STAFF PAPER

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IFRS® Interpretations Committee meeting

Project	**Demand Deposits with Restrictions on Use (IAS 7)**
Paper topic	Initial Consideration

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Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about whether an entity includes demand deposits with restrictions on use as a component of cash and cash equivalents.

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 a standard-setting project to the work plan.

Structure of the paper

3. The paper includes the following:
   (a) background information (paragraphs 5–7);
   (b) summary of outreach (paragraphs 8–18);
   (c) staff analysis (paragraphs 19–40); and
   (d) staff recommendation (paragraphs 41–42).

4. There are two appendices to this paper:

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

   (b) Appendix B—submission.

Background information

5. The submission describes a fact pattern in which:

   (a) an entity sells one of its businesses to a third party (the buyer). The sale agreement requires the entity to keep a specified amount of cash in a separate demand deposit to indemnify the buyer for potential warranty claims extending over several years.

   (b) the terms and conditions of the demand deposit do not prevent the entity from accessing amounts held in the demand deposit—if the entity were to request any amount from that demand deposit, it would immediately receive that amount. However, if the entity uses the cash held in the demand deposit for any purpose other than indemnifying the buyer, it would be in breach of its contractual obligation to the buyer.[1]

6. The submitter asks whether the entity includes the demand deposit as a component of cash and cash equivalents in its statements of cash flows and financial position.

7. Appendix B to this paper reproduces the submission, which provides further details about the alternative views identified by the submitter.

Summary of outreach

8. We sent information requests to members of the International Forum of Accounting Standard Setters, securities regulators and large accounting firms. The submission was also made available on our website.

9. The request asked those participating to provide information about whether:

   (a) fact patterns such as the one described in the submission are common and, if so (i) whether the amounts involved are typically material for entities,

[1] In this paper, we refer to deposits such as the one described in the submission simply as 'demand deposits with restrictions on use'.

and (ii) in which jurisdictions, industries and situations are fact patterns common.

(b) entities include demand deposits with restrictions on use as a component of cash and cash equivalents in their statements of cash flows and financial position.

10. We received 14 responses—seven from large accounting firms, five from national standard-setters and two from organisations representing a group of securities regulators. The views received represent informal opinions and do not reflect the official views of those respondents or their organisations.

Findings from outreach

Are fact patterns common and material?

11. Most respondents said fact patterns such as the one described in the submission are common; many of these respondents said fact patterns can involve material amounts.

12. Some respondents said fact patterns are common in several jurisdictions (for example, Australia, Canada, China, Germany and Malaysia) and industries (for example, automotive, banking, construction and extractive sectors). A few respondents said fact patterns are not specific to any particular jurisdiction, industry or transaction.

13. A few respondents provided examples of fact patterns similar to the one described in the submission—fact patterns in which restrictions on use arise from commitments to third parties, not from the terms and conditions of the demand deposit. These include:

(a) minimum cash balance requirements arising from loan covenants;

(b) minimum reserves held with central banks;

(c) margin accounts required in commodity contracts; and

(d) cash of subsidiaries subject to foreign exchange or capital transfer controls.

14. A few respondents said although they had observed similar fact patterns, the specific facts and circumstances vary across jurisdictions.

15. Some respondents also said they had observed fact patterns in which an entity is restricted in its ability to access amounts held in a deposit account by being unable to

withdraw amounts on demand—for example, deposits held in an escrow account. One respondent said such fact patterns are more common than the one described in the submission.

How do entities account for demand deposits with restrictions on use?

16. Many respondents said they either observed, or would expect there to be, diversity in the way entities report demand deposits with restrictions on use in their statements of cash flows and financial position. Other respondents said entities generally include such demand deposits as a component of cash and cash equivalents.

17. Some respondents said entities might report demand deposits differently depending on the nature or source of the restrictions. For example, if the restrictions arise from legal or regulatory requirements, entities might exclude the related amounts from cash and cash equivalents. However, if the restrictions arise from contractual agreements with third parties, entities might include the related amounts as a component of cash and cash equivalents and provide related disclosures.

