Issues in IAS 7, *Statement of Cash Flows*

A. Background

The statement of cash flows is one of the components of financial statements required to be prepared under Generally Accepted Accounting Principles (GAAP). 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. The statement of cash flows is a key financial statement used by investors, analysts and other users to assess the ability of the entity to generate cash and cash equivalents and the need of the entity to utilise those cash flows under three sections viz., operating, investing, and financing. It also enhances the comparability of the reporting of performance by different entities because it depicts movement of cash flows and eliminates the effects of using different accounting treatments for the same transactions and events.

However, in some cases due to lack of guidance or otherwise, transactions are not properly classified into the operating, investing, and financing sections, which can result in loss of comparability and may not represent fair presentation of various transactions. We have identified few issues in IAS 7 in our jurisdiction, which are detailed in the next section of this paper. According to our work on the subject, such as identifying issues in statement of cash flows and collecting opinions from Indian stakeholders, we have summarized the concerns from the stakeholders in the following categories:

(1) Information needs
(2) Lack of guidance leading to diversity in practice
(3) Other issues wrt language improvement or alignment with other Standards

These issues suggest need of improvements in IAS 7.

B. Issues

(1) Information needs: Restricted cash and cash equivalent

a) Classification of restricted cash and cash equivalents

IAS 7 covers 'cash' and 'cash equivalents' under the head 'Cash and cash equivalents'. The issue is if there is any restriction in use of cash and cash equivalents, whether they will qualify to be classified under the head 'Cash and cash equivalents'. In this regard, following provisions of IAS 7 may be noted:

<u>Paragraph 6:</u>

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

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

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

…

Paragraph 7:

Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition.….

In view of paragraph 7, an item that is restricted from use does not qualify to be cash equivalent if it is not available for the purpose of meeting short-term cash commitments.

On the other hand, an item which qualifies the definition of cash would continue to be classified as 'cash' even if there is restriction on its usage.

This does not appear to be conceptually correct because cash, particularly demand deposits, with restrictions on use are classified as cash, however, other short term investments with similar restrictions on use may not be classified as 'cash and cash equivalent'. For example, if the amounts with restrictions on use would have been held in a time (or term) deposit, rather than in a demand deposit, such amount would have been excluded from cash and cash equivalents. Moreover, IFRS Standards do not define the term 'demand deposits'. In common parlance it is understood as a bank balance that can be withdrawn at any time without prior notice.

In our view, demand deposits having restriction on its use cannot be used to meet short-term commitments and, therefore, its nature cannot be said to be similar to unrestricted cash. For example, an entity may be required formally to set aside cash, for example maintaining a minimum cash deposit with bank continuously until the issued bonds are fully redeemed. In such cases balances might not be available to meet short-term commitments and hence should not be regarded as cash.

In view of the above, it may be appropriate to specifically deal with the impact of restrictions on classification of cash. In this regard, guidance similar to paragraph 7 may be considered. Further, if IASB undertakes the project to amend IAS 7, guidance on following aspects will be helpful:

a) What is meant by 'demand deposits'
b) Elaborate on the term 'restrictions' i.e. clarity as to what kind of restrictions can change the nature of the deposit. It may be relevant to note that IFRS 12, *Disclosure of Interests in Other Entities,* in paragraph 13 considers significant restrictions (eg statutory, contractual and regulatory restrictions) on its ability to access or use the

assets and settle the liabilities of the group. In our view, restriction on both 'use' and 'ability to access' should be considered while determining whether the demand deposit qualifies to be cash.

