IFRS 9: Application Issues with the Statement of Cash Flows

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Background

IAS 7 *Statement of Cash Flows* specifies how entities report information about the historical changes in their cash and cash equivalents. This standard applies to all entities regardless of their business activities, including financial institutions. IAS 7 was issued in 1992 and modifications to the standard have been limited since it was published.

IAS 7 requires that inflows and outflows of cash and cash equivalents are classified and reported under three different headings: operating activities, investing activities and financing activities. The resulting information in the statement of cash flows provides insight into an entity's ability to generate cash to fund its operations, reinvest its cash to maintain or expand its operating capacity, repay its debt and distribute dividends, and manage cash.

The definitions of operating, investing and financing activities in IAS 7 are broad. In recent years, investors and regulators have increasingly scrutinized the statement of cash flows, citing classification errors, misidentified cash components and inadequate disclosures as key concerns. In part, this may be because companies are increasingly relying on information from the statement of cash flows to generate key performance metrics and in their communications with current and potential investors.

For example, some of the regulators' concerns associated with the preparation of the statement of cash flows include:

- unclear or incorrect classifications;
- inconsistent cash flow treatment;
- insufficient disclosure for reclassifications (such as the amount of each item or class of items that is reclassified);
- lack of detail regarding the nature and context of classifications or reclassifications; and
- inadequate disclosure of non-cash and complex items.

Issue 1: Defining cash, cash equivalents and restrictions on the use of cash

Analysis

The statement of cash flows analyzes changes in cash and cash equivalents. Therefore, understanding what qualifies as cash and cash equivalents is essential for its preparation.

Definition of cash

Paragraph 6 of IAS 7 defines "cash" as "cash on hand and demand deposits." It does not provide additional guidance for determining whether an item qualifies as cash.

IAS 7 also does not clarify what is meant by "demand deposits". With that said, the term is generally understood to refer to amounts that can be withdrawn on demand without needing prior notice or incurring a penalty.

Common forms of cash are currency on hand and demand deposits with financial institutions. In addition to being accessible on demand, some other common features of cash include that it:

- serves as the standard medium of exchange; and
- is the basis for measuring and accounting for all other elements in the financial statements.

Definition of cash equivalents

Paragraph 6 of IAS 7 defines cash equivalents as "short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value."

Paragraph 7 of IAS 7 states that "cash equivalents are held to meet short-term cash commitments rather than for investment or other purposes." Therefore, it is important to understand the entity's cash management policies, especially when assessing whether some balances, such as those beyond cash on hand or demand deposits, qualify as cash equivalents.

Cash management includes the investment of cash in excess of immediate needs into cash equivalents, such as short-term investments (see paragraph 9 of IAS 7). For investments to qualify as cash equivalents, they must be:

- short-term in maturity (generally three months or less from the date of acquisition);
- highly liquid;
- readily convertible into known amounts of cash; and
- subject to an insignificant risk of changes in value.

An investment with a maturity period of three months or less from the acquisition date normally qualifies as a cash equivalent, provided it is held to meet the entity's short-term cash commitments (see paragraph 7 of IAS 7).

Common forms of cash equivalents include short-term investments such as treasury bills, commercial paper and money market funds. Items that are denominated in foreign currencies might also qualify as cash equivalents.

Bank overdrafts that are repayable on demand are included as cash and cash equivalents to the extent that they form an integral part of the entity's cash management (see paragraph 8 of IAS 7). However, even though a bank overdraft might be netted against cash and cash equivalents in the statement of cash flows, netting is not permitted in the statement of financial position unless the offsetting criteria in paragraph 42 of IAS 32 *Financial Instruments: Presentation* are met.

Any investment (e.g., a government bond or certain deposit certificates) purchased with a maturity period of more than three months and without an early redemption option will likely not be a cash equivalent. This is because its maturity period exceeds the short-term period suggested by the standard. Moreover, such an investment will not become a cash equivalent when its remaining maturity period from a subsequent reporting date becomes three months or less because the maturity period is measured from the investment's acquisition date.

