Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Alert

Updates on financial reporting and auditing

Issue 12 (December 2010)

Dear members,

Statement of cash flows

A statement of cash flows is required as part of a complete set of HKFRS financial statements. This alert summarizes common issues noted from the reviews of published financial statements on presentation and reporting of statements of cash flows under HKAS 7 *Statement of Cash Flows*.

Overview of key principles of HKAS 7

The information delivered by a statement of cash flows depends on the items treated as "cash and cash equivalents". Non-cash transactions are excluded. Therefore it is essential to properly determine components of "cash and cash equivalents" in the first place.

Cash equivalents include short-term highly liquid investments (say three months or less from the date of acquisition) that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value. Equity investments are excluded from cash equivalents unless they are in substance cash equivalents e.g. preferred shares with short period of maturity and a definite redemption date.

Cash flows are classified by activities – operating, investing and financing. Operating activities are the principal revenue-generating activities of an entity and those 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. Financing activities are activities that result in changes to the entity's equity capital and borrowing structure. An entity presents its cash flows under these three kinds of activities in a manner that is most appropriate to its business.

An entity can choose to report cash flows from operating activities using either the direct method, i.e. to show gross receipts and payments, or the indirect method, i.e. to adjust profit or loss the effects of non-cash items, changes in working capital and items that are classifies as investing and financing activities.

Cash flows from investing and financing activities are required to be reported on a gross basis with limited exceptions.

Examples of non-cash investing or financing activities that are required to exclude from statement of cash flows are acquisition of assets either by assuming directly related liabilities or by means of a finance lease and the conversion of debt to equity. Such transactions are required to be disclosed separately in the financial statements in a way that provides all the relevant information.

Common observations on presentation and reporting of statement of cash flows

- The accounting policy for determining the composition of cash and cash equivalents was not disclosed.
- Bank overdrafts and other investments were included in statement of cash flows as a component of cash and cash equivalents. However, the reconciliation of cash and cash equivalents in the statement of cash flows with the equivalent item reported in the statement of financial position was not presented.
- Pledged bank deposits with maturities over three months were included in cash and cash equivalents. Members are reminded that "cash equivalents" are held for the purpose of meeting short-term cash commitments. Pledged deposits or other investments do not meet the definition of a cash equivalent when it has a maturity of three months or more from the date of acquisition or have restrictions in use.
- When securities and loans are held for dealing or trading purposes, e.g. financial assets at fair value through profit or loss classified as held for trading, the relevant cash flows from purchases and sales are required to be classified as operating activities. We often see these were inappropriately classified as investing activities.
- Financing or investing cash flows (e.g. bank borrowings, advances to or from related companies) were reported on a net basis and not gross although they had not met the limited exemptions permitted by the standard. Members are recommended to refer to HKAS 7 paragraphs 22 to 24 for further guidance.
- Inconsistent classification of interest and dividends received and paid was noted in current and prior years. An entity may classify these cash flows in a manner that is most appropriate to its business and this often requires judgment. However the classification shall be applied consistently.
- Deferred consideration in relation to acquisitions of subsidiaries that was paid in the following year was inappropriately classified in operating activities. Members are reminded that aggregate cash flows arising from obtaining or losing control of subsidiaries or other businesses shall be presented separately and classified as investing activities. Consistent with the requirements of revised HKAS 27, HKAS 7 was amended to require that cash flows arising from changes in ownership interests in a subsidiary that do <u>not</u> result in a loss of control are classified as financing activities because such changes in ownership interests are accounted for as equity transactions.

Improvements to HKFRSs

Members are reminded that:

- only expenditures that result in a recognized asset in the statement of financial position are eligible for classification as investing activities; and
- cash payments to manufacture or acquire assets held for rental and subsequently held for sale are cash flows from operating activities. Cash flows from rental payments and subsequent sales of these assets are also classified as operating.

Sincere regards,

Chris Joy
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Hong Kong Institute of Certified Public Accountants
CPA: *The Success Ingredient*