Tips and common pitfalls in preparing and auditing cashflow statements

10 September 2024

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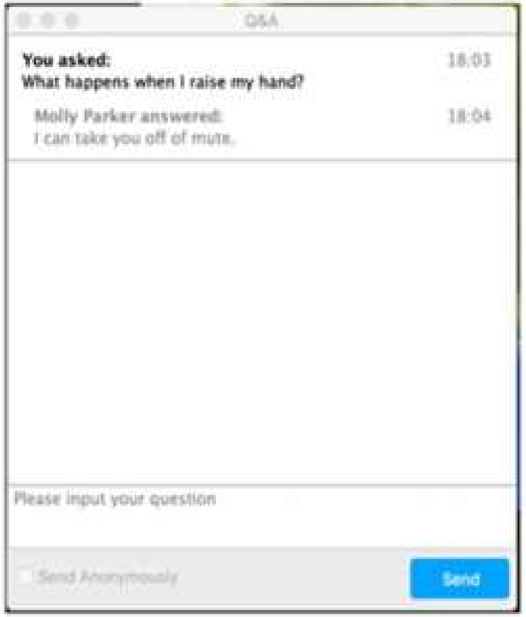

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Today's presenters

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Why focus on Cash Flows

- Cash flows are an area where regulators like the FRC repeatedly find errors
- Although the cash flow statement is a primary statement, the FRC finds that it does not always get the necessary amount of input from either preparers or auditors
- Recently FRC shared their findings in
  - a thematic review of cash flow and liquidity disclosures (2020),
  - a thematic briefing on the audit of cash flow statements (2021),
  - its annual audit firm specific reports for 2023 and previous years and
  - in other outputs.
- But cash flows continue to be an issue
- FRC has identified cash flow statements as an area of supervisory focus during its 2024/25 programme of audit quality inspections and corporate reporting reviews

1. Recurring messages
2. Accounting: overview and approach
3. Common errors in cashflow statement preparation
   a) Understanding the impact of foreign exchange in cashflow statements
4. Practical tips – planning and execution
5. Root causes of cash flow errors
6. Ways in which audit firms are addressing cash flow issues

01

Recurring messages

FRC – Recurring messages 1

- Amounts and descriptions of cash flows should be consistent with those reported elsewhere in the report and accounts;
- Classification of cash flows should be carefully assessed utilising the requirements and examples in the Standards (IAS 7 10-17, FRS 102 7.4-7.6);
- Non-cash investing and financing transactions should be excluded from the statement and disclosed elsewhere if material (non-cash operating transactions will normally be disclosed as adjustments in deriving cash flows from operating activities);
- Appropriateness of any netting of cash flows should be carefully considered (IAS 7 22-24, FRS 102 7.2);

FRC – Recurring messages 2

- The classification of amounts as cash equivalents should be carefully considered against the requirements of the Standards (IAS 7.7-9, FRS 102.7.10A-7.10E);
- Consider whether the investment is held for the purpose of meeting short-term cash commitments and whether it is ‘highly liquid’;
- Sufficient attention should be paid to the parent company cash flow statement;
- Appropriate disclosures should be made e.g. in relation to restrictions on cash and accounting policy choices which management has made with regard to classification of cash flows.

