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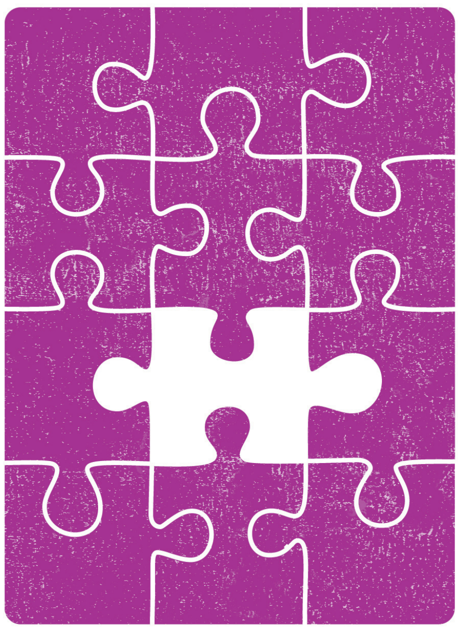
MFRS Hot Topics

Cash flow statements – common pitfalls and application issues

Part III - Presentation issues

NOVEMBER 2015

Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This is a series of issues that provide guidance on the practical application issues of MFRS 107 Statement of Cash Flows.



Introduction

There are a number of presentation issues that have created differences in the practical application of MFRS 107.

The Part III of this series of Hot Topics will highlight the more common issues and provide some reminders of how to address them. In some areas, an entity can choose the most appropriate method of presentation, which should then be applied consistently each period.

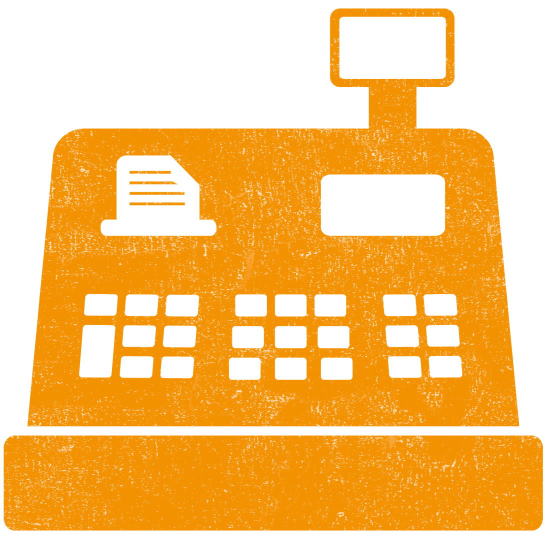
Part I	**Definition of cash and cash equivalents (August 2015 issue)**
Part II	**Classification of cash flow by activity (September 2015 issue)**
Part III	**Presentation issues**
Part IV	**Foreign currency exchange differences**
Part V	**Cash flows relating to business combinations and disposals**

Presentation issues

Cash flows from operating activities can be presented using either:

- the direct method (MFRS107.18(a)) – each major class of gross cash receipts and gross cash payments is disclosed separately, such as cash receipts from the sale of goods or services; cash payments to suppliers and cash payments to and on behalf of employees

- the indirect method (MFRS107.18(b)) – profit or loss is adjusted for items relating to investing and financing activities and for the effects of non- cash transactions, such as changes in inventories and operating receivables and payables; depreciation and amortisation; movements in provisions; deferred taxes and unrealised foreign currency gains and losses.



Gross cash flows

Major classes of investing and financing cash receipts and payments should be presented gross on the face of the statement of cash flows (MFRS107.21). Similarly, when using the direct method, major classes of operating cash receipts and payments are also presented gross (MFRS107.18). There are limited exceptions to this gross presentation where inflows and outflows can be offset and presented net (MFRS107.22). For non-financial institutions, cash receipts and payments made on behalf of customers, where these reflect the activities of the customer, can be presented net. For example, where an entity is acting as agent, cash flows should only reflect the commission received by the agent. There may also be some limited circumstances where the turnover of transactions is quick, the amounts are large and the maturities are short. For example, an entity may have a portfolio of investments that it actively manages with frequent sales and purchases.

For financial institutions, there are additional exceptions to the gross presentation requirements, allowing many transactions with customers such as making loans and collecting repayments, to be presented net (MFRS107.24).

Example – net cash flows

Entity A is a travel agent that provides travel services to its customers. Customers pay the entity and entity A then remits the cash to the travel service providers, after deducting the related agency commissions. The suppliers are responsible for providing services direct to customers and for settling any claims from customers. Entity A presents as revenue the net commissions earned in accordance with MFRS 118 Revenue.

Analysis

If the direct method of presenting operating cash flows is used, entity A will present cash receipts from customers and cash payments to suppliers on a net basis. This reflects the substance of the transactions with customers and suppliers, consistently with the statement of comprehensive income presentation of net revenue. If the indirect method of presenting operating cash flows is used, this net presentation is automatically reflected.

