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Project	**IAS 7 *Statement of Cash Flows***
Paper topic	Definitions of operating, investing and financing activities

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Purpose of this paper

1. The purpose of this paper is to explore how the definitions of operating, investing and financing activities in paragraph 6 of IAS 7 *Statement of Cash Flows* can be made clearer so that greater consistency is achieved in the application of the primary principle identified by the IFRS Interpretations Committee (the Interpretations Committee) at the March 2012 meeting.

2. The Interpretations Committee identified the primary principle behind the classification of cash flows in paragraph 11 of IAS 7 to be that cash flows should be classified in accordance with the nature of the activity in a manner that is most appropriate to the business of the entity.

3. Our objective is not to perform a major revision or restructuring of IAS 7. Our findings in this paper are limited to analysing the definitions of operating, investing and financing activities in paragraph 6 and deciding whether and how these definitions can be improved.

4. We will report the Interpretations Committee's observations and conclusions to the IASB at a future meeting.

Structure of the paper

5. This paper:

   (a) provides background information on the issue;

   (b) analyses the issue in response to the Interpretations Committee's request to:

      (i) analyse the definitions of operating, investing and financing activities in IAS 7;

      (ii) provide a summary of the comments received on the IASB's 2011 agenda consultation and the views received through the outreach performed on the Financial Statement Presentation Project that relate to IAS 7. We have summarised these comments in **Appendix A** of this paper;

   (c) assesses the issue against the annual improvements criteria;

   (d) includes the staff recommendation to amend IAS 7 in a way that would make the definitions of operating, investing and financing activities clearer. These proposed amendments are shown in **Appendix B** of this agenda paper.

   (e) asks the Interpretations Committee to confirm whether they agree with the staff recommendation.

6. This agenda paper also asks the Interpretations Committee whether it would like to proceed with previous amendments proposed to IAS 7 (refer to **Appendix C** in this paper). These amendments are:

   (a) a proposal made by the staff (but not yet approved by the IASB) to amend paragraph 14 of IAS 7 to clarify that an operator that provides construction or upgrade services in a service concession arrangement should present all of the cash flows relating to this activity as operating cash flows (refer to Agenda Paper 11 of November 2011).

   (b) a proposal to amend paragraphs 16(a) and 33 and the addition of paragraphs 33A of IAS 7 regarding the classification of interest that is capitalised. This proposed amendment was included in the Exposure Draft (ED) on *Annual Improvements to IFRSs 2010 –2012 cycle* (ED/2012/1) published in May 2012.

Background information

7. At its March 2012 meeting (refer to *IFRIC Update* of March 2012), the Interpretations Committee observed that the primary principle behind the classification of cash flows in IAS 7 is that cash flows should be classified in accordance with the nature of the activity in a manner that is most appropriate to the business of the entity, in accordance with the definitions of *operating*, *investing* and *financing* activities in paragraph 6 of IAS 7.

8. At its July 2012 meeting (refer to *IFRIC Update* of July 2012), the Interpretations Committee discussed our analysis of some fact patterns to illustrate the application of the identified primary principle behind the classification of the cash flows, in an attempt to consider how to develop further guidance on the application of the primary principle (for this analysis, refer to the July 2012 Agenda Paper 3).

9. The objective of our analysis was to explore the nature of cash flows by analysing different fact patterns. As a result of our analysis, we identified some (mutually exclusive) elements that we stated could help management to decide the nature of cash flows and decide the most appropriate classification. The elements identified were:

   (a) the cause or reason for which the cash flow is received or paid;

   (b) the counterparty who receives or pays the cash flow;

   (c) whether cash flows result from transactions that enter into the determination of profit or loss;

   (d) the predominant source of cash flows; or

   (e) the occurrence (timing) of the cash flows.

10. Few of the Interpretations Committee members objected to the staff conclusions on the analysis of the fact patterns. This situation confirmed that the existing guidance in IAS 7 can lead to inconsistent interpretations of the application of the main principle for classifying cash flows.

11. At its July 2012 meeting, the Interpretations Committee directed the staff to consider how the definitions of operating, investing and financing cash flows in IAS 7 can be made clearer and thus lead to a more consistent application of the primary principle. In this analysis, the Interpretations Committee asked the staff to consider:

    (a) whether the identity of the counterparty, and the timing of the cash flows, is relevant to the classification of those cash flows;

    (b) the comments received on the IASB's 2011 agenda consultation that relate to IAS 7. We have summarised these comments in **Appendix A** of this paper; and

    (c) the views received through the outreach performed on the Financial Statement Presentation Project that relate to IAS 7. We have summarised these views in **Appendix A** of this paper.

12. This paper responds to that request by the Interpretations Committee at their July 2012 meeting.

Introduction

13. In our previous analysis we observed that the definitions of operating, investing and financing activities (paragraph 6) provide guidance on how to distinguish cash flows by activity. However, it was our view that these definitions are too broad and lead to inconsistencies in the classification of cash flows. Moreover, the classification of cash flows in IAS 7 is driven by lists of examples (included within each description by cash flow activity), which are not exhaustive.

14. With the aim of finding more robust definitions of operating, financing and investing activities, we provide an analysis of the issue as follows:

(a) In Section 1 of this agenda paper, we examine the current definitions of operating, investing and financing activities in IAS 7 and make proposals on whether and how such definitions can be improved.

(b) In Section 2 of this agenda paper, we test the improved definitions against the fact patterns that we had analysed at the July 2012 Interpretations Committee meeting.

15. The proposed amendments to IAS 7, which are based on our analysis in Sections 1 and 2 of this paper, are shown in **Appendix B** of this agenda paper.

Staff analysis

Section 1: Analysis of the current definitions

The operating, financing and investing distinction

16. IAS 7 does not clarify why the three-way distinction (operating–financing–investing cash flows) is made. However, paragraph 4 of IAS 7 states why information about cash flows is relevant (emphasis added):

> **A statement of cash flows**, when used in conjunction with the rest of the financial statements, **provides information that enables users to evaluate the changes in net assets of an entity, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities.** Cash flow information is useful in assessing the ability of the entity to generate cash and cash equivalents **and enables users to develop models to assess and compare the present value of the future cash flows of different entities**. It also enhances the comparability of the reporting of operating performance by different entities because it eliminates the effects of using different accounting treatments for the same transactions and events.

17. Paragraph OB12 of the *Conceptual Framework for Financial Reporting* specifies that general purpose financial reports provide information about an entity's

resources and the claims on those resources as well as on the changes in the entity's resources and claims (emphasis added):

> General purpose financial reports provide information about the financial position of a reporting entity, which is information about the **entity's economic resources and the claims against the reporting entity**. Financial reports also provide information about the effects of transactions and other events **that change a reporting entity's economic resources and claims**. Both types of information provide useful input for decisions about providing resources to an entity.

18. We observe that in accordance with paragraph 3 of IAS 7, cash flow information is useful for users because (emphasis added):

> Users of an entity's financial statements are interested in **how the entity generates cash and uses** cash and cash equivalents.

19. According to paragraph 84 of SFAS 95 *Statement of Cash Flows*[1] the split between cash flows into operating, investing and financing is useful for making decisions. This paragraph states that (emphasis added):

> **The Board decided that grouping cash flows provided by or used in operating, investing and financing activities enables significant relationships within and among the three kinds of activities to be evaluated**. It links cash flows that are often perceived to be related, such as cash proceeds from borrowing transactions and cash repayments of borrowings. Thus, **the statement reflects the cash flow effects of each of the <u>major activities</u> of the enterprise. Those relationships and trends in them provide information useful to investors and creditors**. Almost all of the respondents to the Exposure Draft agreed that cash flows should be classified as operating, investing, and financing.

[1] We are citing SFAS 95 because we understand (from one of our staff members) that IAS 7 was based on this standard. We were not able to find this rationale in in Topic 230 *Statement of Cash Flows* of the *FASB Accounting Standards Codification*®, so this is why we are citing SFAS 95.

20. Cash flows from operating, financing and investing activities are defined in paragraph 6 of IAS 7. We will discuss these definitions in the following paragraphs.

Operating activities

Current guidance in IAS 7

21. In IAS 7 the operating category is a residual category that includes all of the entity's transactions other than investing and financing transactions, as defined in paragraph 6 of IAS 7 (emphasis added):

> **Operating activities** are the **principal revenue-producing activities** of the entity **and other activities that are not investing or financing activities**.

22. We observe that in accordance with paragraph 4.29 of the *Conceptual Framework for Financial Reporting* (emphasis added):

> "revenue arises in the course of **ordinary activities** of an entity";

23. Paragraph 14 of IAS 7 also states that (emphasis added):

> **Cash flows from operating activities** are primarily derived from the principal **revenue-producing activities** of the entity. Therefore, they **generally result from the transactions and other events that enter into the determination of profit or loss**.

Shortcomings of the current definition and ways to address them

24. We have identified the following shortcomings in the definition of 'operating activities' which we analyse in the following paragraphs:

    (a) the cash-flow measure of operating activities is unclear;

    (b) operating activities as a residual category;

(c) some cash flows that are operating in nature are not classified as part of operating activities; and

(d) some cash flows that are financing in nature are allowed to be classified as operating activities.

The cash-flow measure of operating activities is unclear

25. We observe that if *operating activities* are defined in paragraph 6 as the "principal revenue-producing activities", then the objective of the operating section of the statement of cash flows should be to provide a cash-based measure of operating income.