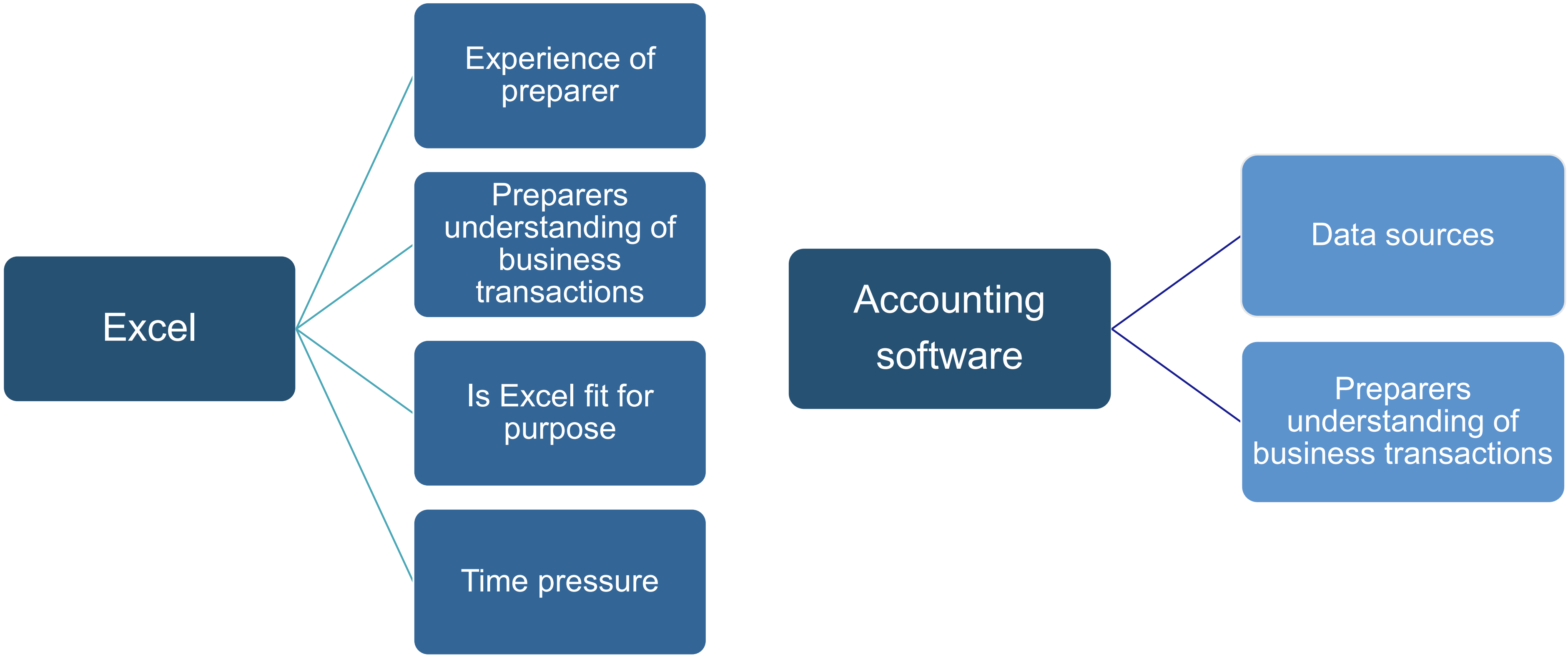
02

Accounting: Overview and approach

Cashflow statements
Overview

Considerations surrounding the preparation of the statement of cash flows (“SOCF”)

In practice different approaches are adopted when preparing the SOCF. Those approaches may result in different challenges:



Cashflow statements
Overview

Poll

How do you currently prepare your company SOCF for inclusion in the statutory financial statements?

- Through the accounting software which accurately produces a SOCF in accordance with accounting standards.
- Using a SOCF generated by the accounting software, and then making further manual adjustments.
- Outside the accounting software – for example in Excel.
- Other.
- I am not a preparer of SOCF.

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Cashflow statements
Approach

A refresher on approach to preparing a SOCF outside the accounting software

1. Obtain the opening and closing balance sheets and calculate the movement for the period.
2. On a line-by-line basis, analyse the movements in the year, identifying separately:

Cash outflow
e.g. repayment of a loan, or payment of interest

Cash inflows
e.g. drawdown on a loan

Non-cash elements
e.g. accrued and unpaid interest, imputed interest, foreign currency translation movements

3. Present within cash flows from financing and investing activities only actual cash movements (it should be possible to agree these amounts back to bank statements / cashbook). Non-cash movements within asset and liability balances will be adjusted for in the cash flows from operating activities section of the SOCF.
4. The items presented within cash flows from operating activities sum to a total cash outflow or inflow. Where the indirect method is applied, the elements in this section of the SOCF are individually often not cash movements.
5. When the SOCF is complete perform checks to other areas of the financial statements to which they are expected to agree.
6. Take a step back and sense check the SOCF. Do the cash flows make sense based on the preparer's understanding of the transactions in the period?

