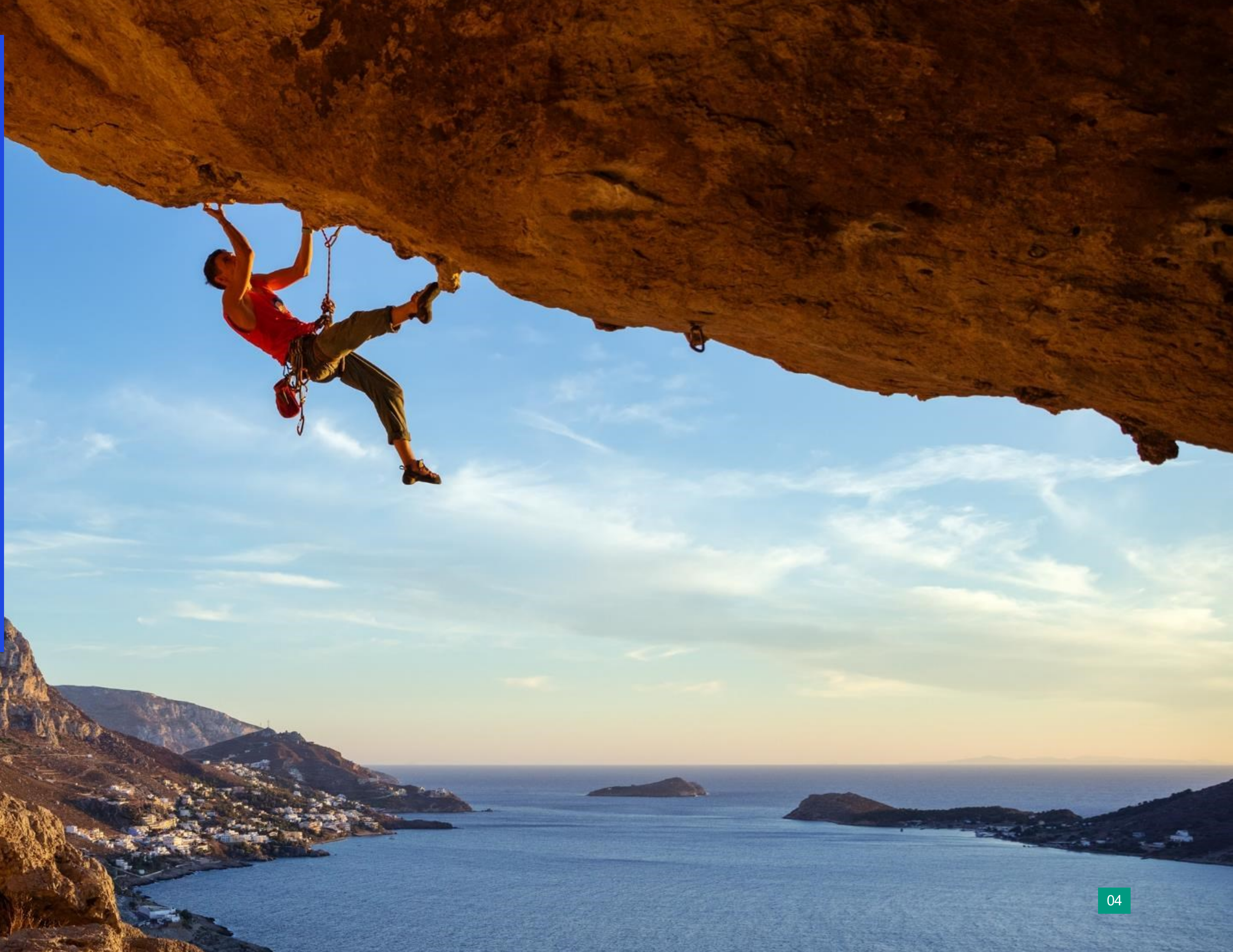
CHAPTER 1

Key accounting and financial reporting issues- statement of cash flows



Background

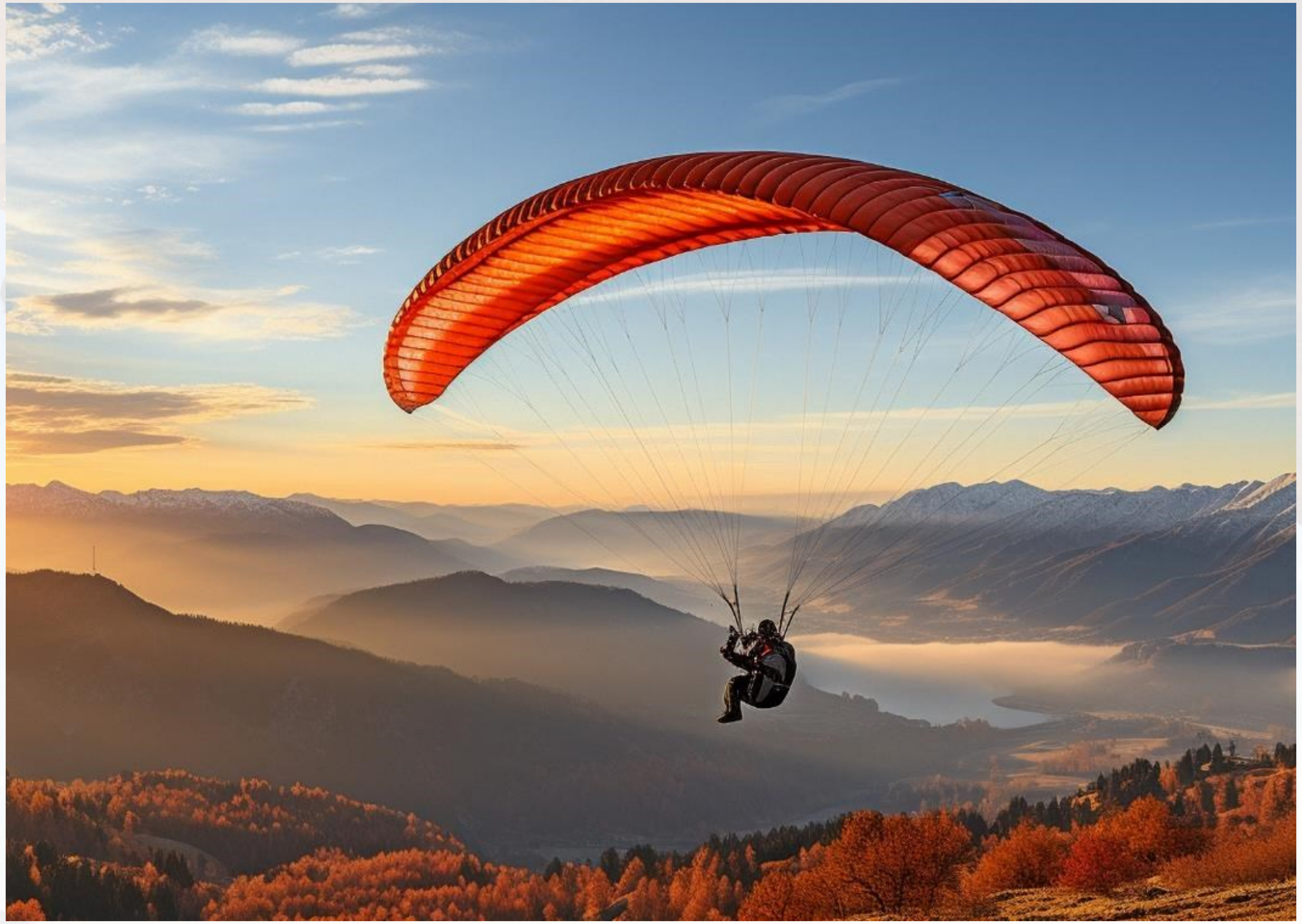
Information about cash flows of an entity is useful in providing users of financial statements with a basis to assess a company's financial strength, ability to generate cash and cash equivalents and the need of the entity to utilise those cash flows. This not only helps a company in its budgeting matters, but also assists users of financial statements to make investment decisions (for investors)/lending decisions (for lenders).

Ind AS 7, *Statement of Cash Flows* prescribes certain disclosure requirements for an effective review of operating, investing, and financing activities of a company. However, regulators have observed discrepancies in application of certain requirements. Accordingly, in this issue of key accounting and financial reporting issues, we will touch upon some of the key areas that regulators have highlighted and provided improvement points in the area of statement of cash flows. We have also provided illustrations of disclosures from thematic reviews performed by the Financial Reporting Council (FRC) and illustrative disclosures issued by KPMG in India in 2023.

Source

While preparing this article, we have referred to:

- The recent observations of the National Financial Reporting Authority (NFRA),
- The Report on Audit Quality Review issued by the Quality Review Board issued in October 2023,
- The Ind AS observations of the Financial Reporting Review Board (FRRB) of the Institute of Chartered Accountants of India (ICAI),
- Recent report of ICAI- 'Commonly found Errors in Reporting Practices' issued in January, 2024
- The report- Annual Review of Corporate Reporting (2022/23) issued by the Financial Reporting Council, and
- Recent ESMA[1] enforcement directions.



