IFRS

STAFF PAPER

March 2018

IFRS Interpretations Committee Meeting

Project	**IAS 7 *Statement of Cash Flows*–Classification of short-term loans and credit facilities**		
Paper topic	Initial consideration		
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Introduction

1. The IFRS Interpretation Committee (Committee) received a request to clarify when an entity includes particular short-term loans and credit facilities as a component of cash and cash equivalents in its statement of cash flows.

2. The objective of this paper is to:
   (a) provide the Committee with a summary of the matter;
   (b) present our research and analysis; and
   (c) ask the Committee whether it agrees with our recommendation not to add the matter to its standard-setting agenda.

Structure of the paper

3. This paper includes:
   (a) background information;
   (b) summary of outreach;
   (c) staff analysis; and
   (d) staff recommendation.

4. There are two appendices to this paper:

   (a) Appendix A—proposed tentative agenda decision; and

   (b) Appendix B—submission.

Background information

5. In the fact pattern described in the request:

   (a) an entity has short-term loans and credit facilities (short-term arrangements) that have a short contractual notice period (eg 14 days);

   (b) the short-term arrangements form an integral part of the entity's cash management; and

   (c) the balance in the short-term arrangements is almost always negative and does not often fluctuate from being negative to positive.

6. The request asks whether, applying paragraph 8 of IAS 7 *Statement of Cash Flows*, an entity includes the short-term arrangements as a component of cash and cash equivalents in the statement of cash flows. In particular, the request asks whether the last sentence of paragraph 8 of IAS 7 is a requirement that must be met to include a short-term arrangements as a component of cash and cash equivalents or an indicator to be considered.

7. Paragraph 8 of IAS 7 is included below for ease of reference:

> Bank borrowings are generally considered to be financing activities. However, in some countries, bank overdrafts which are repayable on demand form an integral part of an entity's cash management. In these circumstances, 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.

8. If included as a component of cash and cash equivalents, the entity would incorporate any changes in the short-term arrangements within the overall net increase or decrease in cash and cash equivalents for the period. If not included as a component of cash

and cash equivalents, the entity would consider the short-term arrangements to be financing activities.

Summary of outreach

9. We sent information requests to members of the International Forum of Accounting Standard-Setters, securities regulators and the large accounting firms.

10. In our request we asked whether, in their experience:

    (a) entities have material short-term borrowings or other credit facilities (including bank overdrafts) that are repayable on demand and are generally drawn (ie consistently show a negative balance); and

    (b) entities include any such balances as a component of cash and cash equivalents in the statement of cash flows.

11. We received 12 responses—six from the large accounting firms, five from national standard-setters and one from an organisation representing groups of regulators. The views received represent informal opinions and do not represent the official views of those respondents.

Findings

Prevalence

12. Most respondents said that it is relatively common for entities to have short-term borrowings or other credit facilities that are repayable on demand and are generally drawn. Two respondents said these arrangements are not widespread but are specific to particular jurisdictions. Some respondents said these arrangements could be material.

Accounting treatment observed

13. Many respondents said there is diversity in practice with some entities considering such short-term borrowings or credit facilities to be financing activities and others including these arrangements as a component of cash and cash equivalents.

14. Some respondents commented on the application of paragraph 8 of IAS 7. Four respondents specifically commented on whether the characteristic described in paragraph 8 of IAS 7—that a bank balance often fluctuates from being positive to overdrawn—is a requirement that must be met to include a banking arrangement as a component of cash and cash equivalents or an indicator to be considered. Two respondents said this characteristic is an indicator while the other two expressed mixed views. One of these respondents said that while, in their view, this characteristic was not a requirement, they considered it to be a particularly important indicator.

15. One respondent said that although the balances on short-term borrowings or credit facilities were drawn at the end of reporting periods, they were unable to ascertain whether the balances fluctuated from positive to negative within reporting periods.

16. Some respondents said that, in their view, the key principle in paragraph 8 of IAS 7 is whether a particular type of short-term borrowing or credit facility forms an integral part of an entity's cash management. Some respondents said, in their view, a consistent negative balance for such an arrangement provides evidence that it is not an integral part of an entity's cash management. For example, one respondent said that a consistently negative balance would indicate that the likely purpose of the arrangement is to finance the operations of the entity, rather than forming an integral part of the entity's cash management.