The limit on maturity period reinforces that the amount of cash receivable should be known by the entity at the time of the initial investment and be subject to an insignificant risk of changes in value. However, there could be limited circumstances in which deposits with a term of more than three months may be classified as cash and cash equivalents. For example, consider a redeemable six-month fixed deposit with the following features:

- If held to maturity, the deposit bears interest at a fixed six-month rate determined at inception. The fixed rate is significantly higher than interest rates offered for a typical demand deposit account. The demand deposit rate is significantly higher than zero. If the entity redeems the fixed deposit at any time before the maturity date, the entity is entitled to interest based on the typical demand deposit rate from the initial deposit date to the date of redemption plus the original principal amount. The balance (if any) of interest at the fixed rate in excess of the demand deposit rate is forfeited as an early withdrawal penalty.
- Interest accrues daily based on the fixed rate.
- The entity can redeem the fixed deposit at any time before the maturity date and, if redeemed before the maturity date, it must be redeemed in full.
- The entity may not increase the deposit amount after the initial investment.
- The entity asserts that the investment is used to meet its short-term cash commitments, as supported by the entity's cash management practices.

Based on the fact pattern above, the redeemable six-month fixed deposit would be classified as a cash equivalent.

In determining whether an investment is a cash equivalent, the purpose for which the investment is held must also be determined. When an investment meets the four criteria above but is not held by the entity to meet its short-term cash commitments, it cannot be classified as a cash equivalent. Accordingly, in the example above, if the entity did not hold the redeemable six-month fixed deposit to meet its short-term cash commitments, the instrument could not be classified as a cash equivalent.

An investment that is redeemable at any time is a cash equivalent only if the amount of cash that would be received is known at the time of the initial investment and is subject to an insignificant risk of changes in value. In addition, the other criteria in paragraphs 7-9 of IAS 7 for cash equivalents must be met. The IFRS Interpretations Committee published an Agenda Decision "Determination of cash equivalents" in July 2009, which noted the fact that an investment can be converted at the market price at any time does not mean it is readily convertible to known amounts of cash.

Any restriction on instruments classified as a cash equivalent must be carefully evaluated to determine whether the instrument still meets the definition of cash equivalents. If an investment is restricted – either by its own contractual terms or by a separate contractual arrangement with a third party – and cannot be used to meet the entity's short-term cash commitments, it does not qualify as a cash equivalent.

Restrictions on cash

In practice, an entity may hold cash for specific purposes, or its use may be restricted by the bank, the entity itself or a third party. To determine whether an instrument qualifies as cash under the standard, it is essential to carefully evaluate any restrictions on its use.

While IAS 7 does not define what a demand deposit is, a restriction on access to these deposits (i.e., such that it is not accessible immediately on demand) would result in that bank deposit failing to meet the definition of cash.

In April 2022, the IFRS Interpretations Committee published an Agenda Decision "Demand Deposits with Restrictions on Use arising from a Contract with a Third Party*.*" This Agenda Decision responded to a request about whether an entity should include a demand deposit as a component of cash and cash equivalents when the demand deposit is subject to contractual restrictions on use that were agreed to with a third party.

The IFRS Interpretations Committee concluded that a demand deposit remains classified as cash – even if there are restrictions on its use from a separate contract with a third party – as long as those restrictions do not prevent the deposit from being immediately accessible on demand.

- Example: An entity has a contractual obligation with a third party to keep a specific amount of cash in a separate demand deposit and to use it only for designated purposes. If the entity uses these funds for purposes other than those agreed upon with the third party, the entity would be in breach of its contractual obligation. Although the entity may breach its contract with the third party, there is no restriction on its access to the demand deposit. Therefore, the entity will classify the demand deposit as cash for purposes of the statement of cash flows.

Conversely, if the restrictions on use are not from a separate contractual arrangement with a third party but are instead part of the terms and conditions directly relating to the use of and access to the bank deposit, it is likely that the amount held in the bank deposit will not meet the definition of cash assuming it cannot be withdrawn on demand.

- Example: An entity has debt covenants that require a certain level of cash to be held in a separate account and requires the lender (i.e., the bank where the deposit is held) be notified and provide their approval prior to withdrawing funds. As this restriction prevents the entity from accessing its deposit on demand, the deposit cannot be classified as cash for purposes of the statement of cash flows.