26. However, paragraph 14 of IAS 7 states that operating activities result from transactions that enter into the determination of 'profit or loss' rather than from the transactions that enter into the determination of 'operating income'. This paragraph is reproduced below (emphasis added):

> Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, **they generally result from the transactions and other events that enter into the determination of profit or loss**.

27. We observe that other guidance in IAS 7 permits a closer alignment with profit or loss than with operating income. For instance:

(a) Interest paid can be classified as either an operating or a financing activity on the basis of the guidance in paragraphs 33–34 of IAS 7.

(b) Cash payments or cash refunds of income taxes are primarily identified as operating cash flows in accordance with paragraph 14(f), but they can also be identified with financing and investing activities.

28. Paragraph 33 of IAS 7 justifies the classification of interest paid and interest and dividends received as part of the operating section on the grounds that their

accrual-basis equivalents enter into the determination of profit or loss, as follows (emphasis added):

> Interest paid and interest and dividends received are usually classified as operating cash flows for a financial institution. However, there is no consensus on the classification of these cash flows for other entities. **Interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of profit or loss.** Alternatively, interest paid and interest and dividends received may be classified as financing cash flows and investing cash flows respectively, because they are costs of obtaining financial resources or returns on investments.

29. Our view is that IAS 7 should clarify whether the objective of the operating section of the SCF is to provide a cash-basis measurement of:

    (a) the entity’s profit or loss; or

    (b) the entity’s operating income.

30. We support, in principle, the ‘operating income’ view. We think that clarifying that cash flows from operating activities are a cash-basis measure of operating income could provide more consistency in the way in which cash flows are classified, because cash flows would be *primarily derived from the principal-revenue-producing activities of the entity.*

31. However, we note that ‘operating income’ is not a defined term in IFRSs and some of the guidance in IAS 7 implies that this alignment should be made to profit or loss.

32. In contrast, we think that clarifying that operating activities *“generally result from the transactions and other events that enter into the determination of profit or loss”* rather than representing *principal-revenue-producing activities of the entity,* could create confusion, because the nature of an operating activity is that it

represents a primary source of revenue. We also observe that *transactions and other events that enter into the determination of profit or loss* might include transactions that have an investing (eg interest received) or financing (eg finance costs) nature rather than an operating nature.

33. We also think that clarifying that cash flows from operating activities is the cash-basis equivalent of profit or loss would also be inconsistent with our goal of trying to narrow down the definition of operating activities, inasmuch as the alignment of receipts and payments with items that enter into the determination of profit or loss implies the inclusion of receipts and payments that are not in a strict sense ‘operating’ in nature as we have mentioned above.

34. Despite our reasoning above, we think that, on the basis of the current guidance in IAS 7, operating cash flows are the cash-basis equivalent of transactions that enter into the determination of ‘profit or loss’ but this is for the members of the Interpretations Committee to confirm.

35. Consequently, we need to seek guidance from the Interpretations Committee on this particular point; that is, whether operating cash flows should be viewed as the cash-basis equivalent of ‘profit or loss’ or of ‘operating income’.

36. We should note that the following matters should also be considered and addressed as part of this analysis:

(a) operating activities as a residual category;

(b) some cash flows that are operating in nature are classified as investing activities; and

(c) some cash flows that are financing or investing in nature are allowed to be classified as operating activities.

37. The issues above are analysed in the following paragraphs.

‘Operating activities’ as a residual category

38. One of the main shortcomings that we observe in the current definition of ‘operating activities is that it is a residual category. Consequently, this category might include activities that cannot be clearly distinguished as *investing activities, financing or operating activities* and that by default are considered *operating activities*.

39. We think that one way to address this limitation would be for the ‘operating activities’ section to cease being a residual category and include only the cash effects derived from the principal-revenue-producing activities of the entity (ie those that arise in the course of the ordinary activities of the entity). However, we also think that if the ‘operating activities’ section ceases being a residual category then the question arises of where to classify activities that do not fit into any of the classification definitions. As we have discussed above, we need to seek the guidance of the Interpretations Committee before we can propose such a change.

40. An alternative to the proposal for eliminating from the definition of *operating activities* those activities that are not, in a strict sense, ‘operating’ in nature, would be for the section on ‘operating activities’ in the statement of cash flows to segregate ‘other activities’ that do not represent principal-revenue-producing activities of the entity and that remain undefined. Consequently, the statement of cash flows would show the following sections: operating, investing, financing and ‘other’. An alternative to this presentation would be to show ‘other activities’ as a subsection of the ‘operating activities’ section.

41. In respect of this proposed segregation, we think that if the direct method is used to report cash flows from operating activities (as encouraged in paragraph 19 of IAS 7), an entity would report major classes of gross receipts and payments and would isolate in a subtotal those receipts and payments that are not ‘operating’ in nature (ie not derived from the principal-revenue-producing activities of the entity). This approach would make the alignment of ‘operating’ cash flows with income and expense items clearer.

42. Segregating 'other activities' from 'operating activities' when the indirect method is used to report cash flows from operating activities (as stated in paragraph 20 of IAS 7), could be more challenging. This is because operating cash flows are determined indirectly, by adjusting profit or loss for the effects of changes in related asset and liability accounts and non-cash items. We think that more disaggregation would be required of the adjustments made to derive operating cash flows so that they can be more easily related to items on the statement of financial position (SFP) (eg changes in significant components of working capital assets and liabilities, differences relating to various and others).

43. An alternative view would be to start an indirect reconciliation of cash flows at operating income (instead of at profit or loss) so that fewer non-cash items are required to be eliminated when determining operating cash flows[2]. Nevertheless, because 'operating income' has not been defined in IFRSs, using this subtotal as a starting point for an indirect reconciliation would be subjective.

44. Yet, even though the two approaches mentioned above (ie isolating other activities from operating activities when using the direct method or changing the starting point of the indirect reconciliation and promote more disaggregation) appear to be potential solutions to clarifying the nature of cash flows included as part of an entity's operating activities, we think that both approaches represent a change in practice on how cash flows are presented in the statement of cash flows that would be beyond the scope of the annual improvements project. Nevertheless, a change of this nature could be done as a narrow scope amendment to IAS 7.

[2] This has been one of the issues recently raised by users. See: http://frc.org.uk/Our-Work/Codes-Standards/Financial-Reporting-Lab/Published-public-reports.aspx)

Some cash flows that are operating in nature are classified as investing activities

45. IAS 7 does not clarify why some cash flows that are primarily derived from the principal revenue producing activities of the entity are considered ‘investing’ in nature.

46. Some argue that because as depreciation and amortisation charges are included in the determination of profit or loss (and operating profit) the cash outflows associated with the purchase of property, plant and equipment (PPE), intangibles and other long-term assets should be classified as operating cash flows, rather than investing cash flows. Similarly, the cash inflows on disposal of PPE and intangible assets should also be classified as operating, rather than investing, because the gain or loss on sale on disposals enters into the determination of profit or loss. Others disagree with this view and argue that the rationale behind segregating those activities in investing is because from a finance perspective operating activities involve the acquisition of short-term assets (which some view as a working capital operating decision), whereas some investing activities involve long-term asset acquisition decisions and this segregation provides analysts and investors with useful information[3].

47. We think that if information about investing activities has provided analysts and investors with useful information, then suggesting a change in the classification of long-term asset acquisitions (from being investing activities to being considered operating activities) would not be appropriate.

Some cash flows that are financing or investing in nature are allowed to be classified as operating activities

48. In IAS 7 there is no consensus on the classification of interest paid/received and dividends paid/received (for non-financial institutions). At present, in accordance with paragraph 31 of IAS 7, cash flows from interest and dividends should be

[3] We consulted *Perspectives on the Cash Flow Statement under FASB Statement No. 95*, CEASA, Columbia Business School, October 2006, page 36.

classified in a consistent manner from period to period as either part of operating, investing or financing activities. In addition, as stated in paragraphs 33–34:

(a) cash flows from interest paid and dividends paid may be classified as **either** operating or financing cash flows; and

(b) cash flows from interest received and dividends received may be classified as **either** operating or investing cash flows;

49. In our view cash flows from interest/dividends **paid** and interest/dividends **received** (from entities other than for financial institutions) do not represent cash flows from an entity's ordinary operations that contribute to the generation of revenue, even though they result from transactions that enter into the determination of profit or loss. We think that the following clarifications are needed in IAS 7:

(a) **interest paid and dividends paid** are **not** operating cash flows and should instead (other than for financial institutions) be classified as **financing** cash flows because they represent the cost of obtaining financial resources.

(b) **interest received and dividends received** are **not** operating cash flows and should instead (other than for financial institutions) be classified as **investing** cash flows because they represent returns on investments.

50. We consequently propose the following amendments to paragraphs 31 and 32–34 of IAS 7 (proposed text to be deleted has been ~~struck-through~~).

> 31 Cash flows from interest and dividends received and paid shall each be disclosed separately. ~~Each shall be classified in a consistent manner from period to period as either operating, investing or financing activities.~~
>
> 33 Interest paid and interest and dividends received are usually classified as operating cash flows for a financial institution. ~~However, there is no consensus on the classification of these cash flows for other entities. Interest~~

~~paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of profit or loss. Alternatively,~~ I~~i~~nterest paid is classified as a financing cash flow by entities that are not financial institutions because it is a cost of obtaining financial resources. ~~and~~ I~~i~~nterest and dividends received ~~may be~~ are classified as ~~financing cash flows and~~ investing cash flows ~~respectively,~~ because they are ~~costs of obtaining financial resources or~~ returns on investments.