03

Accounting: Common errors in cashflow statement preparation

Cashflow statements
Common errors

Cash and cash equivalents

Incorrectly including in cash and cash equivalents:

- Overdrafts that are not an integral part of an entity's cash management.
- Cash pooling arrangements where cash swept cannot be accessed on demand.

Classification - consistency

Not consistently classifying items:

- Presenting interest on a loan within operating activities in year 1 and with financing activities in year 2.
- Classifying interest payments on lease liabilities as a financing cash flow while classifying interest on borrowings as operating cash flows.

Non-cash transactions

Incorrectly presenting non-cash items in investing and financing activities:

- Acquisition of a right-of use asset being presented as a cash outflow.
- Exchange of one liability for another under a refinancing arrangement being presented as a cash outflow.

Inappropriate netting off

- Offsetting intragroup borrowing and lending cash flows.
- Presenting opening to closing balance sheet movements as a single net amount, without analysing the movement.

Business combinations

- Incorrect classification of cash payments for the purchase of a business as an operating activity rather than investing.
- Failure to adjust the outflow on the disposal of a subsidiary for the subsidiary's cash disposed of.

Foreign currency exchange

- Not appropriately reflecting the impact of foreign exchange on foreign currency balances.
- Inappropriate treatment of foreign currency translation differences arising on translation to the presentational currency in a consolidated cash flow statement.

Cashflow statements
Delve into foreign currency exchange

Foreign currency cash flows

- Cash flows arising from transactions in a foreign currency are recorded in a company's functional currency by applying to the foreign currency amount the exchange rate at the date of the cash flow.

- It is permitted to use an exchange rate that approximates the actual rate. For example, a weighted average exchange rate for a period may be used for recording foreign currency transactions.

- Unrealised gains and losses arising from changes in exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents held in a foreign currency is reported in the statement of cash flows in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flows from operating, investing and financing activities.

Cashflow statements
Delve into foreign currency exchange

Foreign currency cash flows - example

Company X has a functional currency of £.

Company X holds all its cash in $.

On 31 August 202X Company bought PPE for $600k, which it paid for on 30 September 202X.

Company X had no other transactions.

Company X recognises the cash outflow on purchase of PPE at the exchange rate on the date the payment was made, and recognises a foreign exchange loss on the movement in the rate between 31 August 202X and 30 September 202X.

At the year-end Company X translates is $ cash balances using the closing rate.

Opening rate	1.5
31 August 202X rate	1.40
30 September 202X rate	1.35
Closing rate	1.3

Date	**Rate: $/£**	**Transaction**	**$**	**£**
31/08/2001	1.40	Acquisition of PPE	600,000	428,571
30/09/2001	1.35	Payment for PPE	600,000	444,444

Cashflow statements
Delve into foreign currency exchange

Foreign currency cash flows - example

Company X SOCF	**31 December 202X**		
	£		
Operating activities			
Foreign exchange	(15,873)	Being the foreign currency loss between the date of purchase of PPE and the date of payment	**$600,000/1.40 - $600,000/1.35**
Loss for year	(15,873)		
Adjusted for:			
Add back of foreign exchange	15,873		
Cash flow from operating activities	-		
Purchase of PPE	(444,444)	Being $600,000 translated at the rate on the date the payment was made	**$600,000/1.35**
Cash flow from investing activities	(444,444)		
Cash movement in the year	(444,444)		
Opening cash	1,000,000		
Impact of exchange rates on foreign currency cash	136,752		
Closing cash	692,308		