A demand deposit with restrictions on its use that meets the definition of cash or cash equivalents may need to be separately presented in the statement of financial position to provide a clear understanding of the entity's financial position (see paragraphs 54-55 of IAS 1 *Presentation of Financial Statements*). However, because it meets the definition of cash or cash equivalents, it should also be included as part of cash and cash equivalents in the statement of cash flows. The amount included in the statement of cash flows should be reconciled to the equivalent items in the statement of financial position (see paragraph 45 of IAS 7).

Paragraph 48 of IAS 7 requires disclosure of significant cash and cash equivalent balances held by the entity that are not available for use by the group.

The entity must also consider whether additional disclosure is needed under IFRS 7 *Financial Instruments: Disclosures* about liquidity risk and how that risk is managed.

If the information provided in accordance with IAS 7 and IFRS 7 is insufficient for users of financial statements to understand the impact of the restrictions on the entity's financial position, the entity should consider whether additional disclosures are required (see paragraph 31 of IAS 1).

The entity also considers paragraph 66(d) of IAS 1 and assesses whether the restricted cash is current or non-current.

In practice, the term "restricted cash" on the statement of financial position can include cash that both does and does not meet the definition of cash and cash equivalents for purposes of the statement of cash flows. As a result, the disclosure requirement in paragraph 45 of IAS 7 (i.e., requiring the amount presented as part of cash and cash equivalents in the statement of cash flows to be reconciled to the equivalent items in the statement of financial position) may be material.

The Group's Discussion

The Group agreed with the analysis presented.

One Group member reiterated that items meeting the definition of "cash" or "cash equivalents" in IAS 7 should be included in the statement of cash flows, irrespective of how these items are presented in the statement of financial position. They also emphasized the importance of properly assessing whether cash with restrictions on its use meets the definition of cash or cash equivalents and is therefore included in the statement of cash flows.

One Group member noted that judgment may need to be applied in determining whether bank overdrafts that are repayable on demand form an integral part of an entity's cash management. In particular, judgment may need to be applied in assessing whether an entity's bank balance often fluctuates from being positive to overdrawn as IAS 7 does not specify the specific time periods that should be considered as part of this assessment.

Issue 2: Classification of cash flows on business combinations and dispositions

Analysis

Cash flows related to acquiring or disposing of a subsidiary or business unit must be reported separately under investing activities in the statement of cash flows. The amounts paid or received should be shown net of any cash and cash equivalents acquired or disposed of as part of the transaction (see paragraphs 39 and 42 of IAS 7).

Paragraph 41 of IAS 7 allows the aggregation of cash flows from acquisitions or from disposals. However, the cash flow from disposals should be presented separately from the cash flow from acquisitions. The cash flow effects of losing control are not deducted from those associated with gaining control.

Cash flows arising from changes in ownership interests in a subsidiary that do not result in a loss of control are classified as cash flows from financing activities, unless the subsidiary is held by an investment entity (as defined in IFRS 10 *Consolidated Financial Statements*) and is measured at fair value through profit or loss (see paragraph 42A of IAS 7).

If an entity obtains or loses control of subsidiaries or other businesses during the period**,** the following disclosures are required, in aggregate (see paragraph 40 of IAS 7):

- the total consideration paid or received;
- the portion of the consideration consisting of cash and cash equivalents;
- the amount of cash and cash equivalents in the subsidiaries or other businesses over which control is obtained or lost; and
- the amount of assets and liabilities, other than cash or cash equivalents, in the subsidiaries or other businesses over which control is obtained or lost, summarized by each major category.

Paragraph 43 of IAS 7 also requires disclosure of the non-cash element of the acquisition or disposal of subsidiaries or other businesses. For example, if a subsidiary is acquired for consideration that is paid partly in cash, and partly in shares, only the portion paid in cash would be reflected in the statement of cash flows. The portion paid in shares would not be reflected in the statement of cash flows but would be subject to disclosure (see paragraph 43 of IAS 7).

Contingent consideration paid on business combinations

When the purchase price in a business combination agreement allows for adjustments to the cost of the combination that are contingent on one or more future events, IFRS 3 *Business Combinations* requires the acquirer to:

- recognize the acquisition-date fair value of the contingent consideration (see paragraph 39 of IFRS 3); and
- classify an obligation to pay contingent consideration that meets the definition of a financial instrument as a liability or as equity in accordance with the provisions of IAS 32 *Financial Instruments: Presentation* (see paragraph 40 of IFRS 3).