34 Dividends paid ~~may be~~ are classified as a financing cash flow because they are a cost of obtaining financial resources. ~~Alternatively, dividends paid may be classified as a component of cash flows from operating activities in order to assist users to determine the ability of an entity to pay dividends out of operating cash flows.~~

51. In relation to this topic we should mention that the IASB has proposed a modification to paragraph 16(a) and 33 (and has proposed adding paragraph 33A) to clarify that the classification of payments of interest that is capitalised shall follow the same classification as the underlying asset into which those payments were capitalised. This proposal was included in the Exposure Draft on *Annual Improvements to IFRSs 2010 –2012 cycle* (ED/2012/1) published in May 2012.

52. The IASB has received comments on this proposal that we have analysed in Agenda Paper 12A of January 2013. Our conclusion in this paper is that the Interpretations Committee should **not** recommend the IASB that it should proceed with the proposed changes to IAS 7 regarding the classification of interest paid that is capitalised, until the Interpretations Committee finalises its discussions on the clarification of the underlying principle for classifying cash flows.[4] We will ask the Interpretations Committee at the end of this agenda paper whether it

[4] The Interpretations Committee tentatively decided that cash flows in IAS 7 should be classified in accordance with the nature of the activity to which they relate, following the definitions of operating, investing and financing activities in paragraph 6 of IAS 7. We have concluded in paragraphs above that interest paid and dividends paid should be classified as financing cash flows because they represent the cost of obtaining financial resources. In addition, in our view, interest received and dividends received should be classified as investing cash flows because they represent returns on investments.

wishes to go ahead with the amendments proposed in the ED (May 2012) regarding the classification of interest that is capitalised.

Summary of views on operating cash flows classification

53. In summary, we think that:

(a) on the basis of the current guidance in IAS 7, operating cash flows are the cash-basis equivalent of transactions that enter into the determination of 'profit or loss'. In line with this we think that the definition of operating activities in paragraph 6 should also state so, and we are asking the members of the Interpretations Committee for their views on this.

(b) the section on cash flows from 'operating activities' would be maintained as a residual. However, we recommend in the section on 'operating activities' in the statement of cash flows that there should be segregation of 'other activities' that do not represent principal-revenue-producing activities of the entity and that remain undefined. Consequently, the statement of cash flows could show 'other activities' as a subsection of the 'operating activities' section where other activities that remained undefined could be classified.

(c) cash flows from interest/dividends paid (paragraph 33) should not be classified as operating activities; instead (other than for financial institutions) they should be classified as financing activities; and

(d) cash flows from interest/dividends received (paragraph 33) should not be classified as operating activities; instead (other than for financial institutions) they should be classified as investing activities.

54. In addition, we think that because operating activities is the residual, the operating classification is dependent on the investing and financing classifications. Consequently we think that the definitions of investing and financing activities could be made more robust to overcome the fact that operating cash flows is

defined as a residual, because it would avoid the risk of having unidentified cash flows classified within the operating section.

55. We will analyse the definitions of financing and investing activities in subsequent sections of this paper and will offer alternatives for making these definitions more robust.

Financing activities

Current guidance

56. Paragraph 6 in 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**[5] **and borrowings** of the entity.

57. In addition, paragraph 17 of IAS 7 states that (emphasis added):

> The separate disclosure of cash flows arising from financing activities **is important because it is useful in predicting claims on future cash flows by providers of capital to the entity**.

Shortcoming of the current definition and ways to address it

58. A major shortcoming that we observe in the definition of 'financing activities' is that the term 'borrowings' in paragraph 6 of IAS 7 has not been defined.

59. We note that 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):

[5] In our view the term 'contributed equity' in the definition of 'financing activities' does not need further clarification. The term 'equity' is defined as an element of the financial statements in section 4.4 of the *Conceptual Framework for Financial Reporting* (Conceptual Framework) as "a residual interest in the assets of the entity after deducting all its liabilities". Paragraph 4.20 further explains that 'funds contributed by shareholders' (ie contributed equity) could be shown as a subclassification in the balance sheet.

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

60. Basically, to 'borrow'[6] means:

The action of taking and using (something belonging to someone else) under agreement to pay it back later.

61. On the basis of the examples of cash flows from financing activities in paragraph 17 of IAS 7, an entity could receive:

(a) cash proceeds from issuing shares or other equity instruments (paragraph 17(a));

(b) cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short-term or long-term borrowings (17(c)).

(c) a loan in cash from a provider of finance that will be repaid in accordance with paragraph 17(d); or

(d) a right to use an asset (ie a finance lease) for an agreed period of time that will also be repaid in accordance with paragraph 17(e).

Elements of a financing activity

62. From looking at the above definition we think that the **nature of a financing activity** could involve one or all of the following three elements:

(a) the **receipt** or **use** of a resource from a provider of finance (eg an entity **receives money** from the bank; or an entity receives cash in return for issuing equity instruments);

(b) the expectation that the resource **will be returned** to the provider of finance (eg a company **repays** the money borrowed);

(c) the expectation that the provider of finance **will be appropriately compensated** (eg the bank **charges interest** to the entity as compensation for lending the funds).

[6] *Oxford English Dictionary* (10th ed).

Elements 1 and 2: the receipt or use of a resource from a provider of finance and the expectation that the resource will be returned to the provider of finance

63. We observe that in accordance with paragraph 11 of IAS 32 *Financial Instruments: Presentation*, financial liability is (emphasis added):

> any liability that **is a contractual obligation to deliver cash** or another financial asset **to another entity**.

64. An extract of paragraph AG9 of IAS 32 provides an illustration in this respect (emphasis added):

> Under IAS 17 *Leases* **a finance lease is regarded as primarily an entitlement of the lessor to receive, and an obligation of the lessee to pay, a stream of payments that are substantially the same as blended payments of principal and interest under a loan agreement**.

65. In addition, paragraph AG 4 of IAS 32 provides some examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash, as follows:

> Common examples of financial assets representing a contractual right to receive cash in the future **and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are**:
>
> **(a) trade accounts receivable and payable;**
>
> **(b) notes receivable and payable;**
>
> **(c) loans receivable and payable; and**
>
> **(d) bonds receivable and payable.**
>
> **In each case, one party's contractual right to receive (or obligation to pay) cash is matched by the other**

party's corresponding obligation to pay (or right to receive)

66. We think that cash flows derived from financial liabilities meet the first and second elements that we have identified when defining financing activities, because financial liabilities represent the receipt or use of a resource from a provider of finance and the expectation that the resource will be returned to the provider of finance.

67. We observe, however, that stating in the definition of financing activities that cash flows associated with **all financial** liabilities represent cash flows from financing activities would not be appropriate because some cash flows associated with some financial liabilities are considered operating activities in accordance with IAS 7. Take for example the case of a cash payment to a supplier for goods and services to settle a trade accounts payable (considered a financial liability in accordance with letter (a) of paragraph AG4 of IAS 32); rather than a 'financing' activity it is considered an operating activity in accordance with paragraph 14(c) of IAS 7.

68. We think that a similar logic applies for some **financial** assets. For instance, a cash receipt from the repayment of loans made to other parties to settle a loan receivable (that is considered a financial asset in accordance with letter (c) of paragraph AG4 of IAS 32); rather than a 'financing' activity it is considered an investing activity in accordance with paragraph 16(f) of IAS 7.

69. We also observe that in accordance with IAS 32, cash flows derived from the acquisition or issue of the entity's own equity instrument meet the first element that we have identified in defining a financing activity (ie the receipt or use of a resource from a provider of finance) because they represent for the entity an obligation to deliver instruments to another party in exchange for an amount of cash or another financial asset, as described in paragraph AG13, which establishes that:

> Examples of equity instruments include non-puttable ordinary shares, some puttable instruments (see paragraphs 16A and 16B), some instruments that impose on the entity an obligation to deliver to another party a pro

> rata share of the net assets of the entity only on liquidation (see paragraphs 16C and 16D), some types of preference shares (see paragraphs AG25 and AG26), and warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable ordinary shares in the issuing entity in exchange for a fixed amount of cash or another financial asset. **An entity's obligation to issue or purchase a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument of the entity** (except as stated in paragraph 22A).

70. We observe, however, that the issue of ordinary shares gives shareholders a share on the entity's net assets but does not impose on an entity an obligation to return the cash received.

71. We think that even though the second element that we have identified (ie the expectation that the resource will be returned to the provider of finance) is not present in the issue of an entity's own equity instruments, we think that such transaction should be considered 'financing' by nature because such cash flows are providing finance to an entity. We think that the definition of financing activities should clearly state so.

Element 3: the expectation that the provider of finance will be appropriately compensated

72. We think that there is a third element that is present in some financing activities and this is the expectation that the provider of finance **will be appropriately compensated throughout the period that the financing is outstanding**. This means that in borrowing activities an entity will incur a finance cost for obtaining and using the resource received[7].

[7] Shareholders contributing equity to an entity would receive this 'third' element in the form of dividends, but as the receipt of dividends is discretionary to an entity, in our view this 'third' element would not be always present.

73. Some could argue that this third element, ‘that the provider of finance **will be appropriately compensated’** (eg by charging interest) is important for differentiating financing activities from operating activities.

74. For instance, take the case of a purchase of materials from a supplier. If an entity decides to buy the materials directly from the supplier, the entity will receive the goods and in return agrees to pay a certain amount at a future date[8]; the entity would classify this activity as an operating activity in accordance with paragraph 14(c) of IAS 7.