Reconciliation of cash				
	$	£		
Opening cash balance	1,500,000	1,000,000	Opening cash translated at opening rate	**$1,500,000/1.5**
Payment for PPE at the actual rate	(600,000)	(444,444)		**$600,000/1.35**
Effect of foreign currency:				
Translate opening cash to closing rate		153,846	Opening cash at the closing rate less the opening rate	**$1,500,000/1.3 - $1,500,000/1.5**
Translate movement in cash (on payment for PPE) to closing rate		(17,094)	Movement in cash at the closing rate less the average / actual rate	**$900,000 - $1,500,000/1.3 - $900,000 - $1,500,000/1.35**
Impact of exchange rates on foreign currency cash		136,752		
Closing balance	900,000	692,308	Closing cash translated at closing rate	**$900,000/1.3**

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Cashflow statements
Delve into foreign currency exchange

Overseas subsidiaries in the consolidated SOCF

- When preparing a consolidated SOCF, it is not unusual to see the SOCF prepared using a “top-down” approach, using the consolidated balance sheets as the basis for preparation.
- This approach is not compliant with IAS 7 (FRS 102 Section 7), which requires cash flows to be translated at the transaction date rate, or an approximation thereof, often the average rate.
- Subsidiary statements of cash flows should be prepared in the subsidiary’s functional currency and then translated to the presentational currency of the parent.
- Exchange differences arising on translation to the presentational currency are not cash flows and should be presented in the reconciliation from opening to closing cash in the consolidated SOCF.

Cashflow statements
Delve into foreign currency exchange

Overseas subsidiaries in the consolidated SOCF – example

Subsidiary S has a functional currency of $. Its's parent company P has a functional and presentational currency of £.

Opening rate	1.5
Average rate	1.4
Closing rate	1.3

Cash flow statement of S	$	£	
Cash inflows from operating activities	100,000	71,429	At average rate
Cash outflows from investing activities	(60,000)	(42,857)	At average rate
Cash outflow from financing activities	(10,000)	(7,143)	At average rate
Total cash flows	30,000	21,429	At average rate
Cash b/f	120,000	80,000	At opening rate
Effect of foreign currency - b/f cash		12,308	At closing rate less opening rate
Effect of foreign currency - cash movement in period		1,648	At closing rate less average rate
Cash c/f	150,000	115,385	

Cashflow statements
Delve into foreign currency exchange

Intercompany balances in the consolidated SOCF

- It is necessary to make adjustments in the consolidated statement of cash flows for intercompany balances between group companies that have different functional currencies.
- Assuming the balance is stated in the functional currency of one of the parties to the balance, that party will not be required retranslate the loan at the period end. The other party however will be required to retranslate the loan using the closing exchange rate and recognise a gain or loss through profit or loss.
- Subsidiary statements of cash flows should be prepared in the subsidiary’s functional currency and then translated to the presentational currency of the parent.
- Upon consolidation, to the extent that there is no cash flow as a result of the transaction, an adjustment is made to eliminate the non-cash movement in operating activities.

Cashflow statements
Delve into foreign currency exchange

Intercompany balances in the consolidated SOCF - example

Parent company P has an intercompany receivable from subsidiary company S of £200,000.

In the year end company balance sheets, the intercompany balances are stated as follows:

Opening rate	1.50
Average rate	1.40
Closing rate	1.30

Balance sheet of P	**Period 2**	**Period 1**	**Movement in Period 2**
	£	**£**	**£**
Intercompany receivable	200,000	200,000	-

Balance sheet of S	**Period 2**	**Period 1**	**Movement in Period 2**
	$	**$**	**$**
Intercompany payable	153,846	133,333	(20,513)

Cashflow statements
Delve into foreign currency exchange

Intercompany balances in the consolidated SOCF - example

S translates its functional currency SOCF to £ using the average rate. A consolidation entry is needed to eliminate the mismatch between the movement in the intercompany payable and the intercompany receivable. In this case the intercompany balance has not moved in the period, so there should be no cash flow impact in the consolidated SOCF.