1. European Securities and Markets Authority.

Key issues and recommendations pertaining to statement of cash flows

Some of the key issues and recommendations pertaining to statement of cash flows is given below:

Accounting policy and components of cash and cash equivalent:

- **Accounting policy:** Ind AS 1, *Presentation of Financial Statements*, requires the disclosure of material accounting policies[2]. Ind AS 1 also requires disclosure of judgements apart from those involving estimations that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Ind AS 7 does not contain detailed guidance on classification of many types of transactions. Given the range, complexity and size of transactions companies undertake, judgement will often be required, on classification of certain transactions in operating, investing, or financing activities. For example, a description of where contingent consideration is presented within the statement of cash flows.

Example disclosure

Acquisition related arrangements

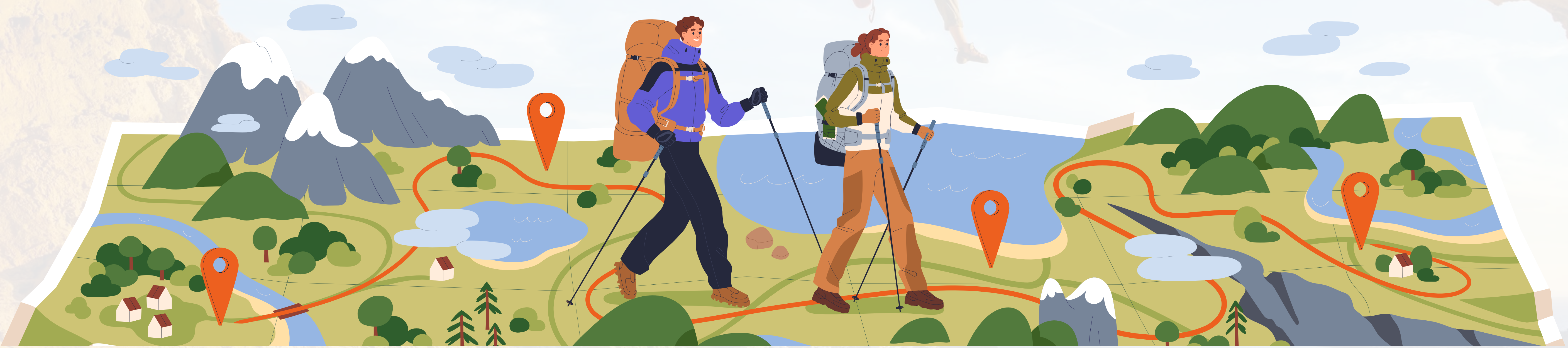
The cash payments are reflected in the statement of cash flows partly in operating cash flows and partly within investing activities. The tax relief on these payments is reflected in the Group's Adjusting items as part of the tax charge. The part of each payment relating to the original estimate of the fair value of the contingent consideration on the acquisition of the XXX Healthcare joint venture in 2012 of £659 million is reported within investing activities in the statement of cash flows and the part of each payment relating to the increase in the liability since the acquisition is reported within operating cash flows.

(Source: Thematic review: Cash flow and liquidity disclosures, issued by the Financial Reporting Council in November 2020)

2. With effect from 1 April 2023, Ind AS 1 requires the disclosure of material accounting policies.

- **Components of cash and cash equivalent:** An accounting policy should provide details of what constitutes cash and cash equivalents for the purpose of the statement of cash flows. For example, Ind AS 7 considers bank overdrafts which are repayable on demand to be an integral part of the entity's cash management system, accordingly these are included as a component of cash and cash equivalents for the purpose of the statement of cash flows. However, for the purpose of presentation in the balance sheet, the guidance note on Schedule III (Division II) requires bank overdraft to be disclosed as borrowings (and not part of cash and cash equivalent[3]).

  Similarly, a description of the terms of deposits, such as maturity, break clauses and interest rates, amounts of restricted cash and nature of restriction, etc. should be disclosed.



