax. We have observed diversity in practice in which items companies classify as finance income/expenses. Therefore if we are to introduce an EBIT subtotal that is comparable across entities, we will need to define finance income/expenses.

How should we define finance income/expenses?

8. To help investors make comparisons between entities with different capital structures, it seems logical to define finance income/expenses as income/expenses related to capital structure. Nevertheless, the implication of doing this would be that interest on

any liabilities that are not part of an entity's capital structure would not be part of finance income/expenses.

9. As explained in paragraph 6, capital structure is generally considered to include debt and equity financing. The staff do not think that liabilities such as net defined benefit liabilities and decommissioning and other long-term provisions are typically considered debt financing. Therefore, unless we use a broad definition of capital structure that includes these liabilities, defining finance income/expenses as only including income/expenses related to capital structure would result in a significant change in practice in how we present the interest on these liabilities. For example:

   (a) unwinding of the discount on decommissioning liabilities is required to be included in finance costs (IFRIC 1.8); and

   (b) increases in the carrying amount of provisions that reflect the passage of time are recognised as 'borrowing cost' (IAS 37.60) —we think the intention is to prescribe presentation as a finance cost and this is how we see the requirement applied in practice.

   Furthermore, many users treat the interest on these liabilities as finance income/expenses—ie they treat such amounts as a financing element of deferred expenditure—and it is likely they may want to continue with this practice.

10. For the above reasons at previous meetings the staff proposed defining finance income/expenses to include both 'income/expenses related to capital structure' and 'interest on liabilities not part of capital structure'. However, the staff suggested presenting them as separate line items. Separate presentation would provide users with more information, including the flexibility to measure EBIT as including or excluding 'interest on liabilities not part of capital structure' (since they could add this line item to EBIT to give a pure capital structure view of EBIT).

What decisions has the Board made about the EBIT subtotal so far?

11. The Board has not yet taken a decision about whether to introduce an EBIT subtotal. However, the Board generally appears supportive of the staff proposals to:

   (a) require presentation of an EBIT subtotal in the statement(s) of financial performance;

(b) define EBIT as profit before finance income/expenses and income tax;

(c) describe finance income/expenses as including both income/expenses related to capital structure and interest on other liabilities;

(d) use a principles-based approach to defining finance income/expenses and capital structure rather than either:

  (i) allowing management's view of what constitutes capital structure and finance income/expenses, with no or little guidance or constraints in IFRS Standards; or

  (ii) the Board prescribing what capital structure and finance income/expenses should consist of.

In addition, ASAF, CMAC and GPF members were generally supportive of the Board developing principles-based guidance for the presentation of subtotals in the statement(s) of financial performance, rather than having prescriptive requirements.

12. Furthermore, in September 2017, the Board tentatively decided that, if it introduces both an investing category and an EBIT (or profit before financing and income tax) subtotal, finance income/expenses should consist of the following separate line items in the statement(s) of financial performance:

(a) income related to capital structure;

(b) expenses related to capital structure;

(c) interest income on a net defined benefit asset or a net asset that arises when a liability not part of an entity's capital structure qualifies for offset with an asset; and

(d) interest expenses on liabilities not part of an entity's capital structure.

13. If we use the description of finance income/expense in paragraph 12, the staff think there are a couple of outstanding issues for us to address before the Board can make a decision on requiring an EBIT subtotal:

(a) does the Board support the staff definition of capital structure to be used in the definition of finance income/expenses? At recent Board meetings the staff recommended defining capital structure as 'equity, assets and liabilities arising from financing activities (using the definition of financing

activities in paragraph 6 of IAS 7 as a starting point), and cash and cash equivalents'. Board members' main concern about this definition seems to be that 'cash and cash equivalents' might be too restrictive as a proxy for 'excess cash'.