75. However, if in turn the supplier had not granted such credit the entity would have had to borrow the funds in order in order to pay for the goods on the date of delivery, and then repay the lender at a future date, **including the payment of compensation to the lender.** The borrowing of funds and the **payment of compensation** to **a lender** would have indicated that the purchase of materials represents a borrowing activity.

76. Others could have argued that the “compensation fee” might also have been wrapped up in the price charged by the supplier and not separately disclosed; in other words, the amount of consideration payable to the supplier would have also included a “time value of money” element but not separately disclosed. This element is explained in paragraph 58 of the Exposure Draft ED/2011/6 (a revision of ED/2010/6) *Revenue from Contracts with Customers*, issued in November 2011 which states that (emphasis added):

> 58 **In determining the transaction price, an entity shall adjust the promised amount of consideration to reflect the time value of money if the contract has a financing component that is significant to the contract.** The objective when adjusting the promised amount of consideration to reflect the time value of money is for an entity to recognise revenue at an amount that reflects what the cash selling price would have been if the customer had

[8] This is assuming this transaction is under normal credit terms (ie the entity has a moderate length of time to settle the transaction).

> paid cash for the promised goods or services at the point that they are transferred to the customer. **If the promised amount of consideration differs from the cash selling price of the promised goods or services, then the contract also has a financing component (ie interest either to or from the customer) that may be significant to the contract**.

77. In our view, if an entity decides to buy the materials directly from the supplier on normal credit terms, the transaction would be considered an operating activity. If an entity decides to buy the materials on extended credit terms, then we think that the whole amount of the payment (including the payment of interest to the supplier) should be disclosed as a financing activity.

78. If an entity borrows funds from a lender to settle the amount owed to the supplier, this transaction represents a financing activity.

Other considerations

Is the counterparty relevant to distinguish financing activities?

79. Paragraph 17 of IAS 7 mentions that (emphasis added) "cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of capital to the entity".

80. In this respect we observe that the definition of financing activities does not focus on the type of counterparty that provides capital to the entity as a basis for the classification of cash flows.

81. Even we think that identifying the capital provider in a financing activity is troublesome. For example, referring it as a "third-party creditor" is not clear because one could claim that a supplier of inventory is also included within this category.

82. One alternative could be that the definition of financing activities further indicates the type of provider who does not provide capital. For instance, we observe that

the following can be identified as operating activities in accordance with paragraph 14 of IAS 7:

(a) ‘transactions with suppliers for goods and services’ in paragraph 14 (c)

(b) ‘cash to and on behalf of employees’ in paragraph 14 (d); or

(c) ‘cash payments or refunds of income taxes’ to the government in paragraph 14 (f).

83. Nevertheless we think that the list of counterparties identified above that would be excluded from financing activities is not exhaustive and would only create confusion. Consequently, even though we reaffirm our position that the identification of the counterparty is informative in IAS 7 in classifying cash flows we do not think that it would be practical to indicate which are the providers of capital within the definition of financing activities.

Is the timing of cash flows relevant in distinguishing financing activities?

84. Under the current guidance in IAS 7 the nature of cash outflows to purchase some items (ie goods or services or long-term assets) appears to remain the same irrespective of whether the credit terms change. For instance, we observe that on the basis of paragraph 17(c) of IAS 7 a borrowing activity would always be classified as a ‘financing activity’ irrespective of its short- or long-term nature. This paragraph states that the following are examples of cash flows arising from financing activities:

> “cash proceeds from issuing debentures, loans, notes, bonds, mortgages **and other short-term or long-term borrowings**”.

85. We however, observe that an operating activity that involves a payment to a supplier for goods or services on extended credit terms (ie beyond normal credit terms) or deferred terms would also qualify for classification as a financing activity. This is because the supplier in this case might have built into the pricing of the goods or services provided, a finance charge (ie interest), that would have changed the nature of the activity from being ‘operating’ into being a ‘financing’

activity. Consequently, we think that the timing of cash flows is relevant in distinguishing financing activities

86. For example, the purchase of an item under normal or customary credit terms from a supplier would be considered an operating transaction. However, the nature of this transaction changes when the supplier extends the credit term for this purchase because a financing element appears in the transaction (ie the supplier implicitly or explicitly charges interest).

87. The question is, however, whether the nature of the whole transaction (ie principal and interest) ceases to be operating and becomes a financing transaction or whether only the financing element added to the transaction is a financing transaction. In our view, because the timing of the transaction has changed, the nature of the transaction has also changed from being operating into becoming a financing transaction.

88. Consequently, we think that another relevant element in defining financing is the notion of time for paying back a credit. Making a derivation from this, we think that the definition of financing activities should include a clarification that financing activities include those transactions that have been negotiated on extended credit terms.

Summary of views on financing cash flows classification

89. In line with our analysis above we think that the definition of financing activities in paragraph 6 of IAS 7 should indicate that the **nature of a financing activity** involves:

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

90. The definition of financing activities should also state that cash flows that provide finance to an entity that are derived from the issue of an entity's own equity instruments (as defined in IAS 32) are considered financing by nature.

91. In our view, financing activities also include those purchase transactions that have been negotiated on extended credit terms.

Investing activities

92. Paragraph 6 in IAS 7 defines investing activities as (emphasis added):

> ***Investing activities*** are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

93. In addition, reporting the amount of cash flows arising from investing activities is important according to paragraph 16 in IAS 7 because (emphasis added):

> The separate disclosure of cash flows arising from investing activities is important **because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows**.

94. We think that the purpose of providing information about investing activities is to describe how much an entity has invested in specific productive assets and/or in investments in debt or equity instruments (other than cash equivalents).

95. We observe that the definition of investing activities in IAS 7 is more prescriptive (than the definitions of financing and operating activities) about the cash flow activities that should be included in this section.

96. We particularly note that this definition includes the cash effects of long-term asset acquisitions or disposals.

97. As we have mentioned above, we think that part of the rationale behind segregating certain activities in the investing section is because, from a finance perspective, operating activities involve the acquisition of short-term assets, which

some view as a working capital operating decision, whereas some investing activities involve the acquisition of long-term assets, which some view as long-term investing decisions.

98. An alternative view would be, however, to remove the investing activities section from the statement of cash flows and classify a portion of these activities as part of an entity's operating activities (eg the cash flows derived from an entity's acquisitions or disposals of long-term assets) and another portion as part of an entity's financing activities (eg the cash flows derived from financial assets). Even though we observe that analysts and preparers have felt comfortable about removing and/or narrowing down the investing section according to the field tests results in the financial statement presentation project (refer to Appendix A in this agenda paper), we think that such a change would be beyond the scope of the annual improvements project.

99. We also note that the definition of investing activities includes "other investments not included in cash equivalents". We think that this description could be supplemented as follows (emphasis added):

> Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents **(such as the making and collecting of loans and acquiring and disposing of debt or equity instruments of other entities)**.

Classification of expenditures

100. We noted in our previous paper (refer to paragraphs 49–55 of the July 2012 Agenda Paper 3) that the indication in paragraph 16 that "only expenditures that result in a recognised asset in the SFP are eligible for classification as investing activities" leads to misunderstandings about the classification of cash flows. This is because some think that this classification supports the fact that cash flows should be classified consistently with the classification of the related or underlying item (ie the asset) in the SFP.

101. As a consequence, there have been some misinterpretations that expenditures that give rise to recognised assets are, by default, investing activities.

102. We think that an expenditure that gives rise to a recognised asset should be classified as an investing activity if the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows as stated in paragraph 16 of IAS 7.

103. One could argue, though, that some expenditures that do not give rise to a recognisable asset (eg expenses for research) could also be classified as investing activities, because these cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. We think that this is controversial because some others could say that if it does not give rise to an asset that can be recognised, then it would not lead to a resource that will generate future income and cash flows.

104. We think that in paragraph 16 the sentence "only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities" is unnecessary and it is leading to misunderstandings about the classification of cash flows, because it is giving precedence to Principle 2 as identified by the Interpretations Committee (ie "cash flows in IAS 7 should be classified consistently with the classification of the related or underlying item in the statement of financial position"). Our proposal is to eliminate that sentence from paragraph 16 of IAS 7 because in our view this clarification is not indispensable and is adding confusion to the classification of cash flows.