Starting point for the indirect method

Using the indirect method, an entity determines its cash flows from operating activities by adjusting profit or loss for various items (MFRS107.18(b)). This raises the question as to which profit or loss figure should be used. The illustrative example in Appendix A to MFRS107 starts with 'profit before tax' and so may be considered the preferred treatment but others are acceptable. Alternatives commonly seen in practice are:

- start with operating profit (this term is not defined in MFRS and so management judgement is needed to identify an appropriate sub-total for this item)
- start with the final profit or loss figure at the foot of the income statement (or the sub-total used immediately before the section presenting other comprehensive income if a single statement format is used).

MFRS 5 Non-current Assets Held for Sale and Discontinued Operations requires the results of any discontinued operation to be presented separately from those of continuing operations on the face of the statement of comprehensive income. Consequently, the 'profit before tax' figure relates only to continuing operations and so will need to be adjusted for relevant operating cash flows relating to the discontinued operation if profit before tax is used as the starting point in the statement of cash flows. If the entity chooses to use the 'bottom line' profit or loss for the period amount, then this will include both continuing and discontinued operations and so no adjustment is needed.

In either case, the taxation paid figure should include the total from both continuing and discontinued operations.

Reconciliation of cash and cash equivalent balances

MFRS107 requires that the components making up the total opening and closing balances of cash and cash equivalents in the statement of cash flows should be disclosed. These totals should be reconciled to the appropriate line items in the statement of financial position (MFRS107.45). For example, some term deposits or restricted cash deposits may be included in the line item 'cash at bank' in the statement of financial position, but are excluded from the balance of cash and cash equivalents (see 'Definition of cash and cash equivalents' in Part I).

Where the reporting entity holds foreign currency cash and cash equivalent balances, these are monetary items that will be retranslated at the reporting date in accordance with MFRS 121 The Effects of Changes in Foreign Exchange Rates. Any exchange differences arising on retranslation will increase or decrease these balances but do not give rise to cash flows. The effect of these exchange differences is presented at the foot of the statement of cash flows in order to reconcile cash and cash equivalents at the beginning and end of the period (MFRS107.28).

Example – foreign exchange differences
Extract from statement of cash flows

	20X1	**20X0**
	CU000	**CU000**
Net change in cash and cash equivalents	23,469	1,165
Cash and cash equivalents, beginning of year	11,259	10,029
Exchange differences on cash and cash equivalents	61	43
Cash and cash equivalents, end of year	34,789	11,237

Extract from notes to the financial statements - Cash and cash equivalents

Cash and cash equivalents consist of the following:	**20X1**	**20X0**
Cash at bank and in hand:	**CU000**	**CU000**
CU	24,352	7,867
GBP	2,087	674
USD	1,392	449
Short-term deposits (CU)	6,958	2,247
	34,789	11,237

Non-cash transactions

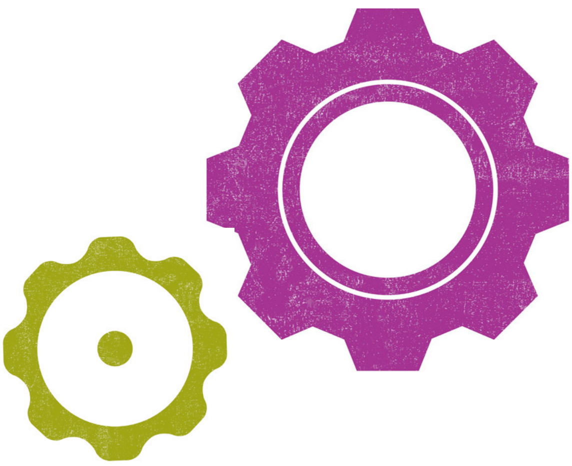
MFRS107.43 requires that investing and financing transactions that do not involve an inflow or outflow of cash or cash equivalents are excluded from the statement of cash flows. Examples of such transactions include the issuance of shares in exchange for shares in another entity and the acquisition of property, plant or equipment under a finance lease.

Such transactions require specific disclosure to give the user of the financial statements relevant information about the transaction. For example, when equipment is acquired under a finance lease, it is necessary to eliminate this item from the total amount of tangible asset additions to identify the appropriate investing cash outflow. The non-cash transaction note can be used to reconcile the tangible asset additions figure, distinguishing cash additions from leased additions. Similarly, the creation of the finance lease liability does not involve any cash inflow so again the non-cash transaction note can be used to reconcile the movement in the liability. Any payments of principal are reported as financing cash outflows (MFRS107.17(e)), with any interest element reported as financing or operating, depending on the entity's accounting policy.