(b) what additional guidance do we need to ensure our definitions of 'finance income/expenses' and 'capital structure' are applied consistently by companies? At the June 2017 Board meeting, the staff suggested clarifying what we mean by:

(i) 'financing activities', because the definition in IAS 7 is very broad ('activities that result in changes in the size and composition of the contributed equity and borrowings of the entity') and is subject to different interpretations by entities; and

(ii) 'income/expenses related to capital structure' in our definition of finance income/expenses (because we may not want to capture in finance income/expenses all income/expenses that are recognised in relation to some items of capital structure such as lease liabilities[1], for example variable lease expenses not included in the lease liability).

The Board did not specifically discuss the staff recommendations in (b)(i) and (ii) (see June 2017 Agenda Paper 21B for the staff proposals).

Question 1
Does the Board have any questions or concerns about our discussions so far?

[1] The staff think that lease liabilities are liabilities arising from financing activities (and hence part of capital structure) under our existing definition of 'financing activities' in IAS 7, This is because 'cash payments by a lessee for the reduction of the outstanding liability relating to a lease' are listed as a cash flow from financing activities in paragraph 17 of IAS 7.

Are we happy with the outcome of our discussions so far or should we consider other approaches?

What is the problem?

14. Our approach for introducing a comparable EBIT subtotal contains several steps:

    (a) to define EBIT we must define finance income/expenses (the 'I' in EBIT);

    (b) to define finance income/expenses we must define capital structure;

    (c) we are likely to need to develop additional guidance to ensure capital structure is determined consistently across companies as follows:

        (i) clarify what we mean by 'financing activities' or 'arising from financing activities';

        (ii) determine a reasonable and comparable proxy for 'excess cash'; and

        (iii) clarify what we mean by income/expenses <u>related to</u> capital structure.

15. Whilst the staff think our approach is conceptually right, we are concerned that the steps involved may be unnecessarily complex. Therefore, the staff think that before discussing the outstanding issues in paragraph 13, we should consider whether we can simplify our approach.

The need to also consider the interaction with IFRS 9 in our chosen approach

16. As a consequential amendment, IFRS 9 *Financial Instruments* amended paragraph 82(a) of IAS 1 to require entities to separately present interest revenue calculated using the effective interest method. We think the effect of this amendment on the line items in paragraph 12 is that we would need to have a separate line item in finance income/expenses for interest income on financial assets that form part of capital structure calculated using the effective interest method.

17. Therefore, the staff think that the line items in paragraph 12 should instead be presented as follows:

    (a) interest income on cash and cash equivalents calculated using the effective interest method;

(b) other income related to capital structure;[2]

(c) expenses related to capital structure;

(d) interest income on a net defined benefit asset or a net asset that arises when a liability not part of an entity's capital structure qualifies for offset with an asset; and

(e) interest expenses on liabilities not part of an entity's capital structure.

18. Furthermore, the staff observes that there is diversity in practice with regards to what amounts entities present as 'interest' on financial assets in the statement(s) of financial performance. We do not think that addressing the issue of 'what is interest?' should form part of the scope of this project because our proposals only consider how an entity presents the amounts it ultimately determines to be interest. Nevertheless, we think we should be careful how we use the word 'interest' as part of the project to ensure that our usage does not conflict with use of the term in IFRS 9. For this reason the staff think we may wish to refer to 'other finance income/expense' rather than 'interest income/expense' in paragraphs 17(d) and (e) and clarify that this covers the unwinding of the discount on liabilities not part of an entity's capital structure (and on a net defined benefit asset or a net asset that arises when a liability not part of an entity's capital structure qualifies for offset with an asset).