18. A few respondents also provided views on the requirements in IAS 7 *Statement of Cash Flows* on cash (and restricted cash), and on the relevance of including or excluding demand deposits with restrictions on use as a component of cash and cash equivalents.

Staff analysis

19. We have separately analysed whether, in the fact pattern described in the submission, the entity would:

    (a) include the demand deposit with restrictions on use as a component of cash and cash equivalents in its statement of cash flows (see paragraphs 21–26); and

    (b) present such a deposit as cash and cash equivalents in its statement of financial position (see paragraphs 27–30).

20. We have also considered applicable disclosure requirements (see paragraphs 31–34).

Inclusion as cash and cash equivalents in the statement of cash flows

21. Paragraph 6 of IAS 7 defines 'cash' and 'cash equivalents' as follows:

> *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.

22. Paragraph 7 of IAS 7 provides further requirements in relation to cash equivalents:

> 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…

23. The requirements in paragraph 7 of IAS 7 apply only in determining whether an item—that does not meet the definition of 'cash'—qualifies as a 'cash equivalent'. IAS 7 defines cash (see paragraph 21 above) and includes no other requirements with respect to determining whether an item qualifies as cash. In particular, the Standard does not require that cash include only items that an entity holds for the purpose of meeting short-term cash commitments. For example, cash on hand meets the definition of cash, irrespective of the purpose for which an entity holds such an item.

24. Furthermore, requirements in both IAS 7 and IAS 1 *Presentation of Financial Statements* indicate that cash or a cash equivalent can be subject to restrictions on use:

   (a) paragraph 48 of IAS 7 requires an entity to disclose information about 'cash and cash equivalent balances held by the entity that are not available for use by the group'. Paragraph 49 of IAS 7 goes on to explain that:

   > There are various circumstances in which cash and cash equivalent balances held by an entity are not available for use by the group. Examples include cash and cash equivalent balances held by a subsidiary that operates in a country where exchange controls or other legal restrictions apply when the

balances are not available for general use by the parent or other subsidiaries.

(b) paragraph 66(d) of IAS 1 requires an entity to classify as a current asset 'cash or a cash equivalent (as defined in IAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period'.

25. Therefore, in our view, restrictions on the use of an item do not preclude the item from being cash and cash equivalents, as long as the restrictions do not change its nature in a way that it would no longer meet the definitions and requirements in IAS 7.

26. In the fact pattern described in the submission, the entity holds amounts in a demand deposit, which meets the definition of 'cash' in paragraph 6 of IAS 7. The entity has a contractual obligation to use the amounts held in that demand deposit only for the purpose of indemnifying the buyer for future potential warranty claims. That contractual obligation does not change the *nature* of the asset the entity holds: the asset is a demand deposit because there are no restrictions on the entity's ability to access—on demand—amounts held in the deposit account. The contractual obligation restricts only the *purpose* for which the entity can use that asset. In our view, therefore, the entity would include the demand deposit as a component of 'cash and cash equivalents' in its statement of cash flows.

Presentation in the statement of financial position

27. Paragraph 54 of IAS 1 requires an entity to include line items in its statement of financial position that present the amounts listed in that paragraph. Paragraph 54(i) requires the inclusion of a line item that presents the amount of 'cash and cash equivalents'.

28. Paragraph 55 of IAS 1 states:

> An entity shall present additional line items (*including by disaggregating the line items listed in paragraph 54*), headings and subtotals in the statement of financial position when such

> presentation is relevant to an understanding of the entity's financial position. (emphasis added)

29. In the fact pattern described in the submission, applying paragraphs 54(i) and 55 of IAS 1, the entity presents the demand deposit with restrictions on use as cash and cash equivalents in its statement of financial position, unless presenting it separately in an additional line item is relevant to an understanding of the entity's financial position.

