ACCOUNTING STANDARDS BOARD

RESEARCH PAPER ON THE DESKTOP REVIEW OF CASH FLOW STATEMENTS PRESENTED IN THE FINANCIAL STATEMENTS

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Research Paper on *The Desktop Review of Cash Flow Statements Presented in the Financial Statements*

Executive summary

This Research Paper reflects the findings of the Board's review that assessed compliance with the Standard of GRAP on *Cash Flow Statements* (GRAP 2) (hereafter referred to as "the review"). The review also identified practices to enable stakeholders to apply the lessons learnt when they prepare cash flow statements.

The review considered the most recently published and audited financial statements of entities that apply Standards of GRAP. The annual financial statements of entities in all spheres of government were considered. Pervasive findings were discussed with a group of stakeholders to understand the potential root causes, to identify other challenges experienced by preparers and to propose possible actions for consideration by the Board. The approach adopted to undertake the review is set out in Section 1.

Areas of non-compliance

Stakeholders confirmed that the principles in GRAP 2 are appropriate, but that most entities experience challenges in applying these principles. The review noted findings of non-compliance with GRAP 2 in the following areas:

- No, or incorrect adjustments made in the cash flow statement.
- Non-cash items not adjusted in the cash flow statement.
- Incorrect presentation of items in the cash flow statement.
- Incorrect classification of items as operating, investing or financing cash flows.
- Adjusting for items in the reconciliation that are not presented in the financial statements, or that differ from amounts presented elsewhere in the financial statements.
- Rigid application of the three-month reference in GRAP 2 of when an investment qualifies as a cash equivalent.

Root causes

Root causes for the findings include:

- Preparers not placing enough importance on the preparation of the cash flow statement.
- Uncertainty about items that require adjustment in preparing the cash flow statement.
- Lack of an understanding of the nature of an entity's activities to make appropriate adjustments when preparing the cash flow statement.
- Over reliance on templates and computer software to generate the cash flow statement.
- Lack of adequate processes and insufficient controls over the accurate preparation of the cash flow statement.
- Uncertainty on the application of materiality in preparing the cash flow statement.

Practices in preparing the cash flow statement

The review also considered practices that are applied by entities when preparing the cash flow statement. These practices are not areas of non-compliance with GRAP 2, but rather trends when entities prepare the cash flow statement. Stakeholders identified the following practices:

- Different classifications for cash receipts and cash payments on the face of the cash flow statement, and the presentation of VAT in the cash flow statement.
- Different treatment for movements in consumer deposits held by municipalities.
- Generic or no accounting policy for cash and cash equivalents.

Details of the non-compliance, practices and root causes are in Section 2.

Actions agreed by the Board

The Board agreed that no amendments are needed to GRAP 2, but that the results of the review should be shared with the relevant stakeholders to consider what actions (if any) could be taken. The detailed actions agreed by the Board are in section 3 of the Research Paper.

Authority of this Research Paper

The Board publishes Research Papers to outline its research into issues such as the results of reviews undertaken to assess compliance with Standards of GRAP and/or to evaluate current reporting practices developing. This Research Paper is not authoritative.

Section 1 – Approach to undertaking the review

1. The review focused on compliance with the requirements in GRAP 2, how information is presented in the cash flow statement, and identified practices applied in preparing the cash flow statement. The Board is not a regulator. It uses the results of its reviews to assess the adequacy of the standard-setting process and to identify potential actions for its standard-setting agenda.

2. The objective of the review was to highlight pervasive issues rather than issues at individual entities.

3. The review was based on the latest publicly audited financial statements for the 2018/2019 financial periods of entities in all spheres of government that apply Standards of GRAP. The financial statements of CET colleges were excluded from the review as at the time of the review, many of them were still adopting the Standards of GRAP.

4. The findings of the review were discussed with stakeholders to understand the reasons for the non-compliance and to identify other practices applied in preparing the cash flow statement. Stakeholders also noted concerns in preparing the cash flow statement.

5. The Board analysed the findings and their root causes and determined appropriate actions. These aspects, along with the Board's considerations are included in sections 2 and 3 of this Research Paper.