3. Unless the bank overdraft meets the offsetting conditions prescribed by Ind AS 32, Financial Instruments: Presentation

Example disclosure of reconciliation of cash and cash equivalents and restrictions in use

Cash and cash equivalents

in lakh of INR		**3/31/2023**	3/31/2022
Balances with bank	*On current account* (Refer Note 1)	**50**	988
	Deposits with original maturity of less than three months (Refer Note 2)	**1,112**	511
Cheques, drafts on hand		**102**	-
Cash on hand		**25**	20
Cash and cash equivalent in the balance sheet		**1,289**	**1,519**
Bank overdrafts repayable on demand and used for cash management purposes		**(334)**	(282)
Cash and cash equivalent in the statement of cash flows		**955**	1,2936

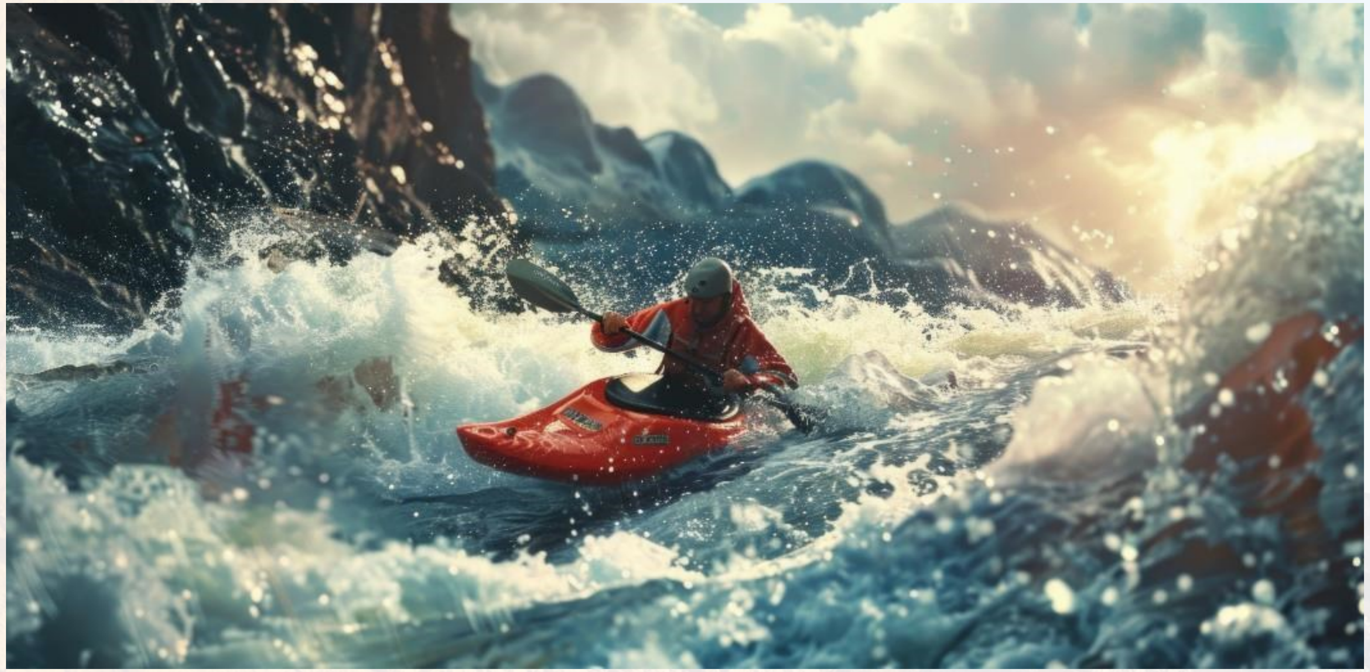
Note 1: Bank balance includes INR7 lakh (31 March 2022: INR7 lakh) held in foreign country which are not freely remissible because of exchange restrictions.

Note 2: An amount of INR300 lakh included in demand deposits is subject to restrictions imposed by certain customers. While the amount can be withdrawn at any time from the bank without penalty, the agreements with the customers require the Group to keep an aggregate amount of INR300 lakh in a demand deposit account and to use it only for the purpose of meeting warranty claims arising in the next 12 months.

(Source: Illustrative Ind AS consolidated financial statements issued by KPMG in India in March 2023)

Disclosure of cash flows from investing activities:

As per Ind AS 7, only expenditure that results in a recognised asset in the balance sheet is eligible for classification as investing activities. Accordingly, cash flows that do not result in a recognised asset within investing activities, such as acquisition expenses in a business combination or settlement of provisions should not form part of cash flows from investing activities.