Changes in the measurement of a contingent consideration liability resulting from events after the acquisition date, such as meeting a performance target, are not reflected by adjusting the recorded cost of the business combination. When a liability has been recognized for the contingent consideration payable, any subsequent payment in excess of or below the carrying amount of the liability is recognized in profit or loss, except in limited circumstances when changes relate to measurement period adjustments (see paragraph 58 of IFRS 3).

Cash flow classification depends on the nature of the activity – whether it is operating, investing or financing – as defined in the standard. While this may suggest that all payments related to a business combination should be classified as investing activities, paragraph 16 of IAS 7 specifies that only expenditures resulting in a recognized asset qualify for that classification.

In most cases, cash payments up to the amount recognized for the acquisition-date fair value of the contingent consideration (and thereby included in the carrying value of the acquired assets, including goodwill) are classified as investing activities. This is because these are cash flows arising from obtaining control of subsidiaries and result in the recognition of an asset.

IAS 7 states that investing cash flows should arise only when an asset is recognized. However, remeasurements of contingent consideration other than measurement period adjustments are recognized in profit or loss. As a result, since contingent consideration typically arises for reasons other than to finance the acquirer, payments for additional contingent consideration in excess of the amount recognized at the acquisition date or resulting from measurement period adjustments are normally classified as operating cash flows.

If a subsequent remeasurement of the liability reduces the total cash payable below the amount recognized at the acquisition date for the acquired assets, the resulting payment of the liability is classified as investing in its entirety.

In practice, some arrangements may, in substance, represent a financing activity (that is, the arrangement represents the entity borrowing from the vendor to finance the acquisition). In such cases, when there is a very high probability of the payments being made, the entity should consider the classification in a similar way to deferred consideration (discussed below). As a result, the settlement of the initial amount and subsequent contingent consideration payments may be classified as a financing outflow. When assessing the substance of the arrangement, it is important to consider the purpose and structure of the contingent consideration, including the nature and probability of future events or conditions that will determine the contingent consideration amount paid.

Contingent consideration conditional on continuing employment

Contingent payments that are linked to continued employment of the acquiree's employees, or former owners that may become employees, are generally recognized as an employee compensation expense in the post-combination period (see paragraph 52 of IFRS 3). Subsequent payment of contingent amounts that are recognized as an employee compensation expense should be classified as an operating cash outflow in the statement of cash flows (see paragraph B55(a) of IFRS 3).

Contingent consideration received on disposal of a subsidiary

When an entity disposes of a subsidiary, it presents the related cash flows separately within investing activities. This applies even for the receipt of contingent consideration because the cash inflow is still an investing cash flow (i.e., as it is the receipt from the sale of equity or debt instruments of another entity) (see paragraph 16 of IAS 7).

The Group's Discussion

The Group agreed with the analysis presented and raised several other points for consideration.

Some Group members recognized that the outcome of applying the requirements in paragraph 16 of IAS 7 to the remeasurement of contingent consideration paid on a business combination may be surprising to some preparers. They acknowledged that preparation of the statement cash flows can be challenging and encouraged preparers to carefully assess whether certain items (e.g., payments related to the purchase of assets on deferred payment terms) can be classified as investing activities. Some Group members also encouraged individuals to stay informed of the IASB's Statement of Cash Flows and Related Matters project.

Some Group members also raised the following points:

- Acquisition costs that are expensed through the statement of profit and loss should not be classified as investing activities in the statement of cash flows. This is because, in accordance with paragraph 16 of IAS 7, these expenditures do not result in a recognized asset in the statement of financial position.
- Entities should carefully assess the classification of payments relating to the liabilities of an acquired business in the statement of cash flows. For example, if an acquired business has a liability (e.g., a trade payable) that is not settled until after the acquisition date, this payment may need to be classified as an operating activity in the acquirer's cash flow statement.

Issue 3: Payments to settle deferred consideration liability

Analysis

The purchase of assets on deferred payment terms can be complex, as it may not be clear whether to classify the associated cash flows as investing activities (i.e., purchasing an asset) or financing activities (i.e., repayment of borrowings). Therefore, judgment is required when determining the appropriate classification of deferred payments in the statement of cash flows. In making this determination, an entity might consider the purpose and structure of the deferred consideration, including the period of time before the amounts are due and any explicit or implicit financing terms. These same principles apply on the acquisition of a business involving deferred consideration.