19. The approaches described below have been developed with the considerations above in mind.

Other approaches

20. When we initially discussed 'capital structure', the staff noted that the term was a working title for the purposes of our discussions. Some Board members queried why we are using a new term to define finance income/expenses, rather than a 'financing' notion (for example 'financing activities' is defined in IAS 7). Our reason for using a new term, at least initially, was so that we were not restricted by the existing requirements for 'financing activities' in IAS 7. Nevertheless we have ultimately

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[2] We do not think interest income calculated using the effective rate would arise on assets arising from financing activities (ie those assets that form part of capital structure other than 'excess cash'). We think such assets would be rare and might be restricted to derivative assets related to liabilities arising from financing activities.

proposed to describe capital structure in terms of financing activities, making the use of a new term potentially unnecessary. Consequently the staff think we should consider the following approaches to reduce complexity:

(a) Approach 1: Leave out the term 'capital structure' and focus on financing activities:

  (i) Alternative 1a Focus on assets/liabilities arising from financing activities

  (ii) Alternative 1b Focus on financing activities

(b) Approach 2: Consider another way to disaggregate finance income/expenses

Approach 1, Alternative 1a: Focus on assets/liabilities arising from financing activities

Description

21. Under Alternative 1a we would simply replace the term 'capital structure' with our proposed definition of capital structure 'equity, assets and liabilities arising from financing activities, and cash and cash equivalents'. Income/expenses on equity would not be included in the statement(s) of financial performance. Therefore, based on the five line items in paragraph 17, finance income/expenses would consist of:

(a) interest income from cash and cash equivalents calculated using the effective interest method;

(b) other income related to cash, cash equivalents and any assets arising from financing activities;

(c) expenses related to liabilities arising from financing activities;

(d) finance income on a net defined benefit asset or a net asset that arises when a liability arising from financing activities qualifies for offset (or alternatively we could just describe this as 'other finance income'); and

(e) finance expenses on liabilities not arising from financing activities (or alternatively 'other finance expenses').

22. The staff think that in most cases entities would not have finance income in paragraph 21(d), nor assets arising from financing activities. Therefore we think most entities would have the following presentation:

    (a) interest income from cash and cash equivalents calculated using the effective interest method;

    (b) other income from cash and cash equivalents;

    (c) expenses related to liabilities arising from financing activities; and

    (d) other finance expenses.

Advantages and disadvantages

23. The only advantage of Alternative 1a over the approach in paragraph 17 would be avoiding use of the new term ‘capital structure’. Nevertheless Alternative 1a would still require us to clarify what we mean by ‘financing activities’, ‘excess cash’ and ‘income/expenses related to assets/liabilities arising from financing activities’ as explained in paragraph 14(c)(i)-(iii).

Approach 1, Alternative 1b: Focus on financing activities

Description

24. Alternative 1b is similar to Alternative 1a and would likely have no effect on the amounts shown as the five line items in paragraph 21. However, instead of having a balance sheet focus (ie income/expenses relating to assets and liabilities arising from financing activities), we would directly consider what income/expenses arise from financing activities (ie income/expenses from financing activities).

25. The reason for considering Alternative 1b is we think focussing on ‘financing activities’ rather than ‘liabilities arising from financing activities’ may avoid the need to:

    (a) provide additional guidance on which expenses from those liabilities are finance income/expenses; and

    (b) use the ambiguous wording ‘income/expenses related to liabilities arising from financing activities’ in our description of finance income/expenses, because instead we can say all income/expenses on financing activities.

26. To illustrate, a trade payable negotiated on extended credit terms could be considered to be a liability that arises from both financing and operating activities. Furthermore, the transaction resulting in that trade payable gives rise to both income/expenses that are financing in nature and income/expenses that are 'operating' in nature. We think we would want to:

    (a) exclude expenses related to the cost of goods/services purchased from finance income/expenses (expenses from the entity's operating activities); and

    (b) include expenses related to the borrowing of money over an extended period in finance income/expenses (expenses from the entity's financing activities).

27. We think the expenses in paragraph 26(a) are clearly not expenses from financing activities, ie not expenses from 'activities that result in changes in the size and composition of the contributed equity and borrowings of the entity'. However we think the expenses in paragraph 26(b) clearly are expenses from financing activities.