Section 2 – Findings and root causes

6. This section explains findings relating to the non-compliance with the requirements in GRAP 2, their root causes, and other practices applied by entities in preparing the cash flow statement. Practices refers to how entities apply the principles in GRAP 2, but do not include non-compliance with the GRAP 2 requirements.

General observations

7. The review concluded that the principles in GRAP 2 are appropriate, but that preparers struggle with the application of the principles.

8. The root causes noted by preparers in applying the principles in GRAP 2 include:

   - Entities do not place enough emphasis on the importance of the cash flow statement – often the cash flow statement is the last component of the financial statements to be prepared resulting in fewer resources allocated to accurately prepare the cash flow statement.
   - Uncertainty about items that require adjustments in preparing the cash flow statement – this root cause often results from a lack of skill of capacity constraints within the entity.
   - Lack of an understanding of the nature of the entity's activities – this results in the omission of necessary adjustments when the cash flow statement is prepared.
   - Over reliance on templates and computer software to generate the cash flow statement – this results in some entity specific adjustments not being reflected or adjusted in the cash flow statement.
   - Lack of adequate processes and insufficient controls over the accurate preparation of the cash flow statement – the lack of appropriate internal management systems, controls and processes to identify adjustments in preparing the cash flow statement resulting in unnecessary errors and mathematical mistakes.
   - Uncertainty related to the application of materiality when preparing the cash flow statement – preparers are unaware of the role that materiality plays, or they do not consider materiality when they prepare the cash flow statement. This despite guidance being available in, for example, the Materiality Guideline.

Part A – Findings relating to areas of non-compliance with GRAP 2

9. The following section highlights the findings of non-compliance with the requirements in GRAP 2.

<u>Reconciliation of surplus/(deficit) to net cash flows from operating activities (the reconciliation)</u>

GRAP requirements

10. GRAP 2 requires entities to:

    - provide a reconciliation. This reconciliation may be provided as part of the cash flow statement or in the notes to the financial statements;

- adjust the operating revenues and operating expenses with:
  - changes during the period in inventories and operating receivables and payables;
  - other non-cash items; and
  - other items for which the cash effects are investing or financing cash flows;
- exclude from the cash flow statement investing and financing transactions that do not require the use of cash or cash equivalents. Unrealised gains and losses arising from changes in foreign currency exchange rates are not cash flows; and
- not report cash flow activities on a net basis unless they are:
  - cash receipts collected and payments made on behalf of customers, taxpayers or beneficiaries when the cash flows reflect the activities of the other party rather than those of the entity; and
  - cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.

Findings

11. Non-compliance with the requirements in GRAP 2 include:

- No, or incorrect adjustments made to items in the cash flow statement

  A number of instances were noted where entities do not adjust for items that need to be presented separately on the face of the cash flow statement. Examples include interest received, finance costs, taxation paid and cash dividends received and paid.

  Some entities also incorrectly adjust for cash payments, such as contributions to post-employment retirement benefits, as non-cash items or as movements in working capital.

- Non-cash items not adjusted in the cash flow statement

  Not all entities adjust for all non-cash items in the cash flow statements. Examples of items that are not adjusted include non-cash donations and other in-kind benefits, straight lining of operating lease expenses, depreciation or amortisation, inventory losses or write-downs and fair value adjustments.

- Incorrect presentation of items in the cash flow statement

  Some entities do not distinguish between the movement in non-cash items and movements in working capital in the reconciliation, but present all the information together. It was also noted that the surplus/(deficit) amount in the reconciliation and the surplus/(deficit) as in the statement of financial performance, differ.

  Some entities do not present receivables from non-exchange transactions, and tax receivables or tax payables as movements in working capital. Others incorrectly present the movements in provisions for leave pay, accrued leave, long-term service, post-retirement medical aid benefits, performance bonuses, and environmental rehabilitation as movements in working-capital, rather than reflected these movements as non-cash adjustments.

It was also noted that some entities incorrectly reflect some amounts on a net basis in the reconciliation – for example, the movement in an operating lease asset and operating lease liability.