If the period between the acquisition and payment is not significant, it is generally not appropriate to classify any part of the payment as a financing cash flow. Conversely, if the deferral period is significant, judgment must be applied to determine whether payments to reduce this liability should be regarded as financing cash flows.

When deferred consideration is measured at amortized cost and effectively represents a financing activity, any cash paid in excess of the initial fair value represents a finance cost. This amount should be classified consistently with other interest paid (i.e., it should be classified as an operating or financing activity depending on the entity's current accounting policy regarding the cash flow classification of interest paid in accordance with paragraph 33 of IAS 7). In addition, disclosures regarding changes in liabilities from financing activities should be considered as outlined in paragraphs 44A-44E of IAS 7.

The classification of deferred consideration in the statement of cash flows should be clearly disclosed, if material.

The Group's Discussion

The Group agreed with the analysis presented. However, one Group member noted that IFRS 18 Presentation and Disclosure in the Financial Statements introduced consequential amendments to IAS 7 that change how interest paid is required to be classified in the statement of cash flows. As a result, the accounting conclusions related to the classification of interest paid outlined in the analysis may no longer be relevant when IFRS 18 becomes effective.[1]

Issue 4: Lessee cash flows from leasing transactions

Analysis

When an entity enters into a lease, the acquisition of the right-of-use (ROU) asset and the incurrence of the lease liability is a non-cash transaction, and, therefore, is excluded from the statement of cash flows. However, leasing transactions can give rise to cash flows that impact the statement of cash flows.

As indicated in IAS 7, a single transaction entered into by an entity could result in several cash flows that can be classified differently. These cash flows should be separated and presented under their respective headings according to their nature (see paragraph 12 of IAS 7).

In relation to the classification of cash flows in the statement of cash flows, a lessee classifies:

- Cash payments for the principal portion of the lease liability within financing activities.
- Cash payments for the interest portion of the lease liability in a consistent manner to the presentation of other interest paid. Depending on the entity's accounting policy adopted for the classification of interest paid, these payments may be classified as either financing or operating activities in accordance with paragraph 33 of IAS 7.
- Variable lease payments not included in the lease liability within operating activities.
- Short-term lease payments and payments for leases of low-value assets to which the recognition exemptions in IFRS 16 are applied within operating activities (see paragraph 50 of IFRS 16 *Leases*).

IFRS 16 also requires disclosure of the total cash outflow for leases (see paragraph 53(g) of IFRS 16). This includes the principal and interest paid on lease liabilities as well as lease payments for short-term leases, leases of low-value assets and variable lease payments.

A lessee must also include lease liabilities and the related cash and non-cash movements in the disclosures required by paragraphs 44A-44E of IAS 7.

Payments made by the lessee before the commencement date

If a lessee makes payments at or before the commencement date of the lease, these payments are included in the initial measurement of the ROU asset (see paragraph 24(b) of IFRS 16). Since these cash outflows are seen as consideration for the acquisition of the ROU asset, they should be classified as an investing activity.

Conversely, if the payment is the first of the periodic lease payments that the lessee will make and is financing in nature (meaning it reduces the lease liability), this cash outflow would be classified as a financing activity, according to paragraph 17(e) of IAS 7.

Lease incentives

Lease incentives are defined in Appendix A of IFRS 16 as payments made by a lessor to a lessee associated with a lease, or the reimbursement or assumption by a lessor of costs incurred by the lessee.

While neither IFRS 16 nor IAS 7 provide specific guidance on the classification of cash inflows from lease incentives, paragraph 17(e) of IAS 7 considers a lease transaction as the provision of finance by the lessor to the lessee.

Appendix A of IFRS 16 defines lease payments as payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term, less any lease incentives. Therefore, lease incentives receivable by lessees (e.g., a reimbursement of the cost of leasehold improvements) are included in the measurement of the lease liability as a reduction in lease payments.

The most appropriate presentation of cash flows from lease incentives may be to treat such incentives as part of financing activities in the statement of cash flows, regardless of whether they are received before or after the commencement date of the lease, as the receipt of the lease incentive may change the size of the lessee's borrowings.