Clarifications pertaining disclosure of specific transactions:

Some clarifications and best disclosures pertaining to cash flows from specific transactions are given below:

- **Material differences in amounts included in cash flows from amounts in notes:** Cash flows from investing activities should agree with the amounts presented in the notes to the financial statements (in such a case a reference to the note agreeing with amount presented in statement of cash flow should be provided). Where there are material differences, regulators have recommended to provide an explanation for the same (this may be done through a reconciliation).

Example disclosure of reconciliation between cash flows and notes

Cash flows from investing activities

Additions to property, plant equipment*	**(138.8)**	(128.6)
Movement in capital accounts	**2.4**	5.4
Payments to acquire property, plant and equipment	**(136.4)**	(123.2)

* This amount is as per the balance sheet notes

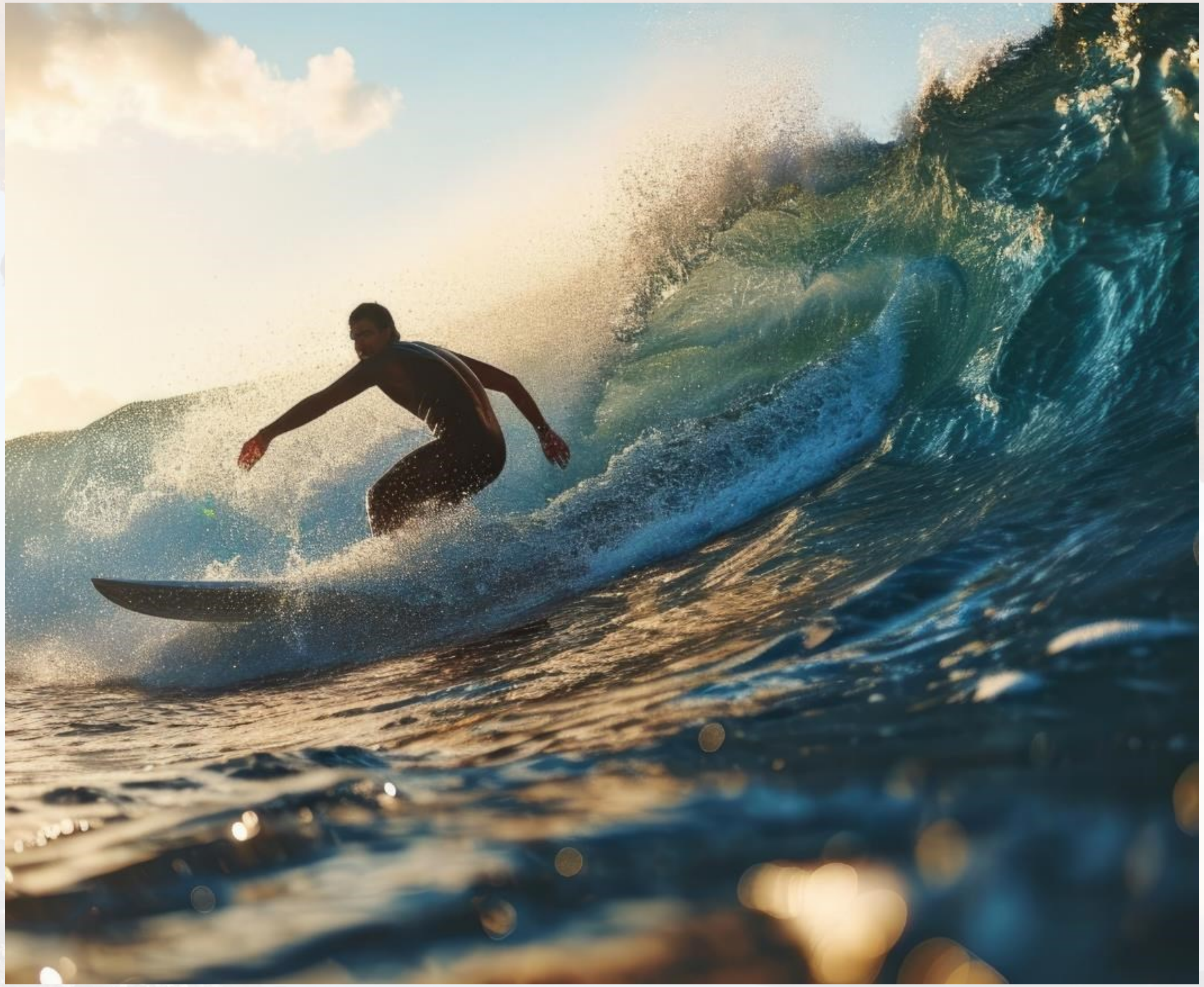
(Source: KPMG in India's analysis, 2024 read with 'Thematic review: Cash flow and liquidity disclosures', issued by the Financial Reporting Council in November 2020)

- **Acquisition and disposal of subsidiaries:** As per Ind AS 7, aggregate cash flows arising from obtaining or losing control of subsidiaries or other businesses should be presented separately and classified as investing activities. Where the impact of acquiring or disposing of a subsidiary or business is material, it is expected by regulators that the notes provide a breakdown of the impact on the statement of cash flow. A reference to such notes should be provided.