30. Furthermore, applying paragraph 66(d) of IAS 1 (see paragraph 24(b) of this paper), the entity would classify the demand deposit with restrictions on use as a non-current asset to the extent that the demand deposit is restricted from being used to settle a liability for at least twelve months after the reporting period.

Disclosure

Composition of cash and cash equivalents

31. 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.

32. In the fact pattern described in the submission, the entity would therefore disclose the demand deposit with restrictions on use as a component of cash and cash equivalents, as well as provide a reconciliation if the amounts included as components of cash and cash equivalents in its statement of cash flows differ from the amounts presented as such in its statement of financial position (as discussed in paragraphs 27–30 of this paper).

Restrictions on use

33. Paragraph 48 of IAS 7 requires an entity to disclose, together with commentary by management, the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the group. Applying these requirements, an entity would disclose the amount of significant cash and cash equivalent balances with restrictions on use (that are unavailable for use by the group), as well as information about those restrictions.

34. Furthermore, paragraph 33 of IFRS 7 *Financial Instruments: Disclosures* requires an entity to disclose, among other information, the exposures to risk arising from financial instruments (which includes liquidity risk), how the exposures arise, and the entity's 'objectives, policies and processes for managing the risk…'.[2] More specifically, paragraph 39(c) of IFRS 7 requires an entity to disclose a description of how it manages liquidity risk inherent in its financial liabilities. An entity would therefore consider disclosing additional information about restrictions on use of cash if that information is necessary to enable users of its financial statements to evaluate the nature and extent of liquidity risk.

Why we disagree with View 2 in the submission

35. The submission sets out an alternative view (View 2) according to which, in the fact pattern described in the submission, the entity would exclude from cash and cash equivalents the demand deposit with restrictions on use. Those supporting View 2 consider a different fact pattern in which amounts are held in a time (or term) deposit, rather than in a demand deposit. In that situation, they say an entity would exclude the amounts from cash equivalents because paragraph 7 of IAS 7 states that 'cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investments or other purposes.'

36. Those supporting View 2 say that excluding time deposits from cash and cash equivalents when they are not held to meet short-term cash commitments is inconsistent with including demand deposits when they are similarly unavailable to meet short-term commitments. Accordingly, if an entity has committed to use the amounts in a demand deposit for a purpose other than to meet short-term cash commitments, in their view the entity excludes that demand deposit from cash and cash equivalents.

37. We disagree with View 2. As explained in paragraphs 21–26 of this paper, paragraph 7 of IAS 7 applies only in determining whether an entity classifies an item as a 'cash equivalent'; IAS 7 includes no requirements with respect to determining whether an item qualifies as cash, other than the definition of 'cash' in paragraph 6. A

[2] Appendix A of IFRS 7 defines liquidity risk as 'the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.'

demand deposit meets the definition of cash, irrespective of the purpose for which it is held.

Conclusion

38. Based on our analysis in paragraphs 19–37, we conclude that, in the fact pattern described in the submission, the entity includes the demand deposit with restrictions on use:

    (a) as a component of cash and cash equivalents in its statement of cash flows (paragraph 6 of IAS 7); and

    (b) as cash and cash equivalents in its statement of financial position, unless presenting it separately in an additional line item is relevant to an understanding of the entity's financial position (paragraphs 54(i) and 55 of IAS 1).

39. Applying paragraphs 45 and 48 of IAS 7, the entity discloses the components of cash and cash equivalents and—together with a commentary by management—the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the group. The entity would also consider whether to disclose additional information in the context of the requirements in IFRS 7 about liquidity risk arising from financial instruments and how an entity manages that risk.

Question 1 for the Committee
Does the Committee agree with our analysis in paragraphs 19–39 of this paper regarding the application of the requirements in IFRS Standards to the fact pattern described in the submission?

Should the Committee add a standard-setting project to the work plan?

Is it necessary to add or change requirements in IFRS Standards to improve financial reporting?

40. Based on our analysis, we conclude that the principles and requirements in IFRS Standards provide an adequate basis for an entity to determine whether to include

demand deposits with restrictions on use as a component of cash and cash equivalents in its statements of cash flow and financial position.