28. Under Alternative 1b, based on the five line items in paragraph 17, finance income/expenses would consist of:

    (a) interest income from cash and cash equivalents calculated using the effective interest method;

    (b) other income from cash, cash equivalents and financing activities;

    (c) expenses from financing activities;

    (d) other finance income; and

    (e) other finance expenses.

Advantages and disadvantages

29. The advantage of Alternative 1b would be avoiding use of a new term 'capital structure'. It would also avoid the need to clarify what we mean by 'income/expenses <u>related to</u> assets and liabilities from financing activities' (paragraph 14(c)(iii)). This is because the staff think all income/expenses from financing activities would be finance income/expense.

30. Nevertheless Alternative 1b would still require us to clarify what we mean by 'financing activities' and 'excess cash' (paragraph 14(c)(i)-(ii)).

Approach 2 Consider another way to disaggregate finance income/expenses

Description

31. We could also consider other ways to disaggregate finance income/expenses. For example, one approach suggested by a Board member is finance income/expenses would consist of:

    (a) interest income from cash and cash equivalents calculated using the effective interest method;

    (b) other income from cash and cash equivalents;

    (c) interest expenses on liabilities arising from financing activities;

    (d) other finance income; and

    (e) other finance expenses.

32. Unlike Alternatives 1a and 1b under Approach 1, Approach 2 would change the allocation of finance income/expenses between the five line items in paragraph 17. For example, the line item in paragraph 31(c) would include only interest rather than all expenses from liabilities arising from financing activities. Therefore, foreign exchange and other gains or losses on these liabilities would be in the line item in paragraph 31(e), rather than paragraph 31(c).

Advantages and disadvantages

33. The advantage of Approach 2 is it would pull out the most significant finance expense 'interest expenses on liabilities arising from financing activities', which is a readily determinable amount, because it uses terminology that is well understood and can be applied consistently by entities. It would also consistently deal with presentation of interest on both financial assets and financial liabilities calculated using the effective interest method by presenting this amount separately from other income/expenses.

34. Nevertheless the disadvantages of this approach are:

    (a) 'other finance income' and 'other finance expenses' would consists of several different types of income/expenses, rather than just unwinding of

the discount on liabilities not part of an entity's capital structure (see paragraph 18). Consequently it would require more guidance to explain what is included and may be more difficult for investors to understand. To ensure that this approach does not change our overall definition of finance income/expenses in paragraph 17, we think that other finance income/expenses would include other expenses such as interest on liabilities not arising from financing activities, foreign exchange gains and losses on liabilities arising from financing activities, and fair value changes on liabilities arising from financing activities (we would not expect to require an interest element to be separated out of the change in fair value).

(b) we would also still be required to clarify what we mean by 'financing activities' and 'excess cash' (paragraph 14(c)(i)-(ii)).

Staff recommendation

35. The staff recommend Approach 1b because we think this is the most straight forward approach to apply and understand. Therefore, finance income/expenses would consist of the following separate line items in the statement(s) of financial performance:

(a) interest income from cash and cash equivalents calculated using the effective interest method;

(b) other income from cash, cash equivalents and financing activities;

(c) expenses from financing activities;

(d) other finance income; and

(e) other finance expenses.

Appendix A of Agenda Paper 21A provides an illustration of these five line items together with the 'income from investments' category. In most cases the staff think that entities will not have any income in paragraph 35(d) so these entities would not present this line item.

36. However, under this approach the staff think we would still need to do the following and these are discussed below.

(a) determine a reasonable and comparable proxy for 'excess cash' (see paragraphs 37-41); and

(b) clarify the term 'financing activities' in IAS 7 (see paragraphs 42-51).

Question 2
Does the Board agree with the staff recommendation for finance income/expenses to consist of the five separate line items in paragraph 35 in the statement(s) of financial performance?

Outstanding issues

Determining a reasonable and comparable proxy for 'excess cash'

What is the problem?