  The aggregate net cash flows from obtaining or losing control of subsidiaries and other businesses are presented separately as a single line item as part of investing activities, which includes the consideration paid by cash and cash equivalents, less any cash and cash equivalents held by the subsidiary at the time of acquisition. Separate cash outflows and inflows for the various net assets and liabilities acquired are not given.

  A subsequent purchase of an additional interest or a sale by a parent of a subsidiary's equity instruments that does not result in a loss of control is classified as cash flows from financing activities because such changes in ownership interests are accounted for as transactions with equity holders.

  Non-cash investing or financing transactions - e.g. shares issued as consideration in a business combination, or acquisition of assets via a lease - are not included in the statement of cash flows, but are disclosed to provide relevant information about investing and financing activities.



- **Deferred or contingent consideration:** Ind AS 7 does not contain detailed guidance on the classification of deferred and contingent consideration judgement would be required for presentation of cash outflows, considering the nature of the activity to which the cash outflow relates.
  - To the extent that the amount paid reflects the finance expense, classification consistent with interest paid may be appropriate,
  - To the extent that the amount paid reflects the settlement of the fair value of the consideration recognised on initial recognition, judgement would be required for classification of the cash outflow as investing activity or as financing activity.
- **Cash flows from discontinued operations:** Ind AS 105, *Non-current Assets Held for Sale and Discontinued Operations* requires disclosure of the net cash flows attributable to the operating, investing, and financing activities of discontinued operations. These disclosures may be presented either in the notes or in the financial statements. Ind AS 7 does not prescribe specific disclosures for cash flows from discontinued operations. Accordingly, there are a range of acceptable approaches, including:
  - Presenting cash flows from discontinued operations by category in the notes to the financial statements
  - Presenting cash flows from discontinued operations by category on the face of the statement of cash flow; and
  - Presenting cash flows from discontinued operations as a separate column within the statement of cash flow.

Example disclosure of cash flows from discontinued operations as a separate note

In August 2022, the Group sold its entire Packaging segment (see Note 5). Management committed to a plan to sell this segment early in 2022-23, following a strategic decision to place greater focus on the Group's key competencies – i.e. the manufacture of paper used in the printing industry, forestry and the manufacture of timber products.

A. Cash flows from (used in) discontinued operations

In lakh of INR	Note	**Year ended 31 March 2023**	Year ended 31 March 2022
Net cash used in operating activities		(225)	(910)
Net cash from investing activities	B	10,890	-
Net cash flows for the year		10,665	(910)

B. Effect of disposal on the financial position of the Group

In lakh of INR	Note	**Year ended 31 March 2023**
Property, plant and equipment		(7,986)
Inventories	B	(134)
Trade receivables		(3,955)
Cash and cash equivalents		(110)
Deferred tax liabilities	17(E)	110
Trade payables		1,921
Assets net of liabilities		**(10,154)**
Consideration received, satisfied in cash		11,000
Cash and cash equivalents disposed of		(110)
Net cash inflows#		**10,890**

This amount appears in the statement of cash flows as 'Disposal of discontinued operation, net of cash and cash equivalents disposed of' within investing activities

(Source: Illustrative Ind AS consolidated financial statements issued by KPMG in India in March 2023)

- **Cash flows from receipt of government grants:** Ind AS 7 does not provide any specific guidance on classification of cash flows from the receipt of government grants. Cash flows should be classified based on the nature of the activity to which they relate. For example, an entity may classify cash flows related to asset-related grants as investing activities and those related to income-related grants as operating activities because this reflects the nature of the related activities.
- **Cash flows related to capitalised interest:** Entities should ensure that total amount of interest paid is disclosed in the statement of cash flows, regardless of whether the related expense has been recognised in profit or loss or capitalised as borrowing costs. They should choose an accounting policy, to be applied consistently, to classify cash flows related to capitalised interest as follows:
  - As investing activities if the other cash payments to acquire the qualifying asset are reflected as investing activities; or
  - Consistently with interest cash flows that are not capitalised.