Staff recommendation

41. Based on our assessment of the work plan criteria in paragraph 5.16 of the *Due Process Handbook* (discussed in paragraph 40 above), we recommend that the Committee does not add a standard-setting project to the work plan. Instead, we recommend publishing a tentative agenda decision that outlines how IFRS Standards apply in the fact pattern described in the submission.

42. Appendix A to this paper sets out the proposed wording of the tentative agenda decision. In our view, the proposed tentative agenda decision (including the explanatory material contained within it) would not add or change requirements in IFRS Standards.[3]

Questions 2 and 3 for the Committee

2. Does the Committee agree with our recommendation not to add a standard-setting project to the work plan?
3. Does the Committee have any comments on the proposed wording of the tentative agenda decision in Appendix A to this paper?

[3] Paragraph 8.4 of the *Due Process Handbook* states: 'Agenda decisions (including any explanatory material contained within them) cannot add or change requirements in IFRS Standards. Instead, explanatory material explains how the applicable principles and requirements in IFRS Standards apply to the transaction or fact pattern described in the agenda decision.'

Appendix A—proposed wording of the tentative agenda decision

Demand Deposits with Restrictions on Use (IAS 7 *Statement of Cash Flows*)

The Committee received a request about whether an entity includes demand deposits with restrictions on use as a component of cash and cash equivalents in its statements of cash flows and financial position. In the fact pattern described in the request:

a. an entity has a contractual obligation to keep a specified amount of cash in a separate demand deposit and use that cash only for specified purposes.
b. the terms and conditions of the demand deposit do not prevent the entity from accessing the amounts held in it (that is, the entity would receive any amounts held in the deposit on demand). However, if the entity were to use the amounts in the demand deposit for purposes other than those specified, the entity would be in breach of its contractual obligation.

Cash and cash equivalents in the statement of cash flows

Paragraph 6 of IAS 7 defines 'cash' by stating that it 'comprises cash on hand and demand deposits.' IAS 7 includes no other requirements on whether an item qualifies as cash beyond the definition itself.

IAS 7 and IAS 1 *Presentation of Financial Statements* indicate that amounts included in cash and cash equivalents may be subject to restrictions. Namely:

a. paragraph 48 of IAS 7 requires an entity to disclose information about 'significant cash and cash equivalent balances held by the entity that are not available for use by the group'; and
b. paragraph 66(d) of IAS 1 requires an entity to classify as current an asset that is 'cash or a cash equivalent (as defined in IAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period'.

The Committee concluded that restrictions on use of a demand deposit do not result in the deposit no longer being cash, unless such restrictions change the nature of the deposit in a way that it would no longer meet the definition of cash in IAS 7.

In the fact pattern described in the request, the restrictions on use of the amounts held in the demand deposit do not change the nature of the deposit—the entity can access those amounts on demand. Therefore, in the fact pattern described in the request, the Committee concluded that the entity includes the demand deposit as a component of 'cash and cash equivalents' in its statement of cash flows.

Presentation in the statement of financial position

Paragraph 54(i) of IAS 1 requires an entity to include a line item in its statement of financial position that presents the amount of 'cash and cash equivalents'. Paragraph 55 of IAS 1 states 'an entity shall present additional line items (including by disaggregating the line items listed in paragraph 54) … in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position'.

The Committee therefore concluded that, in the fact pattern described in the request, the entity presents the demand deposit as cash and cash equivalents in its statement of financial position, unless presenting it separately in an additional line item is relevant to an understanding of the entity's financial position.