37. Regardless of our chosen approach for describing finance income/expenses, the Board will need to consider whether any income/expenses on 'excess cash' should be included in finance income/expense. Whilst income/expenses on excess cash will be negligible for many entities, this is not true for all entities.

Staff analysis

38. Identifying what is truly excess cash, ie identifying excess cash and temporary investments of excess cash that are held to service debt and equity financing, is likely to be very subjective and involve significant management judgement. This is because it would depend how management manages such excess cash.

39. Our objective of introducing an EBIT subtotal is to provide a subtotal that can be used to make comparisons between companies. Therefore, we think our priority should be to provide a transparent and consistent location for income on different types of investments. For this reason, the staff do not think we should allow significant management judgement in determining what constitutes excess cash because this would provide significant flexibility on where income/expenses on excess cash is presented (above or below EBIT), which would be inconsistent with our objective of

comparability. The staff think the following alternatives should be considered for a reasonable and comparable proxy for excess cash:

(a) a very wide view of 'excess cash' as all financial assets;

(b) a wide view of 'excess cash' as cash and liquid investments. Liquid investments are not defined in IFRS Standards but staff think they would be investments that are readily convertible to a known amount of cash. The staff view is deduced based on the explanation of short-term highly 'liquid' investments in paragraph 7 of IAS 7;

(c) a narrow view of 'excess cash' as cash and cash equivalents'. IAS 7 defines cash equivalents as 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. Cash equivalents are a subset of liquid investments because they are those that IAS 7 describes as held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. IAS 7 also states that 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. (see paragraphs 6-7 of IAS 7). Therefore, cash equivalents would exclude liquid investments that have a long maturity; or

(d) not including the notion of excess cash in our definition of finance income/expense.

Any income/expenses on financial assets that are not finance income/expenses would probably be included in the investing category (see Agenda Paper 21A).

40. However we define 'excess cash', we will not find a perfect solution for all entities. This is because entities hold and manage their cash differently between their operating and financing/investing activities. However, the staff think that 'cash and cash equivalents' may be the best proxy for excess cash because:

(a) it acknowledges that most preparers and users view cash and temporary investments as financing in nature.

(b) 'cash and cash equivalents' is defined in IAS 7, whereas 'liquid investments' is not. Whilst 'financial assets' is defined, the staff think that

many of these assets are not temporary investments that are held to service debt. Therefore, they may better be in an investing category, or part of operations.

(c) the staff do not think that using ‘cash and cash equivalents’ would involve significant judgement in application for most entities and the term ‘cash and cash equivalents’ under IAS 7 seems to be relatively consistently applied in practice.

(d) it would help to achieve alignment with IAS 7 because cash and cash equivalents are outside the investing category in the statement of cash flows.

41. If the Board does not support introducing an investing category, the staff think ‘cash and cash equivalents’ would still be an appropriate notion for excess cash in our definition of capital structure for the reasons in paragraph 40.

Question 3
The staff recommend using ‘cash and cash equivalents’ as a proxy for cash and temporary investments of excess cash (‘excess cash’) in our definition of finance income/expenses. Do you agree?

Clarification of the term ‘financing activities’

(This section is largely taken from paragraphs 6-21 of June 2017 Agenda Paper 21B. These paragraphs were not discussed directly by the Board at the June 2017 meeting.)

What is the problem?

42. The definition of financing activities in IAS 7 is broad (‘activities that result in changes in the size and composition of the contributed equity and borrowings of the entity’) and is subject to different interpretations by entities, primarily because the term ‘borrowings’ in the description is not defined (see the appendix for further explanation). Based on the list in paragraph 17 of IAS 7 (see paragraph A6 of the appendix) and the common definition of ‘borrow’[3], the staff think the following

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[33] “The action of taking and using (something belonging to someone else) under agreement to pay it back later” Oxford English Dictionary (10th ed).

liabilities are clearly 'borrowings' for straightforward non-financial entities and so arise from financing activities (because financing activities are defined in terms of changes in borrowings):

(a) debentures, loans, notes, bonds and mortgages;

(b) lease liabilities, because an entity is borrowing a resource, the leased asset; and

(c) trade payables negotiated on extended credit terms because the supplier is providing credit to the entity and the entity is borrowing money from the supplier.