17. Some respondents commented on whether an entity applying paragraph 8 of IAS 7 could include only bank overdrafts as a component of cash and cash equivalents. One respondent said that a bank overdraft is just an example of bank borrowings and hence an entity can include other types of bank borrowings as a component of cash and cash equivalents. Two other respondents said only bank overdrafts repayable on demand could be included as a component of cash and cash equivalents.

Staff analysis

General presumption

18. In our view, paragraph 8 of IAS 7 sets out a general presumption that an entity includes bank borrowings as part of financing activities. This is consistent with

paragraph 17 of IAS 7, which lists cash proceeds from issuing short-term or long-term borrowings as examples of cash flows arising from financing activities.

19. However, paragraph 8 of IAS 7 identifies circumstances in which a bank borrowing is included in cash and cash equivalents. These are :

    (a) the entity has a bank overdraft;

    (b) the bank overdraft is repayable on demand; and

    (c) the bank overdraft forms an integral part of an entity's cash management.

    This paragraph then goes on to state that a characteristic of such a banking arrangement is that the balance often fluctuates from being positive to overdrawn.

20. IAS 7 does not further elaborate on the requirements of paragraph 8 or some of the key terms within this paragraph. The remainder of our analysis provides additional commentary on paragraph 8.

Bank overdraft

21. IAS 7 does not define bank overdraft. A bank overdraft commonly refers to a facility provided by a financial institution to allow customers to draw funds even if the account has no funds in it.

22. Paragraph 8 of IAS 7 specifically identifies bank overdrafts as a possible component of cash and cash equivalents. There is no discussion of other forms of bank borrowings and we think this wording—which refers to bank overdrafts and not bank borrowings more broadly—is intentional. Accordingly, in our view an entity cannot include other banking arrangements as components of cash and cash equivalents.

Repayable on demand

23. Paragraph 8 of IAS 7 also requires that the bank overdraft be 'repayable on demand'. In our view, this means that the entity is required to repay any negative balance in the bank overdraft as soon as the lender requests such repayment (ie 'on demand').

24. Accordingly, we think banking arrangements that have a short contractual notice period (eg 14 days) are not 'repayable on demand' for the purpose of applying paragraph 8 of IAS 7. In our view, IAS 7 does not specify what is meant by 'on demand' because the term is self-explanatory.

Integral part of cash management

25. Paragraph 8 of IAS 7 requires that the bank overdraft form an integral part of an entity's cash management. Assessing whether this overdraft forms an integral (ie an essential) part of an entity's cash management is a matter of facts and circumstances.

26. IAS 7 does not define cash management. Paragraph 7 of IAS 7 states that 'cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes'. Paragraph 9 of IAS 7 goes on to say that 'cash management includes the investment of excess cash in cash equivalents'. Accordingly, we think cash management entails the management of cash and cash equivalents for meeting short-term cash commitments rather than for longer-term investment or financing arrangements.

27. One example of a situation in which a bank overdraft may be an integral part of an entity's cash management is one in which an entity (a) has a bank account with an overdraft facility, and (b) uses that overdraft facility periodically to meet short-term cash flow needs.

Bank balance often fluctuates from being positive to overdrawn

28. The final sentence of paragraph 8 of IAS 7 states that a characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn.

29. In our view, the last sentence of paragraph 8 of IAS 7 describes an expected attribute of a bank overdraft that forms part of cash and cash equivalents. If the overdraft frequently fluctuates from positive to overdrawn then this characteristic is consistent with an assertion that the entity uses the overdraft as an integral part of its cash management. Conversely, if the balance is always, or almost always, negative then this would appear to indicate that the entity uses the overdraft for financing, arguably on a relatively consistent basis.

30. In our view, it would be unusual for an entity to have a banking arrangement that is always, or almost always negative and concurrently be able to support an assertion that it should include the balance of the arrangement as a component of cash and cash equivalents. Accordingly, we think that even if the wording of the last sentence is not

read as being a strict requirement, it is still a strong indicator that the arrangement does not form an integral part of the entity's cash management.

31. We think the wording also indicates that the banking arrangement would have, or be capable of having, either as a starting point or at some time over its life cycle, a positive bank balance. This is because the sentence states that the balance fluctuates 'from positive to overdrawn' (we note here that the request asks whether an item is required to fluctuate from negative to positive). In our view, this paragraph is not intended to capture banking arrangements such as loans or other borrowings, which, by their nature, always have a negative balance and would not fluctuate from negative to positive.