In this regard, we have also noted that the recent Tentative Agenda Decision (TAD) issued by IFRS IC on 'Demand Deposits with Restrictions on Use (IAS 7)' wherein it has been concluded that restrictions on use of a demand deposit arising from a contract with a third party do not result in the deposit no longer being cash, unless those restrictions change the nature of the deposit in a way that it would no longer meet the definition of cash in IAS 7. TAD acknowledges that some restriction may change the nature of the deposits, however, in absence of guidance on the term 'restriction' there is no clarity what kind of restrictions will change the nature of the deposit which may lead to diversity in practice. Therefore, clarification on 'restrictions' similar to IFRS 12 will be useful for consistent application of the Standard.

b) Presentation of restricted cash and cash equivalents:

With regard to the presentation aspect, it may be noted that Conceptual Framework in paragraph 7.2 prescribes as under:

> 7.2 Effective communication of information in financial statements makes that information more relevant and contributes to a faithful representation of an entity's assets, liabilities, equity, income and expenses. It also enhances the understandability and comparability of information in financial statements. Effective communication of information in financial statements requires:
>
> a) …
> b) classifying information in a manner that groups similar items and separates dissimilar items; and
> c) aggregating information in such a way that it is not obscured either by unnecessary detail or by excessive aggregation.

Further, paragraph 54 of IAS 1 requires an entity to include line items in its statement of financial position that present the amounts listed in that paragraph. Paragraph 55 of IAS 1 states that "an entity shall present additional line items (including by disaggregating the line items listed in paragraph 54), headings and subtotals in the statement of financial position when such presentation is relevant to an understanding of the entity's financial position"

In view of the discussions under '(a) Classification of restricted cash and cash equivalents', demand deposit which is not available to meet short-term commitments and hence should not be regarded as cash, it would have to be presented separately. In our view, option given under IAS 1, based on entity's judgement, to present such items as separate line item is not sufficient. In order to ensure faithful representation and because of the reasons given above, restricted demand deposits should be specifically required to be classified and presented separately from line item 'cash' and cash equivalents, in the statement of financial position and cash flows.

(2) Lack of guidance leading to diversity in practice: Cash and cash equivalents in case of overnight mutual funds

Overnight mutual funds are debt funds that invest in collateralized borrowing and lending obligation (CBLOs), overnight reverse repos, and other permitted debt or money market securities that mature in one day. In order to better utilise idle funds, these kinds of funds are commonly used as they bear minimal risk with low-returns, while preserving the value of the assets and maintaining a high level of liquidity. Most of these investments are AAA rated (portfolio of an overnight fund is replaced every day with new overnight securities). On realisation, the Net Asset Value (NAV) of the same day is credited in the account but there is no fixed maturity. Investment in such instruments is generally done for meeting short-term cash commitments rather than for investment or other purpose.

The issue is whether such investments meet the definition of cash and cash equivalents as per IAS 7 because on realisation, the change in value is expected to be insignificant but the exact amount at which the investment will be realised is not known.

In this regard, relevant guidance in IAS 7 is reproduced below:

> <u>Paragraph 6:</u>
>
> …
>
> ***Cash equivalents* are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.**
>
> …
>
> <u>Paragraph 7:</u>
>
> Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition…..

As per the above provisions, for an item to qualify for cash and cash equivalents certain conditions should be met:

a) held for the purpose of meeting short-term cash commitments rather than for investment or other purposes
b) short maturity of, say, three months or less from the date of acquisition
c) readily convertible to known amounts of cash and
d) which are subject to an insignificant risk of changes in value

The given investment meets the conditions given in (a), (b) and (d) above. However, with regard to condition (c), it may be noted the exact amount of NAV on realisation is not known at the time of investment, but it can be calculated/estimated, and the inputs to, and the method of, calculation are known at the acquisition date. The realised amount may vary from estimated amount, however, the variation will be insignificant compared to the amount of investment.

The issue is raised as to whether conditions mentioned in (c) and (d) above are independent conditions or both need to be read together.

In this regard it has been noted that in July 2009 Agenda decision, the IFRIC noted that paragraph 7 of IAS 7 states that the purpose of holding cash equivalents is to meet short term cash commitments. In this context, the critical criteria in the definition of cash equivalents set out in paragraph 6 of IAS 7 are the requirements that cash equivalents be 'convertible to known amounts of cash' and 'subject to insignificant risk of changes in value'. The IFRIC noted that the first criterion means that the amount of cash that will be received must be known at the time of the initial investment, ie the units cannot be considered cash equivalents simply because they can be converted to cash at any time at the then market price in an active market. An entity would also have to satisfy itself that any investment was subject to an insignificant risk of changes in value for it to be classified as a cash equivalent.