Disclosures

Paragraph 45 of IAS 7 states that 'an entity shall disclose the components of cash and cash equivalents…', and paragraph 48 of IAS 7 requires an entity to disclose, together with commentary by management, 'the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the group'. Applying those requirements, the entity discloses the demand deposit with restrictions on use as a component of cash and cash equivalents and the amount of significant cash and cash equivalent balances unavailable for use by the group, as well as information about that amount. The entity would also consider whether to disclose additional information in the context of the requirements in IFRS 7 *Financial Instruments: Disclosures* about liquidity risk arising from financial instruments and how an entity manages that risk.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to determine whether to include demand deposits with restrictions on use as a component of cash and cash equivalents in its statements of cash flows and financial position. Consequently, the Committee [decided] not to add a standard-setting project to the work plan.

Appendix B—submission

B1. We have reproduced the submission below, and in doing so deleted details that would identify the submitter of this request.

…

Suggested agenda item: Effect of a restriction on the use of cash held in a demand deposit on classification in the statement of financial position and the statement of cash flows

It has come to our attention that there are diverse views on whether amounts held in a demand deposit should be presented as cash in the statement of financial position and the statement of cash flows when the entity is prevented from using the amounts to meet short-term cash commitments. We are seeking clarification by the Committee of the issue detailed below.

Background

An entity may be required to keep a minimum balance of cash available to meet commitments to third parties. The requirement may arise from regulations, for example regulations applicable to financial institutions, or from a third-party commitment, for example as an escrow account to fund an acquisition or as a condition to a lending agreement.

This submission considers a situation where the entity is required as a condition of the sale of a business to keep a specified amount of cash on deposit to indemnify the purchaser for potential warranty claims extending over several years. The entity (seller) has deposited the specified amount in a separate demand deposit account. The terms of the demand deposit account itself do not impose conditions restricting its use (i.e. if the entity requested the amount from the bank, it would obtain the amount immediately).

Question: Should the amount be presented as cash and cash equivalents on the statement of financial position (IAS 1:54(i)) and on the statement of cash flows?

VIEW 1: Yes. The amount meets the definition of cash

In IFRS Standards, the definition of cash is provided in IAS 7:1 as "cash on hand and demand deposits". Neither IAS 7 nor any other IFRS Standard indicates that the purpose for which the amount is held affects its classification.

In the case presented above, the cash is held in a bank account the terms of which contain no contractual restriction (i.e. a demand deposit). The restriction only arises because of the entity's contractual commitment to the purchaser not to use that cash. If the entity did use the cash it would be in breach of its obligation to that third party (and would be potentially accounted for the effects of the breach under IAS 37). As the cash is available on demand and there is no contractual restriction with the bank, it meets the definition of cash in IAS 7:1 and consequently it meets the definition of cash and cash equivalents for the purposes of presentation in the statement of financial position and the statement of cash flows.

The only effect of restrictions on use of cash therefore is the need to disclose their existence in line with the requirements of IAS 7:48, which requires disclosure of any significant amount of cash and cash equivalents held that is not available for use by the group.

VIEW 2: No. The amount is neither cash nor cash equivalent.

IAS 7:7 is clear that "[c]ash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes."

Had the cash been placed in a non-demand deposit[4], for example a time deposit, that deposit would not have met the definition of cash equivalents because it is not held to meet short-term cash commitments. The fact the entity places it in a demand deposit should not change the conclusion.

Indeed, it would be inconsistent to exclude time deposits (with a maturity of less than 90 days) from cash equivalents if that time deposit is not intended to be used for meeting short-term commitments, but include on-demand deposits in cash when the on-demand deposits are similarly not available for short-term commitments.

Accordingly, if an entity has committed, through the contractual terms of the bank account or via contractual commitments to third parties that are not part of the bank account, that it will not use the amount held in the bank account for meeting short-term commitments then that balance cannot be presented as cash and cash equivalents.

Reasons for the Committee to address the issue

We believe that restrictions on use of cash are common and often involve material amounts. We are aware of divergent views on this matter in several different jurisdictions. The issue is not related to a Board project that is expected to be completed in the near future.

For these reasons, we believe that this issue is urgent and meets the criteria for acceptance into the Committee's agenda.

…

[4] Even if the time deposit was limited to a 24-hour notice, as it would not be on demand.