Applying the requirements to the short-term arrangements described in the submission

32. The short-term arrangements described in the request have a contractual notice period (eg 14 days). They are not bank overdrafts that are repayable on demand and as such, like other borrowings, would be considered to part of financing activities.

33. Even if the short-term arrangements were repayable on demand, the fact that the balance is almost always negative indicates that the short-term arrangements are a form of financing rather than an integral part of the entity's cash management.

Other considerations – relevant disclosure requirements

34. We think it is helpful to highlight relevant disclosure requirements in IAS 7 that an entity with the short-term arrangements described in the submission applies. In particular, paragraph 45 of IAS 7 states:

> An entity shall disclose the components of cash and cash equivalents and shall present a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in the statement of financial position.

35. Paragraph 46 of IAS 7 states:

> In view of the variety of cash management practices and banking arrangements around the world and in order to comply

with IAS 1 *Presentation of Financial Statements*, an entity discloses the policy which it adopts in determining the composition of cash and cash equivalents.

Conclusion

36. Based on our analysis, we think that:

(a) bank borrowings are generally considered to be financing activities. An entity includes a bank borrowing as a component of cash and cash equivalents only in the particular circumstances described in paragraph 8 of IAS 7—ie the banking arrangement is a bank overdraft that is (i) repayable on demand, and (ii) forms an integral part of an entity's cash management.

(b) cash management includes managing cash and cash equivalents for the purpose of meeting short-term commitments rather than for investment or other purposes. Assessing whether a banking arrangement is an integral part of an entity's cash management is a matter of facts and circumstances.

(c) banking arrangements that have a contractual notice period, even if that contractual notice period is short (eg 14 days), are not repayable on demand for the purpose of applying paragraph 8 of IAS 7.

(d) if the balance of a banking arrangement is always or almost always negative, then this is a strong indicator that the arrangement does not form an integral part of the entity's cash management. A consistently negative balance indicates that the arrangement is a form of financing.

Question 1 for the Committee
Does the Committee agree with our analysis of the requirements in IFRS Standards, summarised in paragraph 36 of this paper?

Should the Committee add this matter to its standard setting agenda?

Is it necessary to add to or change IFRS Standards to improve financial reporting?[1]

37. Based on our analysis, we think the requirements in IAS 7 provide an adequate basis for an entity to assess whether to include the short-term arrangements described in the submission as components of cash and cash equivalents in the statement of cash flows.

Staff recommendation

38. On the basis of our assessment of the Committee's agenda criteria in paragraphs 5.16–5.17 of the *Due Process Handbook* we recommend the Committee does not add this matter to its standard-setting agenda. Instead, we recommend publishing an agenda decision that explains how an entity applies the requirements in paragraph 8 of IAS 7. We also think it would be useful for the agenda decision to outline relevant disclosure requirements for entities with these types of short-term arrangements.

39. Appendix A to this paper outlines the proposed wording of the tentative agenda decision.

Questions 2 and 3 for the Committee

2. Does the Committee agree with the staff recommendation not to add this matter to its standard-setting agenda?
3. Does the Committee have any comments on the proposed wording of the tentative agenda decision outlined in Appendix A to this paper?

[1] Paragraph 5.16(b) of the *Due Process Handbook*.

Appendix A –– Proposed wording of the tentative agenda decision

IAS 7 *Statement of Cash Flows*—Classification of short-term loans and credit facilities

The Committee received a request asking about the types of borrowings an entity can include in its statement of cash flows as a component of cash and cash equivalents. In the fact pattern described in the request:

(a) the entity has short-term loans and credit facilities (short-term arrangements) that have a short contractual notice period (eg 14 days);

(b) the short-term arrangements form an integral part of the entity's cash management; and

(c) the balance of the short-term arrangements do not often fluctuate from being negative to positive.

The Committee observed that:

(a) applying paragraph 8 of IAS 7, an entity generally considers bank borrowings to be financing activities. An entity, however, includes a bank borrowing as a component of cash and cash equivalents only in the particular circumstances described in paragraph 8 of IAS 7—ie the banking arrangement is a bank overdraft that is (i) repayable on demand, and (ii) forms an integral part of the entity's cash management.