105. Based on the above, we are proposing the following amendments to paragraph 16 (deleted text is struck through).

> 16 The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. ~~**Only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities.**~~ Examples of cash flows arising from investing activities are:

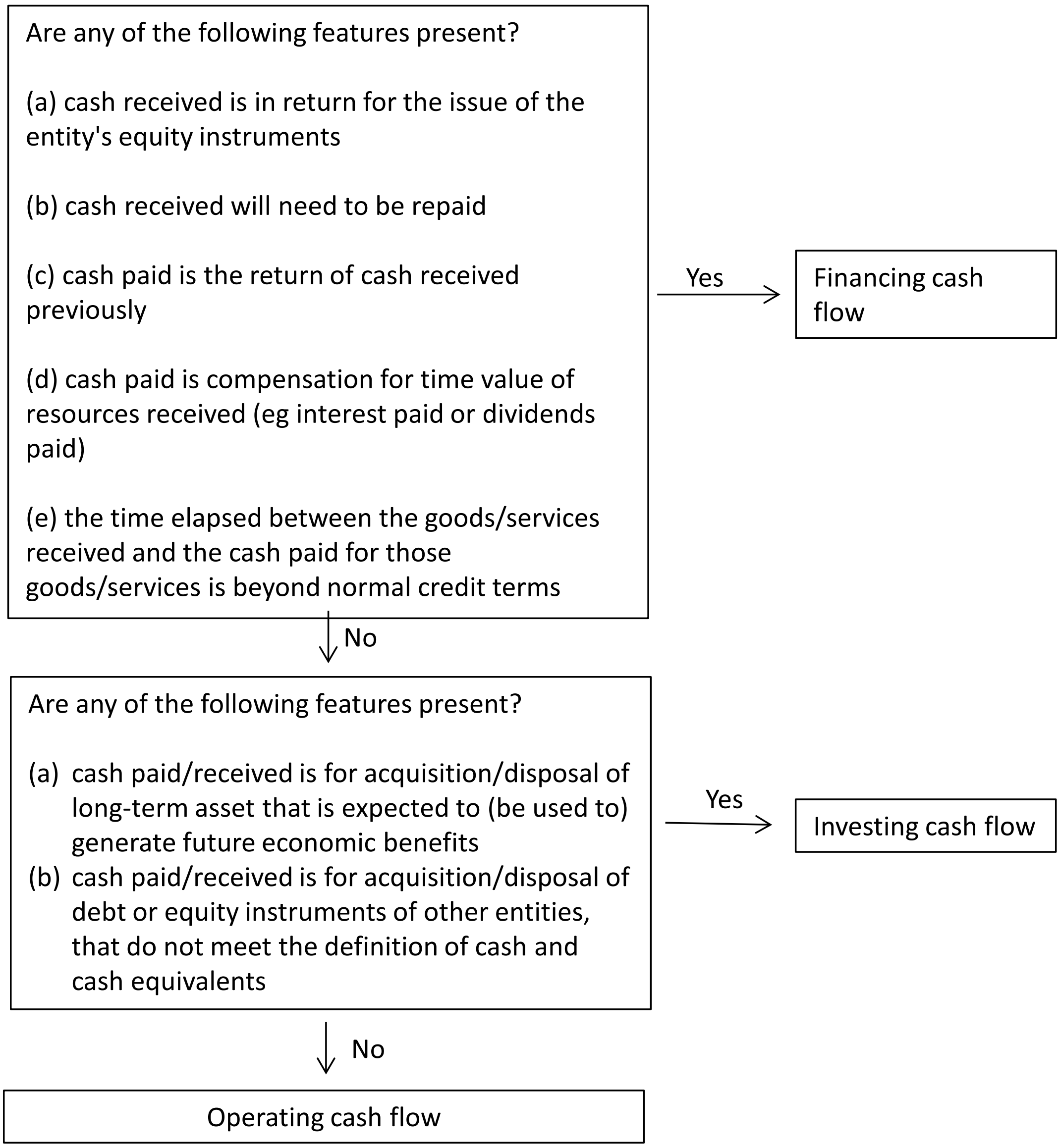
(a) cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalised development costs and self-constructed property, plant and equipment;

(b) – (h)

Summary of views on the classification of cash flows

106. The following flow chart summarises our views on the identification of operating, investing and financing activities on the basis of the proposed amended definitions in paragraph 6 of IAS 7.

Classification of cash flows



Section 2: testing the new definitions against the fact patterns we had analysed

107. The table below summarises the **new assessments** that we have made on the fact patterns that we presented at the July 2012 Interpretations Committee meeting (refer to the July 2012 Agenda Paper 3), based on our findings and conclusions in this agenda paper

108. When applicable we have indicated in the table whether our conclusion has changed with respect to the conclusions we reached for the classification of the cash flows at the July 2012 meeting.

Fact patterns analysed		Cash flows classification	Description of the nature of the transaction	Guidance in IAS 7
1	Cash contributions to a long-term employee benefit fund	Operating activities	Cash outflows are part of the compensation for employment services and would be classified like any other cash payment on behalf of the employees. These cash outflows are derived from the principal-revenue-producing activities of the entity.	Para. 14(d)
2	Cash received as compensation for an insured loss (for damaged PPE)	Investing activities	Cash inflows are received to cover for losses and damages of PPE. Insurance proceeds are not derived from the principal-revenue-producing activities. These proceeds are classified in a manner equivalent to those cash flows that would be received on disposal of PPE.	Para. 16(b)
3	Cash payment to purchase PP&E on deferred payment terms	~~Investing~~* Financing activities	Cash outflows are to acquire PP&E and made to a supplier. The supplier has offered extended long-term credit, which would be considered a borrowing activity.	Para. 6 and par 17(e)
4	Cash payments to meet a rehabilitation obligation	Operating activities	Cash outflows are for costs of rehabilitation, which are derived from the mine's normal operation activities. These activities are for the decommissioning or dismantling of an asset. They therefore do not meet the definition of an investing and/or financing activity.	Para. 14

Fact patterns analysed		Cash flows classification	Description of the nature of the transaction	Guidance in IAS 7
5	Cash received from a government grant	~~Financing~~* Operating activity	Cash inflows from a grant provide the entity with financing for the designated asset/activity. A grant does not represent a borrowing activity because there is no expectation that the resource will be returned to the provider of finance; or that the provider of finance will be appropriately compensated. Consequently, it relates to the operating activities of an entity.	Para. 6
6	Cash payments in a reverse factoring agreement	Financing activities	The bank has provided credit to the entity to allow the entity's liabilities to be settled on the due date. The repayment of that amount to the bank is a financing cash outflow.	Para. 17(d)

* The staff reflected this conclusion in the July 2012 Agenda Paper 3.

Annual Improvements criteria assessment

109. We assessed the potential amendment to IAS 7 to clarify the classification of cash flows. On the basis of the assessment, we recommend that the Interpretations Committee should recommend to the IASB that it should include the proposed amendment in Annual Improvements.

Annual improvements criteria	**Staff assessment of the proposed amendment**
(a) The proposed amendment has one or both of the following characteristics: (i) clarifying—the proposed amendment would improve IFRSs by: • clarifying unclear wording in existing IFRSs, or • providing guidance where an absence of guidance is causing concern. A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs. It does not propose a new principle, or a change to an existing principle. (ii) correcting—the proposed amendment would improve IFRSs by: • resolving a conflict between existing requirements of IFRSs and providing a straightforward rationale for which existing requirements should be applied, or • addressing an oversight or relatively minor unintended consequence of the existing requirements of IFRSs. A correcting amendment does not propose a new principle or a change to an existing principle, but may create an exception from an existing principle.	(a) Yes. The proposed amendments clarify the definitions of operating, investing and financing activities.
(b) The proposed amendment is well-defined and sufficiently narrow in scope such that the consequences of the proposed change have been considered.	(b) Yes. We believe that the proposed amendments are well defined and are sufficiently narrow in scope that the consequences of the proposed change have been considered. It contributes to consistent classification of cash flows.
(c) It is probable that the IASB will reach conclusion on the issue on a timely basis. Inability to reach conclusion on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within annual improvements.	(c) Yes. We think that the IASB will reach a conclusion on this issue on a timely basis, because it is a clarification of the application of IAS 7.
(d) If the proposed amendment would amend IFRSs that are the subject of a current or planned IASB project, there must be a need to make the amendment sooner than the project would.	(d) Yes, because there are no current projects on IAS 7.

Staff conclusion

110. On the basis of the assessment under the existing annual improvements criteria, we think that the Interpretations Committee should recommend to the IASB that the proposed changes to **paragraphs 6, 16, 31, 33 and 34** of IAS 7 and the addition of paragraph 11A and paragraph 13A should be included in a future annual improvements cycle.

111. We also think that a flow chart summarising our conclusions on the identification of the nature of a cash flows could be included as part of an implementation guidance section in IAS 7.

112. The proposed amendments to IAS 7 and the proposed implementation guidance are shown in **Appendix B** of this agenda paper.

113. We also propose to the Interpretations Committee that it should recommend to the IASB that it should halt the previous proposed amendments to IAS 7 until the Interpretations Committee finalises its discussions on the clarification of the underlying principle for classifying cash flows. These previous proposed changes to IAS 7 are shown in **Appendix C** of this paper and include:

    (a) the proposed amendment to paragraph 14 of IAS 7 to provide guidance regarding the classification of cash flows for an operator in a service concession arrangement; and

    (b) the proposed amendment to paragraphs 16(a) and 33 of IAS 7 as well as the addition of paragraph 33A to IAS 7 to clarify that the classification of payments of interest that is capitalised shall follow the same classification as the underlying asset into which those payments are capitalised.

Questions for the Interpretations Committee—classification of cash flows
1. Does the Interpretations Committee agree with the staff that the objective of the operating section of the statement of cash flows is to provide a measure of ‘transactions that enter into the determination of ‘profit or loss’? Does the Interpretations Committee agree that this aspect should be made clear within the definition of ‘operating activities’ in IAS 7? 2. Does the Interpretations Committee generally agree with the staff analysis? 3. Does the Interpretations Committee have any comments on the summary of the comments received on the IASB’s 2011 agenda consultation and the views received through the outreach performed on the Financial Statement Presentation Project that relate to IAS 7, as shown in **Appendix A**? 3. Does the Interpretations Committee have any comments on the proposed amendments to IAS 7 as shown in **Appendix B**? 4. Does the Interpretations Committee agree with our recommendation to recommend to the IASB that it should halt these previous proposed amendments to IAS 7 until the Interpretations Committee finalises its discussions on the clarification of the underlying principle for classifying cash flows?