43. However the application of this definition to other liabilities is less clear. In particular, it is unclear whether the following liabilities are borrowings/arise from financing activities:

(a) net defined benefit liabilities;

(b) decommissioning liabilities; and

(c) other long-term provisions, for example warranty provisions, contingent consideration for a business combination, etc.

Staff analysis

Staff proposals at previous meetings

44. In June 2017 the staff recommended clarifying the definition of 'financing activities' to ensure that it is interpreted more consistently by entities, to support our objective of a comparable EBIT subtotal.

45. At the June 2017 Board meeting the staff said that it had considered, but rejected three alternatives for clarifying the term financing activities (note these still focus on liabilities that arise from financing activities, rather than the nature of a financing activity):

(a) include a presumption that all liabilities arise from financing activities, unless specific criteria are met or the entity can justify otherwise.[4] Such a presumption would be quite a significant change to how financing activities is applied in the cash flow statement and would be a wide interpretation of 'borrowings'.

(b) link financing activities to financial instruments, ie only financial liabilities as defined by IAS 32 *Financial Instruments: Presentation* should be considered liabilities arising from financing activities. This would include trade payables and exclude non-financial liabilities such as provisions.

(c) prescribe that certain liabilities arise from financing activities where there is known diversity in practice, for example for net defined benefit liability. This would mean our approach is a combination of a principles-based approach with some prescribed requirements.

The staff rejected (a) and (b) because we do not think they are consistent with our current definition of financing activities in IAS 7. The staff rejected (c) because it was inconsistent with our decision to follow a principles-based approach.

46. We instead recommended using the wording discussed by the IFRS Interpretations Committee in March 2013, ie that the definition of financing activities in paragraph 6 of IAS 7 should be clarified by indicating that the **nature of a financing activity** involves[5]:

(a) the **receipt** or **use** of a resource from a provider of finance (or provision of credit);

(b) the expectation that the resource **will be returned** to the provider of finance; and

(c) the expectation that the provider of finance **will be appropriately compensated** through a payment of a finance charge. The finance charge is

[4] When we consider financial institutions it might be more appropriate to have the opposite presumption, ie presume that all liabilities relate to operating activities, unless the entity can justify otherwise.

[5] See Agenda Paper 7 paragraph 84 for the March 2013 IFRS Interpretations Committee meeting. Paragraphs 51-86 of that paper provided detailed analysis of the proposal.

both dependent on the amount of the credit and the duration (time of the credit).

This description of financing activities would include those purchase transactions that have been negotiated on extended credit terms.

47. The IFRS Interpretations Committee decided not to provide guidance on the meaning of ‘financing activities’ because it considered that such guidance would be too broad for the Committee to address. However, several committee members noted that they liked the staff proposal. Furthermore, the staff think this clarification is consistent with the examples in paragraph 17 of IAS 7, and the common definition of to ‘borrow’.

48. If we provide additional clarification of ‘financing activities’ this could affect the requirements for the statement of cash flows in IAS 7. However, such clarification would help to improve comparability between entities applying IAS 7. We will be discussing the elimination of some options for classification in the statement of cash flows at a future Board meeting. Clarifying what we mean by financing activities may help us to do this. Similarly providing guidance on financing activities could have implications for how entities interpret borrowing costs in accordance with IAS 23 *Borrowing Costs*. This is because the term financing activities is defined in terms of borrowings and borrowing costs are defined as interest and other costs that an entity incurs in connection with the borrowing of funds.