- Incorrect classification of items as operating, investing or financing activities cash flows

  In some instances, the movement in receivables is incorrectly presented as an operating cash flow items on the face of the cash flow statement, rather than as a movement in working capital as part of the reconciliation.

- Adjusting for amounts in the reconciliation that are not presented in the financial statements, or that differ from amounts presented elsewhere in the financial statements

  A number of entities adjust for items in the reconciliation, that are then not presented in either the statement of financial performance, the statement of financial position or the notes to the financial statements. Examples include unspent conditional grants and adjustments for the profit or loss on the sale of property, plant and equipment.

12. It was also noted the reconciliation includes adjustments for interest received or finance costs as per the statement of financial performance, but that only some of the interest or finance costs are presented as an operating, investing or financing activity on the face of the cash flow statement. In other instances, interest received or finance costs is adjusted in the reconciliation but the amount adjusted differs from that presented in the statement of financial performance or the related disclosure notes. These differences in the presentation of interest received and finance costs in the reconciliation to that presented elsewhere in the financial statements, are not as a result of interest receivable, or finance costs payable. Possible reasons provided by stakeholders for these differences are:

- differences between the effective and contractual interest rates applied; and
- interest that is capitalised to assets, resulting in interest being excluded from the cash flows from operating activities.

<u>Operating activities</u>

GRAP requirements

13. GRAP 2 requires that:

- cash flows from operating activities should be reported using the direct method, where major classes of gross cash receipts and gross cash payments are disclosed. Cash flows from operating activities are primarily derived from the principal cash-generating activities of the entity; and

- the interest and dividends or similar distributions and taxes on surplus should be disclosed separately in the cash flow statement.

Findings

14. Non-compliance with the requirements in GRAP 2 include:

    (a) No or incorrect adjustments made to items in the cash flow statement

    This include entities not presenting cash dividends received and paid, and tax on the surplus separately on the face of the cash flow statement.

    (b) Incorrect presentation of items in the cash flow statements

    Some entities include finance costs as part of the repayment of the finance lease liability rather than presenting them separately on the face of the cash flow statement.

<u>Investing activities</u>

GRAP requirements

15. GRAP 2 requires that:

    - only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities;
    - proceeds on the disposal or sale of items of property, plant and equipment, that gives rise to gains or losses in the surplus or deficit, are a cash flow from investing activities. These gains or losses on the disposal of an asset are therefore adjusted in the reconciliation.

16. GRAP 2 includes guidance on the aggregation of cash flows arising from acquisitions and disposals of controlled entities that are to be classified as investing activities.

Findings

17. The following non-compliance findings were noted:

    - Adjusting for amounts in the reconciliation that are not presented in the financial statements, or that differ from amounts presented elsewhere in the financial statements

      Some entities do not present the proceeds on the sale of assets separately as an investing activity in the cash flow statement, even though adjustments for gains or losses on the sale of assets are included in the reconciliation. It was also noted that some entities present different amounts on the face of the cash flow statement to those presented elsewhere in the financial statements, for example acquisitions of property, plant and equipment. Reasons for these differences include, but were not limited to, the acquisition of property, plant and equipment on credit for which a payable was recognised or non-exchange transfers of property, plant and equipment.

- Incorrect classification of items as operating, investing of financing cash flows – Some entities do not present revenue received from insurance claims to cover losses and damages to assets as investing activities on the face of the cash flow statement.

18. Stakeholders confirmed that they are uncertain about the treatment of revenue received from insurance claims.

Financing activities

GRAP requirements

19. GRAP 2 explains the importance of reflecting cash flows from financing activities in the cash flow statement and lists examples of cash flows from financing activities.

Findings

20. Non-compliance with the requirements in GRAP 2 include:

    - Incorrect presentation of items in the cash flow statement

      This includes some entities incorrectly presenting increases or decreases in short term borrowings or loans as movements in working capital in the reconciliation, rather than reflecting the increases or decreases as movements in cash flows from financing activities.

      It was also noted that some entities do not present finance costs on finance lease liabilities separately on the face of the cash flow statement as financing activities. Instead, finance costs are included as part of the finance lease liability.

21. Reasons for the incorrect treatment of increases or decreases in short term borrowings or loans is because entities use borrowings or loans to fund day-to-day payments, such as salaries. These increases or decreases are then presented as a movement in working capital.