(b) cash management includes managing cash and cash equivalents for the purpose of meeting short-term cash commitments rather than for investment or other purposes. Assessing whether a banking arrangement is an integral part of an entity's cash management is a matter of facts and circumstances.

(c) if the balance of a banking arrangement is consistently negative and does not often fluctuate from positive to negative, then this is a strong indicator that the arrangement does not form an integral part of the entity's cash management and, instead, represents a form of financing.

In the fact pattern described in the request, the Committee concluded that an entity cannot include the short-term arrangements as components of cash and cash equivalents. This is because these short-term arrangements are not repayable on demand. Additionally, the fact that the balance is almost always negative indicates that the short-term arrangements are a form of financing rather than an integral part of the entity's cash management.

The Committee also noted that paragraphs 45 and 46 of IAS 7 require an entity to (a) disclose the components of cash and cash equivalents and present a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in its statement of financial position; and (b) disclose the policy which it adopts in determining the composition of cash and cash equivalents.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to assess whether to include in its statement of cash flows the short-term arrangements described in the request as components of cash and cash equivalents. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Appendix B –– Submission

We have reproduced the submission below. We have deleted details that would identify the submitter of this request.

Enquiry to the Interpretations Committee

[We] would like to submit an issue to IFRS IC regarding the classification of cash and cash equivalents in the cash flow statement.

…

Issue

… [We have] identified divergent application of requirements of IAS 7 regarding the classification of short-term loans and credit facilities as cash and cash equivalents in accordance with IAS 7 paragraph 8.

Specifically, we ask the IFRS IC to clarify whether short-term loans and credit facilities that have a very short notice and form an integral part of an entity’s cash management can be classified as cash and cash equivalents only when their balance often fluctuates from being negative to positive. We also question whether any such fluctuation shall be regarded only as an indicator that entities have to consider when classifying such items as cash or cash equivalents, or whether this would be a requirement.

Some entities may have, together with an overdraft facility with their banks, also other short- term loans and credit facilities that are always drawn and therefore show a negative balance. However, since payments from customers also reduce the negative balances, in theory these facilities could show also positive balances. Nevertheless, in some cases, they show negative balances over a period of several years.

In cases when it is contractually agreed with the banks that the facilities have a very short notice (e.g. 14 days), it is a widespread practice to classify a part of an entity’s short term debt as cash and cash equivalents in the statements of cash flows, even though the debt does not often fluctuate from being positive to overdrawn and the balance is often never positive.

These credit facilities come in many forms - some are without a redemption date, some have a redemption date within 3 months, and some take the form of a revolving credit facility. The entities applying this practice often present the amount for 'cash and cash equivalents' as a significant negative amount year after year.

Cash and cash equivalents are defined in paragraph 6 of IAS 7. Cash is defined as cash on hand and demand deposits. Cash equivalents are defined 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.

Paragraph 7 of IAS 7 states that an investment normally only qualifies as a cash equivalent when it has a short maturity of, for example, three months or less from the date of acquisition.

Paragraph 8 of IAS 7 states that when bank overdrafts are repayable on demand they may form an integral part of an entity's cash management. In these circumstances, bank overdrafts can be 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.

[In the submitter's jurisdiction] entities often classify a part of their short-term debt as cash and cash equivalents even though the short-term loans and credit facilities do not regularly fluctuate between being positive and negative.

The alternative to this would be to classify only positive cash balances and bank overdrafts (provided that they fluctuate between negative and positive balances) as cash and cash equivalents in the statement of cash flows.

Paragraph 8 of IAS 7 seems to point to the fact that it is a requirement that bank balances fluctuate between positive and negative balances in order to classify negative bank balances as cash and cash equivalents. However, some issuers consider this not to be a requirement but only an indication.

[We] seek clarification from the IFRS IC on which types of debt an entity can and should classify as cash and cash equivalents in the statement of cash flows. In particular, we would like to know whether, according to paragraph 8 of IAS 7, an entity can classify short-term loans and credit facilities as cash and cash equivalents when:

(i) bank facilities have a very short notice (e.g. 14 days); and

(ii) they form an integral part of an entity's cash management, even though they do not often fluctuate from being negative to positive.

Particularly, we seek elucidation from the IFRS IC as to whether fluctuation from negative to positive is a requirement for classification as cash and cash equivalents or just an indication.

…