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MFRS Hot Topics

Cash flow statements – common pitfalls and application issues

Part II - Classification of cash flow by activity

OCTOBER 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

Applying MFRS 107 Statement of Cash Flows gives rise to a number of interpretive and application issues. Increasingly, regulators and other commentators on financial statements are highlighting errors or inconsistencies in application of the standard.

The Part II of this series of Hot Topics aims to provide guidance on Classification of cash flow by activities, namely operating, investing and financing activities.

Part I	**Definition of cash and cash equivalents (August 2015 issue)**
Part II	**Classification of cash flow by activity**
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Classification of cash flow by activity

General

MFRS 107 requires entities to classify and report cash flows according to the activity which gave rise to them. There are three activity classes:

1. Operating activities are the principal revenue - producing activities of the entity and other activities that are not investing or financing activities
2. Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents
3. Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

This classification by activities is designed to provide useful information about the relative importance of these activities and the inter-relationships between them to help users of the financial statements to assess the liquidity and financial adaptability of the entity. The wording of the definitions means that operating activities is the 'default' category for all cash flows that do not meet the definition of either investing or financing.

MFRS 107 provides some examples of the cash flows expected to be classified under these headings but the limited guidance provided allows some discretion and leaves a number of questions unanswered. The following guidance is designed to highlight some of the more problematic or unclear areas but is not intended to be comprehensive. The actual classification in practice must reflect the nature of the activities of the entity and so some cash flows that may look similar may be classified differently because the nature and purpose of the business is different; for example dividends received by a venture capital company are likely to be classified as operating but a manufacturing entity is more likely to classify such income as investing.

Interest and dividends

MFRS 107.31-34 allow some flexibility in the classification of cash flows from interest and dividends received and paid. Each category is however classified in a consistent manner from period to period as either operating, investing or financing activities, depending on the nature of the entity's activities.

Interest paid and interest and dividends received are usually classified as operating cash flows for a financial institution because of the nature of the entity's business. For other entities, an accounting policy choice needs to be made. Commonly, interest paid is classified as financing because it is a cost of obtaining finance. Similarly, interest and dividends received are classified as investing because they represent returns on investments.

Alternatively, MFRS 107.33 permits interest paid and interest and dividends received to be classified as operating cash flows "because they enter into the determination of profit or loss" (MFRS 107.33).

Dividends paid are classified as financing because they are a cost of obtaining financial resources. Alternatively, they may be classified as operating to indicate the ability of the entity to pay dividends out of operating cash flows.

Example – Interest received

Entity C is a furniture retailer. It offers customers two years extended credit for sales over CU1,000. During the year, it recorded revenue for these sales of CU980,000 plus finance income of CU65,000 and received cash relating to these sales of CU360,000, of which CU40,000 related to interest.

Analysis

Entity has an accounting policy choice to classify interest received as an operating cash flow, as permitted by MFRS 107.33, or as an investing cash flow on the grounds that it is a return on an investment. In this example, the interest income is primarily derived from the entity's principal revenue-generating activity (the sale of furniture) and so entity C is more likely to classify the interest income within operating cash flows, but this is not mandatory.

In practice, a single cash flow may include both an interest element and a repayment of capital. In such cases, the two elements may need to be disaggregated if they are classified differently. Even if the two elements are included in the same category, interest paid needs to be disclosed separately.

MFRS 123 Borrowing Costs requires some amounts of interest expense to be capitalised into the cost of qualifying assets in certain circumstances. MFRS 107.32 and 33 seem to require that interest paid be classified as either an operating or a financing cash flow. This seems inconsistent with MFRS 107.16, which might be interpreted to require that capitalised interest paid should be classified as an investing cash flow as it is part of the amount recognised for the related asset in the statement of financial position. MFRS 107 does not currently deal explicitly with capitalised interest and so judgement is required to select which category to use. The classification selected should be applied consistently.

Example - Capitalised interest

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. Entity A normally classifies interest paid as a financing cash flow.

Analysis

Entity A has an accounting policy choice:

- recognise CU950 as an investing cash flow and CU120 as financing
- recognise CU1,000 as an investing cash flow and CU70 as financing. In addition, the total amount of CU120 interest paid is disclosed in a note.

Short-term loans to related parties

An entity may provide a loan or advance to another group entity or other related party, sometimes on a short-term basis, with or without charging interest. The short-term nature of such advances does not automatically result in classification as an operating activity. Unless making cash advances to other entities is part of the normal operating activities of the entity (eg. trade receivables or payables), such cash flows would normally be classified as investing.

Expenditure on internally generated intangibles

MFRS 107.16 requires that only expenditure that results in a recognised asset in the statement of financial position is eligible for classification as investing activities. To illustrate two applications of this requirement:

- expenditure relating to internally generated intangible assets is recognised in investing cash flows only if the capitalisation criteria in Paragraph 57 of MFRS 138 Intangible Assets are met
- in the extractive industries, expenditure on exploration or evaluation activities is included as investing only if these costs are capitalised in accordance with MFRS 6 Exploration for and Evaluation of Mineral Resources.

Expenditure that is expensed to profit or loss as incurred, such as research costs or training expenses, is recognised in operating cash flow activities.

Cash flows relating to assets held for rental to others

For entities that routinely rent out assets to others in the ordinary course of business, cash flows associated with the rental assets are classified within operating activities (MFRS 107.14). This includes cash payments to acquire or manufacture such assets and cash receipts from rents and the subsequent sales of the assets. This contrasts to the usual investing activity classification of cash payments made to acquire or manufacture property, plant and equipment for own use and cash receipts from the sale of such assets.

Cash flows relating to a business combination

A number of cash flow statement issues arise in relation to business combinations, including classification of different types of consideration paid. Generally, this is expected to be an investing activity because MFRS 107.39 requires that aggregate cash flows arising from obtaining or losing control of a subsidiary are presented separately within investing activities. However, in more complex scenarios the guidance in MFRS 107 is not always clear. This and other issues related to the acquisition and disposal of subsidiaries are considered in the following series of this Hot Topics.

Tax cash flows

It is usually possible to identify tax expense/income with the related transaction or event in order to recognise the tax amount in profit or loss, other comprehensive income or equity in accordance with Paragraph 57 to 68c of MFRS 112 Income Taxes. Similarly, when it is practicable to identify a tax cash flow with an individual transaction that is classified as investing or financing, the tax cash flow is also classified as investing or financing in accordance with the underlying transaction. However, MFRS 107 notes that it is often impracticable to identify tax cash flows with individual transactions. Also, tax cash flows often arise in a different period from the cash flows of the underlying transactions. Accordingly, taxes paid should generally be classified as operating cash flows (MFRS 107.35-36).

Total cash flows arising from taxes should be separately disclosed, either on the face of the statement or in the notes.

Next: Part III Presentation Issues..

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