Cash and cash equivalents

GRAP requirements

22. GRAP 2 defines cash as “cash on hand and demand deposits”. Cash equivalents are defined as “short-term highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

23. GRAP 2 clarifies that:

    - an investment normally qualifies as a cash equivalent when it has a short maturity of, say, three months or less from the date of acquisition. Equity instruments are excluded from cash equivalents unless they are, in substance, cash equivalents; and

    - bank overdrafts are generally considered to be financing activities, but bank overdrafts that are repayable on demand may form an integral part of the entity’s cash management activities. In these instances, the bank overdraft is included as a component of cash and cash equivalents.

24. GRAP 2 requires an entity to disclose:

- the components of cash and cash equivalents and to present a reconciliation of amounts in its cash flow statement with the equivalent items reported in the statement of financial position; and
- the policy which it adopts in determining the composition of cash and cash equivalents.

Findings

25. The following non-compliance finding was noted:

- Incorrect application of the principles in GRAP 2

  Some entities rigidly apply the three-month reference in GRAP 2 in the context of explaining when an investment qualifies as a cash equivalent. This resulted in some investments with a maturity of more than three-months, not being classified as cash and cash equivalents when they meet the definition of cash and cash equivalents.

Part B – Findings relating to practices applied by entities

26. The following section highlights the practices and trends applied by entities when preparing the cash flow statement. These practices are neither correct nor incorrect.

<u>Operating activities</u>

27. The following practices in preparing the cash flow statement, were noted:

- Different classifications of cash receipts and cash payments on the face of the cash flow statement

  For cash receipts, some entities classify cash receipts based on the nature of the receipt, for example, non-exchange revenue, transfer and subsidies, administration fees, public contributions, interest received and donation income. Others classify cash receipts as cash receipts from customers, sale of goods and services, grants and subsidies.

  Cash payments are sometimes separately classified as (i) payments to employees, (ii) payments to suppliers and (iii) finance cost. In other instances, cash payments to suppliers and employees are presented as a single line item on the face of the cash flow statement.

  Stakeholders noted that the reason for the different classification of cash receipts and cash payments is because (i) judgement is applied in presenting information that best meets the information needs of the entity's users; (ii) the classification is based on the nature of the revenue received as presented in the statement of financial performance; and (iii) the requirements in other reports, for example budget reports issued by the National Treasury, impacts the classification.

- Different presentation of VAT in the cash flow statement

The movement in the VAT receivable or payable is in some instances presented as a change in working capital, while in other instances, it is presented as an operating cash flow on the face of the cash flow statement.

Stakeholders noted that the reasons for the different presentation of VAT are because (i) entities are registered for VAT on different bases; and (ii) preparers are uncertain about the treatment of VAT, specifically if the movement in VAT should be presented as a change in working capital or as an operating cash flow on the face of the cash flow statement, and if VAT should be included or excluded when presenting cash receipts and cash payments in the cash flow statement.

Financing activities

28. Differing treatment of consumer deposits held by municipalities was noted. In preparing the cash flow statement, some entities treat the movement in consumer deposits as financing cash flows, while others present the movement as a change in working capital. Reasons for the different treatment include that:

(a) preparers consider the requirements of other reports, for example budget reports issued by the National Treasury, to classify the movement in consumer deposits;

(b) the classification is based on the terms of the agreement with consumers. If the deposits are settled in goods or services (offset against, for example an outstanding account) the deposits are not considered financial cash flows. Where consumer deposits are settled in cash (paid out), they are classified as a financing activity for purposes of the cash flow statement as it is deemed to be a financial liability; or

(c) as consumer deposits do not accrue any interest and are not utilised in the entity's day to day operations, preparers consider the movement in these deposits to be a change in working capital.

Cash and cash equivalents

29. The following practice was noted:

- Generic or no accounting policy for cash and cash equivalents

  Entities either have no accounting policy, or include a generic accounting policy for cash and cash equivalents that does not explain the composition of the entity's cash and cash equivalents.