Appendix A—Views received

Agenda consultation

A1. In 2010 the Trustees of the IFRS Foundation introduced a three-yearly agenda consultation in response to comments received during the Constitution Review of the IFRS Foundation. In July 2011 the IASB undertook its first agenda consultation project by publishing [Agenda Consultation 2011 (request for views)] to gather views from respondents interested in financial reporting on the strategic direction of the work plan as well as on the priority of individual projects or agenda areas on the next three years. Comments were to be received by November 2011.

A2. In January 2012 the staff presented a summary of the comment letters received. In this analysis we observe that neither IAS 7 nor a project specifically related to the statement of cash flows (SCF) is cited as one that should be included in the IASB's agenda. Respondents referred instead in more general terms to a project on Financial Statement Presentation (FSP) (excluding consideration of other comprehensive income).

A3. Respondents did not support modifications to the overall primary financial statements and thought that FSP should be considered a low-priority project that should not be addressed until there is a stable platform for financial reporting. Three respondents[9] expressed their concern about the IASB's past proposal (as part of the FSP project) to introduce the requirement to present the SCF using the direct method

A4. A small number of respondents[10], however, were in favour of narrow-scope improvements to financial statement presentation. In regard to the SCF, those respondents mentioned the following as some of the aspects that could provide clarity in the analysis of cash flows:

[9] Accounting Standards Board of Japan (ASBJ); Japan Business Federation (Nippon Keidanren); and The Life Insurance Association of Japan (LIAJ).

[10] SwissHoldings; Corporate Reporting Users Forum (CRUF)—UK; and CFA society of the UK.

(a) a reconciliation of net debt[11];

(b) a maturity schedule;

(c) a reconciliation between operating profit and operating cash flows;

(d) aligning the key lines of the primary statements;

(e) starting the cash flow statement at an operating line;

(f) more detailed descriptions of the adjustments made to derive operating cash flow so that they can be more easily related to items on the balance sheet (eg changes in significant components of working capital assets and liabilities, differences relating to various provisions such as pensions, asset retirement obligations, derivatives, etc);

(g) the capital expenditures line being split into maintenance, growth and acquisition spend;

(h) greater clarity about non-cash transactions and how they affect the cash flow statement (eg new finance leases, non-cash contributions to pension trusts, non-cash consideration in a business combination); and

(i) refocus on the reporting of operating performance and on cash flows

A5. One respondent[12] favours the review of the strengths and weaknesses of the existing IAS 1 *Presentation of Financial Statements* and IAS 7 to decide whether a narrow, targeted improvement to these Standards is required.

Outreach during the Financial Statement Presentation project

A6. In October 2008 the IASB and the FASB published the Discussion Paper *Preliminary Views on Financial Statement Presentation*. The comment period ended on 14 April 2009. During the Discussion Paper's six-month comment

[11] 'Net debt' refers to the items an entity manages as debt and the resources management views as available to service those debts. For more information on net debt, refer to the IASB's September 2009 Agenda Paper 14C.

[12] KPMG—UK

period, the staff undertook a field test of the presentation model proposed in the Discussion Paper.

A7. The field test had a number of goals, including:

(a) determining whether the proposed presentation model improves the usefulness of the information in an entity's financial statements to users of those financial statements; and

(b) understanding the costs of implementing the proposed presentation model.

A8. The following participants took part in the field test

(a) 31 entities took part in the preparer portion of the field test. They were asked to recast financial statements using the principles and guidance in the Discussion Paper without making any information systems changes to accommodate the field test; and

(b) 43 individual analysts with a variety of backgrounds took part in the analyst portion of the field test. They reviewed a set of recast and non-recast financial statements—either a set compiled from the financial statements provided by preparer participants or a set used to illustrate the proposals in the Discussion Paper.

Separating business activities from financing activities

Comments from respondents to the Discussion Paper

A9. The majority of respondents believed that the separation of business activities from financing activities does provide useful information, particularly in the statement of comprehensive income (SCI), where users find it helpful to distinguish between the operating activities of an entity and all other activities in which an entity may engage.

A10. Some respondents were concerned that separating business activities from financing would negatively affect the usefulness of the statement of financial position (SFP). Those respondents were most concerned about the lack of total assets and total liabilities subtotals and the possibility that similar or identical assets and liabilities would be presented in different sections (or categories) of the SFP. Consequently, those respondents think that distinguishing between business activities and financing activities on the SFP would add to the complexity of that statement without making the information contained in the SFP more useful.

A11. Many respondents indicated that the distinction between business and financing activities lacked relevance for a financial services entity, because most business activities for that type of entity are financial in nature. Consequently, the proposed presentation model would lead to an arbitrary allocation of activities between the business and financing sections for a financial services entity, and would lead to reduced comparability in the presentation of financial results of otherwise similar entities.

A12. Several respondents were concerned that the proposed presentation model uses the SFP as the starting point for classification decisions (ie the separation of business activities from financing activities begins with consideration of how the assets and liabilities are used in the business). Those respondents thought that classification decisions should begin with the SCI to provide useful information.

Summary of participant (both analyst and preparer) views from the field test

A13. The survey results of the analyst participants in the field test indicated that the majority of analyst participants (nearly 90 per cent) make a distinction between the operating and financing activities of the entities that they evaluate. Almost 70 per cent of the analyst participants viewed the separation of business activities from financing activities as one of the more useful proposals in the Discussion Paper. Approximately 63 per cent thought that the recast statements they reviewed clearly communicated the results of the entity's financing activities. However, only half of the analyst participants thought that the recast statements did a better job than the non-recast statements in presenting the entity's financing activities.

A14. The survey results of the preparer participants in the field test indicated that the majority of preparers believed that the recast statements communicate their entity's financial results with either the same level of information, or less, than the non-recast financial statements. Specifically, while 65 per cent of preparer participants thought that the recast statements clearly identified the core operations (ie business activities) of their entity, only 46 per cent of those preparers thought that the recast statements did a better job than the non-recast statements in communicating that information.

A15. While 50 per cent of the preparer participants thought that the recast statements clearly identified their financing activities; only 25 per cent of those preparers thought that the proposed model did a better job than the non-recast statements at communicating the results of their financing activities

Defining the financing section

Comments from respondents to the Discussion Paper

A16. The majority of respondents thought that the financing section should not be limited to financial assets and financial liabilities as defined in IFRS and US GAAP. Those respondents indicated that some non-financial assets and non-financial liabilities could be viewed as part of an entity's financing activities (eg pension liabilities and asset retirement obligations). Consequently, those non-financial assets and non-financial liabilities should not be prohibited from being presented in the financing section.

A17. Some respondents requested that the financing section should be explicitly tied to a measure called 'net debt'. Those respondents would prefer that the financing section of the SFP should contain all the elements that make up net debt. For those not familiar with the concept, 'net debt' referred to the items that an entity manages as debt and the resources that management views as being available to service those debts.

A18. Other respondents thought that the financing section should be limited to third-party providers of funding that have no other relationships with the entity. That approach to classification includes liabilities (and any associated derivatives) in the financing section, but excludes from that section any assets or liabilities that represent transactions with customers, employees, vendors, lessors and other related parties.

Summary of participant (both analyst and preparer) views from the field test

A19. The survey results of the analyst participants in the field test indicated that there is no consensus as to which liabilities those analysts considered to be appropriately classified in the financing section, except for the following:

(a) Over 90 per cent considered capital leases to be appropriately classified in the financing section; additional comments indicate that the majority of analyst participants would classify all leases as financing.

(b) Only 2 per cent considered trade payables and other short-term operating liabilities to be appropriately classified in the financing section.

(c) Just over half of the analyst participants (58 per cent) considered unfunded post-employment benefits and other non-financial obligations (ie asset retirement obligations) to be appropriately classified in the financing section.

A20. Analyst participants thought the following items should have been classified in the financing section:

(a) operating leases and any lease-related items;

(b) pension liabilities;

(c) proceeds from the reissue of treasury stock;

(d) loss on sale of receivables; and

(e) interest expense related to derivative movements in the SCI.

A21. Additionally, several analyst participants indicated that some cash should be classified as an operating asset.

A22. A number of analyst participants commented on what they perceived as inconsistent treatment in the presentation of debt-related transactions and transactions involving cash, short-term investments, and investments in marketable securities. Their view was that those accounts should be presented in the same category or section.

A23. For debt, the point was argued both directly and indirectly. For example, one respondent stated that all interest-bearing debt should be classified in financing, not split between operating, investing, and financing. That respondent argues that the substance of the transaction is that the entity borrowed an asset (or cash), for which it would pay a usage fee (interest). The form of the transaction should not affect the classification (hence, all leases should be in financing.)

A24. In addition, respondents noted that the interest associated with the debt should be readily identifiable. They believed that the classification of interest-bearing debt as financing, and transparency of the related interest expense, assisted in determining the capital employed. Other arguments stated that it was difficult to separate debt used to acquire fixed or intangible assets from debt used for operating (working) capital items such as the purchase of inventory.

A25. Consequently, classifying only specifically identifiable debt in operating (eg a specific loan for operating PP&E) and not classifying general debt in operating, even though operating assets were obtained with that debt, could be arbitrary and adversely affect comparisons between companies.

A26. A similar issue was raised regarding marketable securities. Some respondents appeared to view the accounts for cash, short-term investments, and marketable securities as all being a means of 'storing excess value' (cash) that is not currently required in the day-to-day operations of the business. There was a concern that all transactions for storing cash should be classified in the same section or category and should not be subject to interpretation by management.