Disclosure of material non-cash transactions:

As per Ind AS 7, investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a statement of cash flows. Such transactions should be disclosed elsewhere in the financial statements in a way that provide all the relevant information about these investing and financing activities.

Example disclosure of material non-cash transactions as a separate note

Non-cash investing and financing activities

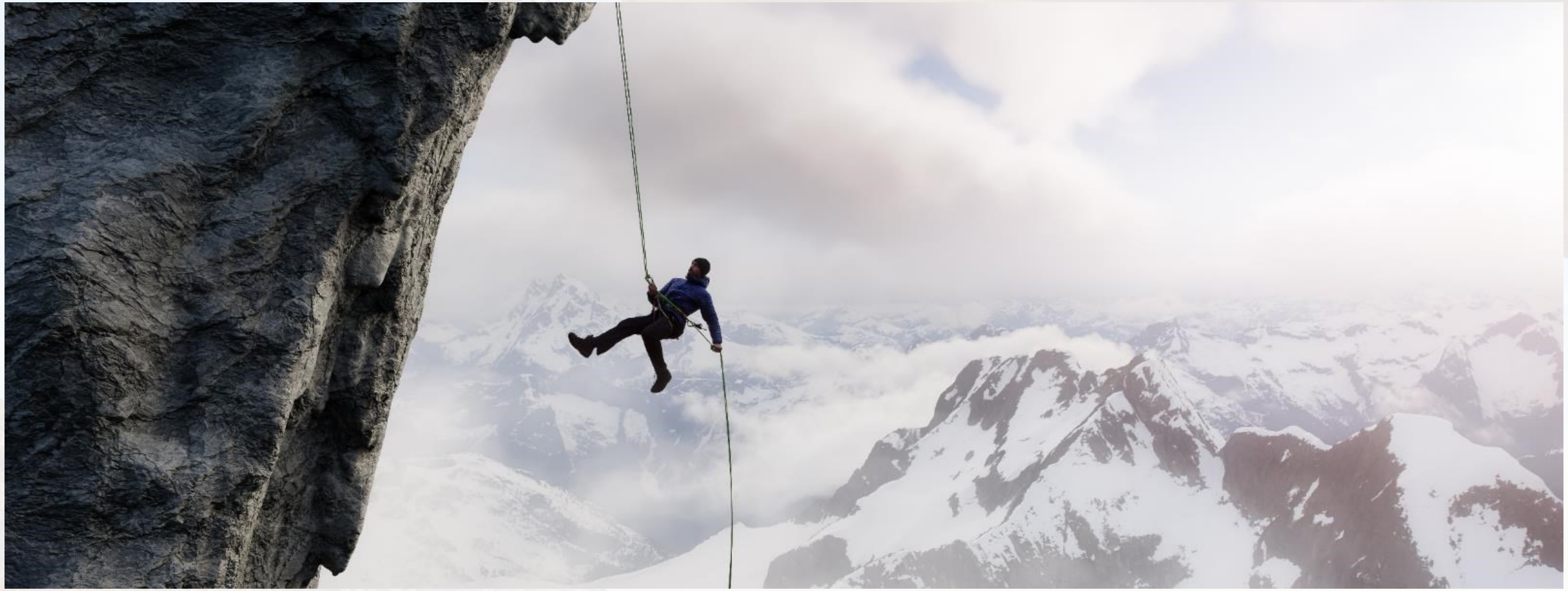
Particulars (Amounts in '000s)	Note	2020	2019
Acquisition of property, plant and equipment by means of a lease	17A	**3,500**	4,000
Acquisition of subsidiary by issue of ordinary shares	16B	**26,000**	0
Settlement of borrowings by issue of ordinary shares	16C	**18,000**	0

(Source: KPMG in India's analysis, 2024 read with 'Thematic review: Cash flow and liquidity disclosures', issued by the Financial Reporting Council in November 2020)

Disclosure of changes in liabilities arising from financing activities:

Paragraph 44A to 44E of Ind AS 7 require entities to provide disclosures that would enable users of financial statements to evaluate changes in liabilities arising from financing activities, including both, changes arising from cash flows and non-cash changes. While the standard is not prescriptive, one of the methods recommended for providing such disclosure is to present a reconciliation between opening and closing balances in the balance sheet for liabilities arising from financing activities.