30. Stakeholders acknowledged that some entities do not have an accounting policy for cash and cash equivalents as:

- in the entity's view, the information presented in the disclosure note for cash and cash equivalent provides sufficient information to users; or
- because cash and cash equivalents are immaterial.

Section 3 – Addressing the findings

Proposals from stakeholders

31. Various proposals were made by stakeholders to ensure that the principles in GRAP 2 are correctly applied when entities prepare their cash flow statement. These include:

    (a) The National Treasury providing more application guidance on the preparation of the cash flow statement.

    (b) Developing a detailed illustrative example that covers every possible adjustment required for the preparation of the cash flow statement, including an explanation of:

    - the adjustments that should be included in the reconciliation;
    - whether these adjustments comprise movements in working capital or adjustments for non-cash items; and
    - where the amounts need to be presented in the cash flow statement.

    (c) Developing a template that comprises a working document of adjustments that are made in preparing the cash flow statement. This working template can also be used as audit evidence.

    (d) Developing a checklist that sets out the GRAP 2 requirements.

    (e) Conducting a workshop on the presentation of the cash flow statement where the treatment of specific items in the cash flow statement is explained.

    (f) Development of appropriate internal management systems by management to identify the required adjustments needed in preparing the cash flow statement.

    (g) Re-instating the illustrative example in GRAP 2 and expanding it with some of the principles that are incorrectly applied in preparing the cash flow statement.

Actions agreed by the Board

32. The Board did not support re-instating the illustrative example in GRAP 2 as a similar example is already included in the GRAP 2 Accounting Guideline. Re-instating the example in GRAP 2 will thus result in duplication of similar guidance.

33. The Board concluded that addressing the proposals in paragraph 31(b) and (c) may drive the wrong behaviour and discourage preparers from considering entity specific transactions and events when preparing the cash flow statement.

34. As the GRAP 2 Accounting Guideline is available to assist entities with applying the principles in GRAP 2, the Board agreed to share all the findings, the root causes and the need for more application guidance with the OAG. This will allow the OAG to consider whether additional guidance is needed in the Guideline.

35. In addition, the need for specific guidance in the following areas will also be highlighted to the OAG:

    (a) the treatment of VAT and insurance revenue;

    (b) the consistent classification of movements in consumer deposits from one year to the next; and

(c) that the three-month explanation of when an investment comprises a cash equivalent should not be applied as an absolute rule.

36. In addition to sharing information with the OAG, the findings and root causes will also be shared with:

- IRBA and the Public Sector Audit Committee Forum so that auditors are aware of the findings;
- the JSE, as they are responsible for public sector debt issuers; and
- CIPC as part of their project to update the GRAP XBRL taxonomy.

37. As part of a future project, the Board will amend the Materiality Guideline to:

- explain that different materiality levels can be considered for different components of the financial statements;
- explain that where immaterial items are aggregated, these may need to be disaggregated if the total amount is considered material, or if its description is unhelpful to users; and
- clarify that an accounting policy will not be included in the financial statements for items that are immaterial.

38. The guidance on the treatment of consumer deposits, as included in the Fact Sheet to GRAP 104(2019), will be converted into a Frequently Asked Question.

Areas for future consideration by the Board

39. The review noted that only a few entities included disclosures in their financial statements on significant cash and cash equivalent balances that are held by the entity, but not available for use. Entities did not provide disclosures on undrawn borrowing facilities or cash flows arising from the operating, investing and financing activities of each reportable segment. As GRAP 2 currently encourages entities to present the amount of cash flows arising from operating, investing and financing activities of each reportable segment, the Board agreed to monitor this encouraged disclosure. If any areas of concern are noted at a later stage, a proposal for a project could be included when the Board consults on its work programme.

40. In addition, the Board will follow a more holistic approach by reviewing the encouraged disclosures in all the Standards of GRAP as part its next Improvements Project.

41. Cash receipts and payments can be reported on a net basis when an entity is an agent. As GRAP 109 on *Accounting by Principals and Agents* only became effective for financial periods commencing on or after 1 April 2019, the Board agreed that the presentation of cash flow items on a net basis, specifically those that involve a principal-agent arrangement, will be considered when it undertakes a review of GRAP 109.