A27. The survey results of the preparer participants in the field test indicated that they do not think the financing section is appropriately defined. The preparer participant responses for the financing section were split between 'too strictly defined' and 'too loosely defined'.

Defining the business section

Comments from respondents to the Discussion Paper

A28. Respondents held mixed views as to whether the operating and investing categories are defined so that their meanings are both understandable and operational. In particular, the majority of respondents requested another label for the 'investing' category. Those respondents noted that the term 'investing' has a variety of meanings and is currently used in the SCF in a way that differs from its use in the Discussion Paper.

A29. Many respondents did not support classifying assets and liabilities (and therefore items of income and expense) that cannot be clearly distinguished as operating, investing, or financing as 'operating' by default. Those respondents consider the operating income subtotal to be one of the more useful subtotals in the proposed working format. Consequently, those respondents are concerned that the operating income subtotal might be made less useful if the operating category was a default category for items that were otherwise difficult to classify.

A30. Several respondents suggested that the operating and investing categories should be relabelled as 'core' and 'non-core' business categories. Respondents thought that those labels provide a better description of the types of items to be presented in those categories within the business section.

Summary of participant (both analyst and preparer) views from the field test

A31. The survey results of the analyst participants in the field test indicated that they appeared to be more comfortable with the definition of the operating category than with that of the investing category. Approximately 60 per cent of the analyst participants agreed with the definition of the operating category provided in the Discussion Paper and 51 per cent agreed with the definition of the investing category. Analyst participants that disagreed with the definition of the operating category and the investing category thought that those categories are too loosely defined.

A32. Analyst participants in the field test did not agree on the presentation of several items in the operating section, primarily lease liabilities, interest on lease liabilities and income taxes. Several thought that lease liabilities and related interest should be a financing item instead of an operating item. Likewise, several analyst participants think that some income taxes should be presented as part of the operating category. Specifically, taxes should be split between their operating and financing components. Other areas of concern included:

(a) *Property, plant and equipment (PP&E).* The gains and losses on disposals of PP&E and capital expenditures are not related to day-to-day operations and therefore should not be included in the operating category.

(b) *Investments in securities.* It was unclear to some analyst participants why investments in securities are classified as operating, when cash and short-term investments are classified as financing assets.

(c) *Investment in associates/affiliates.* Some analyst participants did not understand the classification of investments in associates/affiliates as investing. Comments indicated that some analyst participants think that too much flexibility was given to management to classify an item as operating or investing.

A33. Preparer participant responses regarding the communication of operating and investing activities in the recast statements were generally in line with the analyst participant responses. However, the preparer participants did not think that the recast statements provided as much incremental benefit over the non-recast statements. Only 50 per cent thought the recast statements did a better job at communicating their operating results and 32 per cent thought that the recast statements were better at presenting their investing activities than the non-recast statements.

Appendix B—Proposed changes (IAS 7)

B1. The proposed amendments to IAS 7 are presented below.

Amendment to IAS 7 *Statement of Cash Flows*

Paragraph 11A and 13A are added. Paragraph 11 is not proposed for amendment but is included here for ease of reference. Paragraphs 6, 13, 14, 16, 31, 33 and 34 are amended. New text is underlined and deleted text is struck through.

Presentation of a statement of cash flows

11 An entity presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the entity and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities

11A When classifying cash flows by activity an entity shall focus on the nature of the transaction that gave rise to the cash receipt or the cash payment. This principle of classification takes precedence if other guidance conflicts with it. The definitions of operating, investing and financing activities in paragraph 6 (and subsequent descriptions in IAS 7 for each activity) describe the nature of each of these activities.

Definitions

6 *Operating activities* are the cash effects of the transactions and other events that enter into the determination of profit or loss ~~principal revenue-producing activities of the entity~~ and include other activities that are not investing or financing activities.

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents (such as the making and collecting of loans and acquiring and disposing of debt or equity instruments of other entities).

Financing activities are activities for raising (or repaying) capital. These activities ~~that~~ result in changes in the size and composition of the contributed equity and borrowings of the entity.

Financing activities include obtaining resources derived from the issue of an entity's own equity instruments (as defined in IAS 32 *Financial Instruments: Presentation*).

A financing activity involves (a) the receipt or use of a resource from a provider of finance; (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.

Financing activities include purchase transactions with suppliers who have provided extended credit.

Operating activities

13 The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the entity have generated sufficient cash flows to repay loans, maintain the operating capability of the entity, pay dividends and make new investments without recourse to external sources of financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows. The information provided within operating activities enables users to assess the reasons for differences between profit or loss and associated cash receipts and payments.

13A Cash effects of activities that do not represent principal revenue-producing activities should be segregated in a subsection within the operating activities section in the statement of cash flows.

14 ~~Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity.~~ Cash flows from operating activities are the cash effects of ~~Therefore, they generally result from~~ the transactions and other events that enter into the determination of profit or loss.

Investing activities

16 The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. ~~Only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities.~~ Examples of cash flows arising from investing activities are:

(a) cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalised development costs and self-constructed property, plant and equipment;

(b) (...)

(h) (...)

Interest and dividends

31 Cash flows from interest and dividends received and paid shall each be disclosed separately. ~~Each shall be classified in a consistent manner from period to period as either operating, investing or financing activities.~~

33 Interest paid and interest and dividends received are usually classified as operating cash flows for a financial institution. ~~However, there is no consensus on the classification of these cash flows for other entities. Interest paid and interest and dividends received may be classified as operating cash flows because they enter into the determination of profit or loss. Alternatively,~~ I~~i~~nterest paid is classified as a financing cash flow because it is a cost of obtaining financial resources. ~~and~~ I~~i~~nterest and dividends received ~~may be~~ are classified as ~~financing cash flows and~~ investing cash flows ~~respectively,~~ because they are ~~costs of obtaining financial resources or~~ returns on investments.

34 Dividends paid ~~may be~~ are classified as a financing cash flow because they are a cost of obtaining financial resources. ~~Alternatively, dividends paid may be classified as a component of cash flows from operating activities in order to assist users to determine the ability of an entity to pay dividends out of operating cash flows.~~

Effective date

58 *Annual Improvements* [cycle] issued in [date] added paragraph 11A and 13A and amended paragraphs 6, 13, 14, 16, 31, 33 and 34. An entity shall apply those amendments retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after [date]. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

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

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

Presentation of a statement of cash flows

BC1 The IASB noted that two ‘principles of classification’ in IAS 7 have been used to guide the classification of cash flows. The first principle, based on paragraph 11 of IAS 7, is that cash flows shall be classified in accordance with the nature of the activity in a manner that is most appropriate to the business of the entity in accordance with the definitions of operating, investing and financing activities in paragraph 6 of IAS 7. The second principle, based on paragraph 16 of IAS 7, is that cash flows should be classified consistently with the classification of the related or underlying item in the statement of financial position. The IASB considered it important to clarify that that the primary principle for classification of cash flows on the basis of paragraph 11 of IAS 7 is the classification of cash flows based on their nature. The IASB thinks that this principle of classification takes precedence if other guidance conflicts with this principle.

BC2 The IASB also considered adding more guidance on the application of the primary principle behind the classification of cash flows, to address existing diversity in practice regarding the classification of cash flows by activity. This can occur when transactions can be viewed as having aspects of operating, investing or financing activities and the appropriate classification might not be clear.

BC3 The IASB noted that the definitions of operating, investing and financing activities are too ambiguous to be applied consistently and uniformly in practice. Consequently, the IASB tentatively proposes some amendments to the definitions to give management more elements that can be used to identify the nature of a transaction.

BC4 The IASB proposes that the operating section should include the cash effects of transactions that enter into the determination of profit or loss. In this respect, the IASB observes that the main objective for presenting an operating section in the statement of cash flows is to align profit or loss items with cash receipts and payments so that the operating section provides a cash-basis measure of the entity’s profit or loss.

BC5 The IASB also observed that operating activities involve the acquisition of short-term assets (which are part of working capital); whereas some investing activities involve long-term asset acquisitions. The IASB noted that this distinction is useful for users in making decisions.

BC5 The IASB also proposes to clarify that the financing section should reflect an entity’s capital-raising activities. These activities fund an entity's general business activities, capital expenditures and acquisition activities. The IASB identified some elements that can generally be found in financing activities: (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 both dependent on the amount of the credit and the duration (time of the credit).

BC6 The IASB also proposes to clarify that if the credit term for the purchase of any item is extended beyond normal credit terms, the nature of the transaction changes and becomes a financing transaction. The IASB observes that this information is significant and useful for an investor.

BC6 The IASB also proposes to amend the guidance in paragraph 16 regarding the fact that "only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities". The IASB noted that this guidance is leading to the misinterpretation that expenditures that give rise to recognised assets are by default investing activities. The IASB observed that an expenditure that gives rise to a recognised asset should be classified as an investing activity when it meets the definition of an investing activity and that expenditures that do not give rise to a recognisable asset could also meet the definition of investing activities to the extent to which these expenditures have been made for resources intended to generate future income and cash flows.