Despite the guidance given in Agenda decision, it is not clear whether condition given in (c) of 'known amount of cash' is independent of condition given in (d) 'insignificant risk of changes in value' or the two conditions are to be read together. Our reading of the Agenda Decision suggests conditions (c) and (d) are independent and therefore, both the conditions viz., 'known amounts of cash' and 'insignificant risk of changes in value' should be satisfied independently, for the investment to qualify as cash equivalent.

However, due to diversity in practice on account of interpretation of the above issue, there are two possible views with regard to classification of such investments, as elaborated below:

View 1: Investment is cash equivalent

Investment in Overnight mutual funds is made for the purpose of meeting short-term cash commitments rather than for investment or other purposes. Despite IFRIC Agenda decision as stated above, entities are treating overnight mutual funds as cash equivalents, as the amount at which it can be realised can be estimated and the risk of change in such value (variability) is insignificant. Therefore, on a substantive basis, it appears that the overnight mutual funds meet the cash equivalent criteria of 'known amount of cash'. The relevant extract of annual report is as under:

NOTE 12 CASH AND CASH EQUIVALENTS

	As at 31st March, 2021	As at 31st March, 2020
Cash on hand	0	0
Balances with banks		
In current accounts	189	2,957
Term deposits with original maturity of less than three months	1,650	229
Others		
Overnight Mutual funds	3	30
	1,842	3,216

View 2: Investment is not cash equivalent

Though such investments are subject to insignificant risk of changes in value but since the exact amount that will be realised is not known, the test of 'known amount of cash' would not be met even though the variability is low. Consequently, such investments would be classified under investing activities in the statement of cash flows. The relevant extract of annual report is as under:

	As at 31 March 2021		As at 31 March 2020	
	Nos.	Amount	Nos.	Amount
(b) Current				
Investments in mutual funds				
Unquoted				
(Measured at fair value through profit and loss)				
ICICI Pru Equity Arbitrage Fund -Direct-Growth	3,642,102.04	1,022	-	-
Kotak Equity Arbitrage Fund -Direct- Growth	3,379,725.30	1,023	-	-
DSP Overnight Fund - Direct - Growth	-	-	47,169.05	504
Franklin India Overnight Fund -Direct-Growth	-	-	191,756.92	2,004
HSBC Overnight Fund - Direct - Growth	-	-	67,686.62	707
ICICI Prudential Overnight Fund-Direct-Growth	-	-	1,434,024.43	1,545
Invesco India Overnight Fund - Direct-Growth	-	-	143,281.93	1,447
Kotak Overnight Fund - Direct- Growth	-	-	169,155.80	1,803
		2,045		8,010
Other disclosures for current investments:				
(a) Aggregate amount of unquoted investments		2,045		8,010

Issues for guidance:

- If the intention of IAS 7 is to consider the two conditions together, viz., condition (d) 'subject to an insignificant risk of changes in value' and condition (c) 'known amounts of cash', then given investments may qualify as cash equivalents. If that is the case, then condition (c) is sub-set or subordinate to condition (d). Hence, condition (c) may be removed.
- If the intention of IAS 7 is to read both the conditions (c) and (d) independently, then the same should be clarified. In that case, requisite guidance or explanation may be added in IAS 7.

(3) Other Issues wrt language improvement or alignment with other Standards: Paragraph 7-example of cash equivalents

Paragraph 7 of IAS 7 provides an example of cash equivalents as “Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example in the case of preference shares acquired within a short period of their maturity and with a specified redemption date.” The example relates to preference shares with short maturity. In our view, this example is not appropriate in relation to the equity investments as under IAS 32, *Financial Instruments:* Presentation, such preference shares are classified as debt in the books of issuer. Therefore, this example creates confusion in the minds of readers. Accordingly, we feel that this example may either be deleted or suitably replaced.