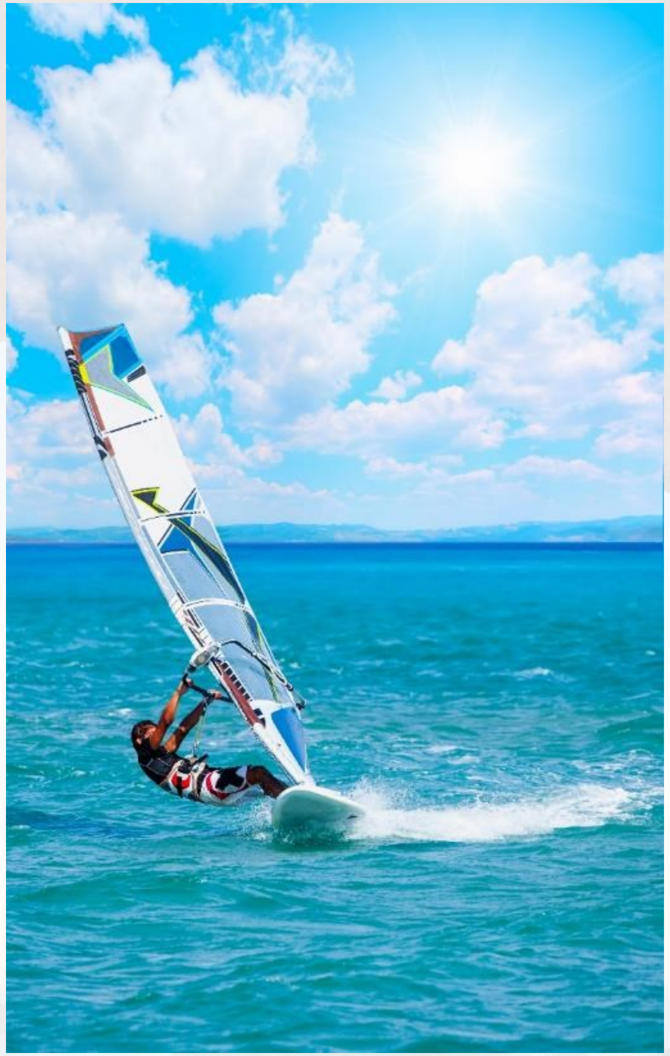
This has been an area where regulators have observed significant non-compliances[4], and hence it is necessary that entities be mindful while providing disclosures in accordance with the stipulated requirements.



4. Some of the errors observed include:
   - Derivative assets which were not hedging risks relating to borrowings, were incorrectly included as part of liabilities from financing activities
   - Inconsistencies between amounts presented in the statement of cash flows and the disclosure of changes in liabilities arising from financing activities
   - Non-cash amounts, such as assets purchased under finance leases and non-cash finance charges, incorrectly presented as cash flows.

Other commonly observed errors and improvement points:

- As per Ind AS 7, all companies are required to prepare a cash flow. The terminology used for the same is statement of cash flows (and not statement of cash flow)
- As per Ind AS 7, entities are required to report separately, major classes of gross cash receipts and gross cash payments arising from investing and financing activities[5]. For example, proceeds and repayment of term loans, current borrowings, etc., purchase/sale of investments in subsidiaries, sale/ purchase of PPE.
- Cash flows arising from a hedging instrument should be classified as operating, investing, or financing activities, based on the classification of the cash flows arising from the hedged item.
- Cash flows from interest and dividends paid should be disclosed separately (and not together).
- Expense on account of provision for obsolescence of inventory should be considered as a non-cash item in the statement of cash flow.
- In accordance with Ind AS 7, dividend distribution tax should be disclosed as financing activities[6] (i.e. within the same classification as dividends to which they pertain).
- The effect of exchange rate changes on cash and cash equivalents held or due in a foreign currency (for example on Exchange Earners Foreign Currency Account) should be reported as a separate part of reconciliation of changes in cash and cash equivalents.
- Capital advances cannot be considered as a part of revenue producing activities (and thus operating activities) therefore cash flows from or to capital advances should be disclosed under cash flows from investing activities.
- Interest expense or interest revenue accrued on borrowings or loans advanced respectively are different from cash outflow/inflows from financing activities/investing activities. Accordingly, actual interest paid/received should be disclosed in the statement of cash flow.



5. Ind AS 7 has specific conditions to be fulfilled in order to report cash flows on a net basis, which have been specified in paragraph 22.
6. As per Para 36 of IND AS 7, ….” when it is practicable to identify the tax cash flow with an individual transaction that gives rise to cash flows that are classified as investing or financing activities the tax cash flow is classified as an investing or financing activity as appropriate.