Initial direct costs

Initial direct costs are incremental costs of obtaining a lease that otherwise would not have been incurred. A lessee includes these costs in the cost of the ROU asset at the commencement date (see paragraph 24(c) of IFRS 16). A lessee should classify initial direct costs within investing activities because the nature of the activity to which this cash outflow relates is the acquisition of the ROU asset.

The Group's Discussion

The Group agreed with the analysis presented. One Group member noted that the classification of lease-related payments in the statement of cash flows changed significantly for lessees upon the adoption of IFRS 16. As outlined in the analysis, under IFRS 16, different types and components of lease payments made by the lessee should be classified as either operating, investing or financing activities in the statement of cash flows based on their nature.

Issue 5: Other statement of cash flow matters

Analysis

Several other topics impact the statement of cash flows, including:

- gross versus net presentation;
- non-cash transactions;
- foreign currency implications;
- non-operating changes in working capital; and
- other situations not included in this paper when the classification of cash flows can involve judgment.

As a result, entities are reminded that the preparation of the statement of cash flows requires careful consideration. Considerable non-authoritative guidance exists, (e.g., published cash flow statement guidance by several accounting firms) that may be useful when assessing the treatment of cash flows in the statement of cash flows.

The Group's Discussion

The Group agreed with the analysis presented and raised several other points for consideration.

Some Group members reiterated the need for entities to apply careful thought and consideration when preparing the statement of cash flows. They noted that this important statement is used extensively by regulators and investors to gain insight into an entity's business model and overall liquidity. Accordingly, entities should invest the appropriate time to prepare the statement of cash flows and involve individuals with the appropriate level of seniority and expertise.

Some Group members also raised the following points relating to the preparation of the statement of cash flows:

- Determining the impact of foreign currency on the statement of cash flows can be complex, particularly for entities with significant foreign subsidiaries.
- It is important to carefully assess how working capital accounts are classified in the statement of cash flows. Specifically, entities should evaluate whether any of these amounts are related to capital expenditures. If so, classifying them as investing activities

may be required. This consideration is especially relevant for capital-intensive entities or those that have made significant capital investments during the period.

- Careful consideration may need to be applied in determining whether cash held in escrow meets the definition of cash or cash equivalents in IAS 7. In making this assessment, entities will need to consider whether an entity has control over the cash held in these accounts, as well as whether access to the cash is restricted. Refer to the Group's discussion at its June 20, 2019 meeting, "Client Money", for further details. Entities may also need to consider whether amounts held in escrow relate to the issuance of subscription receipts. Refer to the Group's discussion at its May 20, 2021, meeting, "IAS 7, IAS 32 and IAS 33: Issuer's Accounting for Subscription Receipts," for further details.

- Entities should exercise caution in classifying amounts associated with supplier finance arrangements in the statement of cash flows.[2] This is because, while payments to suppliers for goods or services are typically classified as operating activities, amounts payable to finance providers under these arrangements may be considered financing activities.

- Challenges may arise in classifying amounts received in association with government grants in the statement of cash flows. In determining the appropriate classification for these amounts, entities will need to consider whether the government grant has been received for an asset or to support operating activities, as well as the timing of when amounts are received.

- Judgment may need to be applied in determining whether amounts held in a margin account meet the definition of cash or cash equivalents in IAS 7. This is because certain amounts held in these accounts (e.g., the funding provided to maintain minimum required balances) may not be used to meet an entity's short-term cash commitments. A Group member noted that an Agenda Decision, "Classification of Cash Flows related to Variation Margin Calls on 'Collateralised-to-Market' Contracts," published in February 2025, summarized the IFRS Interpretations Committee's conclusion on this matter based on staff outreach.

- The aggregation and disaggregation requirements IFRS 18 introduced will apply to the statement of cash flows. As a result, entities will need to consider how these requirements may impact the statement of cash flows when IFRS 18 becomes effective.[3]

- Entities should consider implementing additional controls (e.g., using a completeness checklist) when preparing the statement of cash flows to ensure that cash flows are appropriately classified as operating, investing or financing activities.

Overall, the Group's discussion raised awareness of application issues related to the statement of cash flows. The Group also encouraged the AcSB to closely follow the IASB's project on Statement of Cash Flows and Related Matters.