Application of the staff proposal

49. The staff do not think the activities giving rise to the liabilities in paragraph 43 meet the criteria in the staff proposal in paragraph 46 because:

    (a) for most of the liabilities it is unclear whether there is provider of finance, in particular because there is often no clear counterparty to the obligation. For example, for an obligation to restore a site the counterparty might be the general public (criterion 46(a)and(b)); and

    (b) even if a provider of finance could be identified (for example if it was considered to be the employees of a defined benefit plan), the provider of finance is not consciously lending funds and is not appropriately

compensated for lending funds through a payment of a finance charge (criterion 46(c)).

50. Furthermore, the staff think it would be difficult to define borrowings, and hence financing activities, in such a way that includes the liabilities in paragraph 43. This is because these liabilities do not arise from the taking and using of cash or other resources from a counterparty (the common definition of 'borrow'). The liabilities generally arise because the nature of the obligation is that the payment is not certain or the obligation can only be settled at a future, sometimes unknown, date. They have not arisen because a counterparty has consciously lent money to the entity or the entity has consciously borrowed money from a counterparty. One might argue that an entity could make a funding decision to borrow money to transfer, fund or settle these liabilities in most circumstances. For example, an entity might be able to transfer a defined benefit liability to an insurer or pay the government to take over a decommissioning liability. However, even if an entity is able to transfer the liability to a third party it would likely be at a significant extra cost and the entity may still retain a contingent liability in respect of the obligation.

51. Therefore, under the staff proposal in paragraph 46, income/expenses on the liabilities in paragraph 43 would not constitute income/expenses from financing activities. Nevertheless, as a result of the Board's tentative decision in paragraph 12 to provide a separate line item 'interest on liabilities not part of capital structure' (or 'other finance expenses' in the revised staff proposal in paragraph 35 that includes such interest) in finance income/expenses, interest expenses on these liabilities would still be included in finance income/expenses. We think this is the right outcome because our outreach indicated the preferred treatment of most users would be to treat the unwinding of the discount (or 'interest') on these liabilities as a finance cost. Furthermore, this is also the required treatment under IFRS Standards in most cases, apart from net interest on a net defined benefit liability where IAS 19 allows a choice.[6]

[6] IAS 19 *Employee Benefits* does not specify how an entity should present net interest on the net defined benefit liability (see IAS 19 paragraph 134). This accounting policy choice leads to diversity in practice.

Question 4

Does the Board agree with the staff recommendations to clarify the current description of financing activities in IAS 7 using the wording recommended to the IFRS Interpretation Committee by the staff in March 2013 in paragraph 46?

Appendix: Current IFRS requirements for financing activities[7]

A1. Paragraph 6 of IAS 7 defines *financing activities* as (emphasis added):

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

A2. A major shortcoming in the definition of 'financing activities' is that the term 'borrowings' is not defined.

A3. Paragraph 5 of IAS 23 *Borrowing Costs* describes the meaning of 'borrowing costs'. However, this definition is unclear because it provides a circular definition as follows (emphasis added):

> **Borrowing costs are** interest and other costs that an entity incurs **in connection with the borrowing of funds**.

A4. Paragraph BC26 of IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* notes that the IFRIC concluded that the unwinding of the discount on a decommissioning liability is not a borrowing cost for the purposes of IAS 23 because it does not reflect funds (ie cash) borrowed.

A5. Paragraph 60 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* states that the increase in a provision [in the scope of IAS 37] to reflect the passage in time is recognised as borrowing cost, but we think the intention is to prescribe the presentation of the cost as a 'finance cost', rather than a 'borrowing cost' in IAS 23.

A6. Paragraph 17 of IAS 7 provides the following examples of cash flows arising from financing activities:

(a) cash proceeds from issuing shares or other equity instruments;

(b) cash payments to owners to acquire or redeem the entity's shares;

(c) cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings;

(d) cash repayments of amounts borrowed; and

(e) cash payments by a lessee for the reduction of the outstanding liability relating to a lease.

[7] Taken from paragraphs 6-12 June 2017 Agenda Paper 21B.