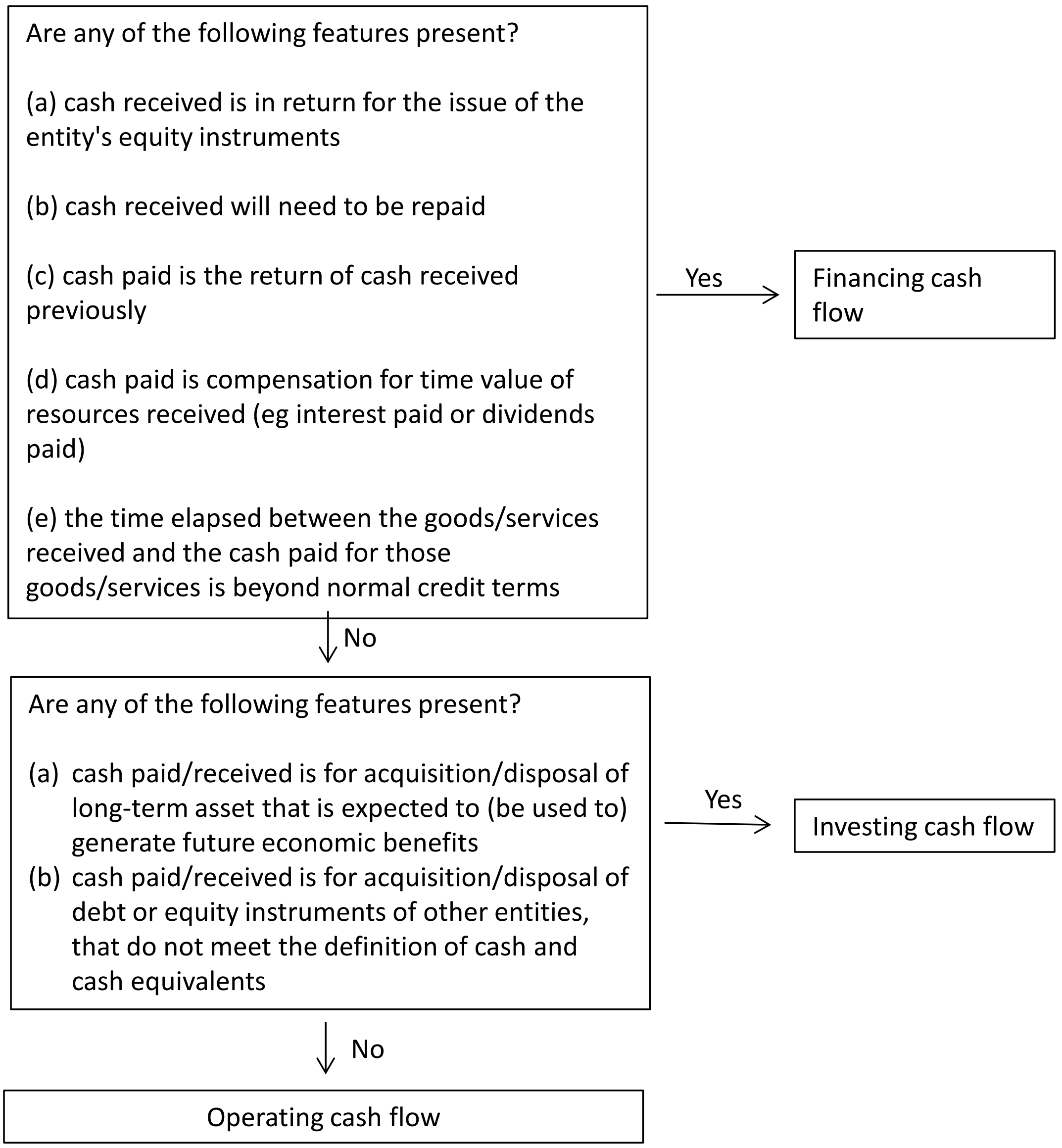
BC6 The IASB also proposes to amend the guidance in paragraphs 31, 33 and 34 to promote a consistent classification of cash flows from interest and dividends. The IASB proposes that cash flows from interest/dividends paid should not be classified as operating activities; instead they should be classified as financing activities. The IASB also proposes that cash flows from interest/dividends received should not be classified as operating activities; instead, they should be classified as investing activities.

Guidance on implementing IAS 7 *Statement of Cash Flows*

This guidance accompanies, but is not part of, IAS 7

The following flow chart provides guidance on the identification of operating, investing and financing activities on the basis of the definitions in paragraph 6 of IAS 7.

Classification of cash flows



Appendix C—Previous proposed amendments to (IAS 7)

Issue on service concession arrangements

C1. The amendment proposed by the staff (and not yet approved by the IASB) in agenda paper 11 of November 2011 to paragraph 14 of IAS 7 is presented below.

C2. Our staff recommendation in this agenda paper is that the Interpretations Committee should recommend to the IASB that it should halt these proposed amendments to IAS 7 until the Interpretations Committee finalises its discussions on the clarification of the underlying principle for classifying cash flows.

Amendment to IAS 7 *Statement of Cash Flows*

Paragraph 14 is amended as follows (new text is underlined):

Operating activities

14 Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events that enter into the determination of profit or loss. Examples of cash flows from operating activities are:

(a) cash receipts from the sale of goods and the rendering of services;

…

(f) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; ~~and~~

(g) cash receipts and payments from contracts held for dealing or trading purposes~~.~~<u>; and</u>

<u>(h) cash receipts and payments from construction or upgrade services related to service concession arrangements within the scope of IFRIC 12.</u>

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

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

Cash payments for contingent and deferred considerations

BC1 The IASB received a request to clarify how an operator, in a service concession arrangement within the scope of IFRIC 12 *Service Concession Arrangements*, should classify the cash inflows and cash outflows resulting from construction or upgrade services.

BC2 The IASB thinks that the different accounting models in IFRIC 12 (intangible asset or financial asset) are not the relevant factor in determining cash flow presentation. The different accounting models, for construction or upgrade services, are a consequence of the different types of arrangements and definitions of a financial asset versus an intangible asset. However the IASB noted that this does not change the activity to which the construction services relate. In other words, regardless of whether the cash inflows will be obtained contractually from the grantor (financial asset model) or through services to the public (intangible asset model), the activity of satisfying a service concession arrangement is expected to be a principal revenue producing activity of an entity which undertakes such arrangements, ie an operating cash flow. For this reason, the IASB proposes to include these types of arrangements in IAS 7 paragraph 14(h) to clarify that the cash inflows and cash outflows resulting from construction or upgrade services should be classified as operating cash flows.

Appendix C (*Continued*)—Previous proposed amendments to IAS 7

Interest that is capitalised

C3 The proposed amendments to paragraphs 16(a) and 33 and the addition of paragraphs 33A and 58 are presented below. Paragraph 32 is not proposed for amendment but is included here for ease of reference[13].

C4. Our staff recommendation in this agenda paper is that the Interpretations Committee should recommend the IASB that it should halt these proposed amendments to IAS 7 until the Interpretations Committee finalises its discussions on the clarification of the underlying principle for classifying cash flows.

Amendment to IAS 7 *Statement of Cash Flows*

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

Presentation of a statement of cash flows

…

Investing activities

16 The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities. Examples of cash flows arising from investing activities are:

(a) cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to <u>capitalised borrowing costs</u>, capitalised development costs and self-constructed property, plant and equipment;

[13] This proposed amendment was included in the Exposure Draft (ED) on *Annual Improvements to IFRSs 2010 –2012 cycle* (ED/2012/1) published in May 2012. The IASB has received comments on this proposal that we have analysed in Agenda paper 12A of January 2013.

(b) ...

Interest and dividends

32 The total amount of interest paid during a period is disclosed in the statement of cash flows whether it has been recognised as an expense in profit or loss or capitalised in accordance with IAS 23 *Borrowing Costs*.

33 Interest paid and interest and dividends received are usually classified as operating cash flows for a financial institution. However, there is no consensus on the classification of these cash flows for other entities. Interest paid <u>(except for payments of interest that is capitalised, which shall be classified in accordance with paragraph 33A),</u> and interest and dividends received, may be classified as operating cash flows because they enter into the determination of profit or loss. Alternatively, interest paid <u>(except for payments of interest that is capitalised, which shall be classified in accordance with paragraph 33A),</u> and interest and dividends received, may be classified as financing cash flows and investing cash flows respectively, because they are either costs of obtaining financial resources or returns on investments.

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

Effective date

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

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

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

Interest paid that is capitalised

BC1 The IASB received a request to clarify the classification in the statement of cash flows of interest paid that is capitalised into the cost of property, plant and equipment. Paragraph 16 of IAS 7 was interpreted as classifying interest paid that has been capitalised as an investing cash flow. However, the IASB was informed that this seemed to be inconsistent with paragraphs 32 and 33, which require interest paid to be classified only as an operating or a financing cash flow.

BC2 The IASB observed that interest paid that is capitalised into the cost of an asset should be classified as an investing activity in accordance with paragraph 16, because it results in a recognised asset in the statement of financial position. Paragraph 32 states that interest paid that is capitalised according to IAS 23 *Borrowing Costs* should be reflected in the statement of cash flows; however, the IASB noted that neither IAS 23 nor IAS 7 specifies where such capitalised interest should be classified in the statement of cash flows. Paragraph 33 allows for interest paid to be classified as part of either operating or financing activities. However, the IASB noted that this paragraph does not specify whether interest paid that is capitalised as part of the cost of an asset should be classified in the same way or not.

BC3 To address this lack of guidance, the IASB proposes to modify paragraphs 16(a) and 33 and proposes adding paragraph 33A to clarify that the classification of payments of interest that is capitalised shall follow the same classification as the underlying asset into which those payments were capitalised. This modification also covers the classification of payments of interest that have been capitalised into the cost of operating assets (such as inventory), which should be classified as part of an entity's cash flows from operating activities.