Consolidated SOCF extract	SOCF of S $	SOCF of S At average rate £	SOCF of P £	Elimination entry £	Consolidated SOCF £
Loss before tax					
Add back foreign exchange loss	20,513	14,652	-	(14,652)	-
Movement in intercompany payable	(20,513)	(14,652)	-	14,652	-
Movement in intercompany receivable	-	-	-	-	-
Cashflows from operating activities	-	-	-	-	-

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04

Practical tips

Auditing the Cash Flow Statement
Practical tips – Planning

- Allocate audit of cash flow to suitably experienced and senior team member;
- Ensure team member responsible is properly briefed;
- Timetable the audit of cash flow statement;
- Agree with client that the cash flow will be ready at same time as the other primary statements;
- Identify and obtain an understanding of the purpose any one-off transaction(s) or non-standard arrangements in the period;
- Consider the impact of one-off transactions/non-standard arrangements on the cash flow;
- Discuss any one-off transactions or non-standard arrangements with component auditors;
- Identify where there are any foreign currency transactions or foreign subsidiaries;
- Don’t forget the audit of the parent company cash flow.

Auditing the Cash Flow Statement
Practical tips - Execution

- Whilst completing the work on each balance sheet area, consider how you expect the various elements of that area to be reflected in the cash flow statement and related disclosures
- Discuss with others on the audit team the financial statement areas they are working on and the cash or non-cash impacts relevant to the review of the cash flow statement
- When reading other information consider whether significant cash/non-cash transactions referred to are appropriately included/excluded from the cash flow and are appropriately disclosed in financial statements
- Use sources of accounting guidance when faced with complexities such as supplier finance arrangements, hedging instruments, derivatives, discontinued operations, sale and leasebacks;
- Consult with internal financial reporting experts or ICAEW helpline if further guidance is needed
- Ensure late changes to the financial statements are included in cash flow
- Stand back assessment – does this make sense, have I missed anything
- FRC notes that most of the errors it finds could have been avoided if the company had a robust pre-issuance review built into its financial statement close process.

05

Root causes of cashflow statement errors

Root causes of cash flow errors - Preparers

- Cash flow not considered as important as other primary statements
- Often delegated to a more junior member of the finance team
- Prepared in isolation of other areas of financial statement without an overview of cash and non-cash transactions
- Cash flow often left to the last minute with main focus on other primary statements
- Front end information not available when cash flow being prepared
- Internal consistency checks across the financial statements not picking up basic errors
- Use of spreadsheets and the manual nature of cash flow workings by companies increased the complexity of auditing the consolidated cash flow statement
- Lack of understanding of accounts preparation software packages

Root causes of cash flow errors - Auditors

- Cash flow not considered as important and other primary statements
- Audit of cash flow statement allocated to more junior member of team working in isolation without a proper overview of report and accounts
- Audit of cash flow not budgeted sufficient time
- Cash flow often received late and incomplete from client/preparer
- Internal consistency checks not properly performed causing basic errors to be missed
- Audit team not challenging management on the accounting policies applied and disclosures made affecting the cash flow statement
- Guidance available to the audit team to deal with technical and complex judgements not always sufficient or embedded through staff awareness, methods, and training
- Pre-issuance review process not robust enough
- No stand back review performed as part of review process

06

How audit firms are addressing cash flow issues

How audit firms are addressing cash flow issues

- Discussing the cash flow statement approach at planning/team meetings
- Assigning cash flow audit work to more senior members of the audit team
- Increasing the emphasis on audit evidence recorded
- Enhancing internal supervision and review of cash flow audit work
- Briefings and training for audit staff
- Changing audit templates/audit programmes to reinforce existing methodology or introduce new procedures
- Reporting to those charged with governance on capacity/capability of the finance team and controls/process recommendations

Questions?

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