Example – non-cash transactions
Entity B is a manufacturing company. It obtains a new machine to use within its manufacturing plant under a 5-year finance lease agreement. Entity B recognises the machine within property, plant and equipment at an amount of CU400,000 and recognises a finance lease liability for CU400,000. By the end of the reporting period, B has paid scheduled repayments of CU35,000, of which CU2,900 was recognised as a finance cost in profit or loss. Entity B has a policy of recognising interest paid within financing activities.

Analysis
The addition to property, plant and equipment of CU400,000 will be shown as a non-cash transaction in the notes to the financial statements (MFRS107.43) because there is no immediate cash flow involved at the inception of the lease. The creation of the CU400,000 lease liability is not shown as a financing inflow but is instead disclosed in the non-cash transactions note.

The CU2,900 interest element of the lease rentals is included in the total of interest paid within financing activities in accordance with the entity's accounting policy and the CU32,100 (CU35,000 – CU2,900) capital element of the lease rentals paid will be classified as a financing outflow in accordance with MFRS107.17(e).



Central banking function

In some cases, the reporting entity may have no cash in its own name. For example, the cash operations of a subsidiary may be administered by the parent company which effectively acts as a bank. All suppliers and employees are paid by the parent company and receipts from customers are received into the parent company's bank account. As the subsidiary has no direct cash transactions, a question arises as to whether a statement of cash flows is required.

MFRS107.43 requires an entity to disclose its non-cash investing and financing transactions, suggesting that the subsidiary's transactions that are channelled through the parent should be disclosed. This does not, however, explicitly require disclosure of non-cash transactions relating to operating activities. On this basis, some may argue that there is no need to provide any such disclosure for a subsidiary that has no bank account. In our view, however, this view is hard to reconcile with MFRS107's overall objectives. The fact that they channel these cash flows through another entity for administrative purposes should not detract from the need to present relevant information to users of the financial statements. In such situations, the subsidiary is effectively using the parent entity as its 'bank' and the intra-group account is, in substance, the subsidiary's 'bank account'. In our view, the cash flow information described above is best presented as a primary statement of cash flows, clearly annotated to confirm that all cash flows are directed through another entity and by recognising a zero balance in cash and cash equivalents at the beginning and end of the reporting period. The net impact of these centrally managed cash flows will be reflected in the intercompany balances between the parent and subsidiary. The net movement should be shown as an investing or financing activity as appropriate. This approach is consistent with the requirements in MFRS107 that all entities should prepare a statement of cash flows that forms an integral part of the financial statements.

Disclosure of total interest paid

MFRS107.31 requires that cash flows arising from interest and dividends received and paid be classified separately under the activity appropriate to their nature. In addition, MFRS107.32 requires that the total amount of interest paid during a period be disclosed in the statement of cash flows. The amount included in this total includes all interest paid in the period, irrespective of whether it has been recognised as an expense in profit or loss or capitalised in accordance with MFRS 123. If all interest paid falls to be classified under a single activity, our preferred view is to show the total under the appropriate heading on the face of the statement of cash flows but presentation in a note to the financial statements is also acceptable. Some entities disclose this information immediately after the statement of cash flows.

Example - Capitalised interest

As in a previous example, entity A constructs a machine (that is a qualifying asset under MFRS 123) and pays construction expenses of CU1,000, which includes CU50 of capitalised interest. The entity paid CU120 interest in the year, including the amount capitalised.

Analysis

Entity A has an accounting policy choice relating to the classification of capitalised interest:

- recognise CU950 as an investing cash flow and CU120 as financing. In this case, the inclusion of a separate line item 'interest paid CU120' in financing activities is sufficient to satisfy the MFRS107.32 disclosure requirement
- recognise CU1,000 as an investing cash flow and CU70 as financing. If this option is selected, entity A would also need to disclose the total amount of CU120 interest paid, either at the foot of the statement of cash flows or in a note to the financial statements.

Next: Part IV   Foreign currency exchange differences...

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KUALA LUMPUR

Level 11, Sheraton Imperial Court
Jalan Sultan Ismail
50774 Kuala Lumpur

T +603 2692 4022
F +603 2721 5229
E info@my.gt.com

PENANG

51-8-A,
Menara BHL Bank
Jalan Sultan Ahmad Shah
10500 Penang

T +604 228 7828
F +604 227 9828

KUANTAN

A-105A, 1st Floor
Sri Dagangan, Jalan Tun Ismail
25000 Kuantan
Pahang

T +609 515 6124
F +609 515 6126

JOHOR BAHRU

Unit 29-08, Level 29
Menara Landmark
12 Jalan Ngee Heng
80000 Johor Bahru, Johor

T +607 223 11848
F +607 224 9848

www.grantthornton.com.my