## The audit’s almost over! Quick, someone tie out the cash flow!

The purpose of this document is to get you thinking about some of the things to consider and look for when you are auditing the statement of cash flows. If you are like me, it is possible that the statement of cash flows was not given the attention that it requires for the simple reason that it is too easy to look at the statement and conclude that it must be right because the ending cash balance agrees with the bank account. How can there be errors in it if the cash balance is correct? Not to mention, it is easy to tie out most of the balances because they are typically derived straight from the statement of financial position or the statement of operations. Unfortunately, both of the statement of financial position and the statement of operations are prepared on an accrual basis. This makes the quick and easy tie outs not appropriate. So let us walk through some steps to consider when auditing the statement of cash flows.

### Basic Refresher #1—Cash flow methods

#### Indirect

The indirect method reports cash flows from operating activities by beginning with net income and making adjustments for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

#### Direct

By contrast, the direct method reports cash flows from operating activities by major classes of gross cash receipts and gross cash payments.

#### Difference between the 2 methods

Presentation of operating activities is impacted by the cash flow method selected but not investing or financing activities. Since investing and financing activities only include cash items, the cash flow method applied will not impact the cash flow items for these activities.

### Basic Refresher #2-What does “cash” mean in “statement of cash flows”?

Your entity may have different assets or liabilities that relate to cash, such as cash in a bank account, bank overdrafts, lines of credit, cash equivalents, restricted cash, cash held in an investment account, etc. With so many terms, it does get confusing! This is why it is important to have a good understanding of the requirements of the reporting framework to ensure the statement reconciles the proper item(s). No worries, we’ve got you covered - the table below discusses some key definitions and requirements.

| **Item** | **PSAS** | **IFRS** | **IPSAS** |
| --- | --- | --- | --- |
| Cash flow | PS 1201.107  *The statement of cash flow should report how a government generated and used cash and cash equivalents in the accounting period and the change in cash and cash equivalents in the period. The statement of cash flow should report the cash and cash equivalents at both the beginning and end of the accounting period.* | IAS 7.6  Cash flows are inflows and outflows of cash and cash equivalents. | 2.8  Cash flows are inflows and outflows of cash and cash equivalents. |
| Cash | PS 1201.104  Cash comprises cash on hand and demand deposits. | IAS 7.6  Cash comprises cash on hand and demand deposits. | IPSAS 2.8  Cash comprises cash on hand and demand deposits. |
| Cash equivalents | PS 1201.105  Cash equivalents are short-term highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value. Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investing or other purposes. An investment would normally qualify as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents. | IAS 7.6  Cash equivalents are 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.  IAS 7.7  Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents, for example in the case of preferred shares acquired within a short period of their maturity and with a specified redemption date. | IPSAS 2.8  Cash equivalents are 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.  IPSAS 2.9  Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Equity investments are excluded from cash equivalents unless they are, in substance, cash equivalents. |
| Bank overdrafts | PS 1201.105  When bank overdrafts, which are repayable on demand, form an integral part of a government's cash management, such that the government's bank balance often fluctuates from being positive to overdrawn, bank overdrafts are included as a component of cash and cash equivalents. | IAS 7.8  Bank borrowings are generally considered to be financing activities. However, in some countries, bank overdrafts which are repayable on demand form an integral part of an entity's cash management. In these circumstances, bank overdrafts are included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn. | IPSAS 2.10  Bank borrowings are generally considered to be financing activities. However, in some countries, bank overdrafts that are repayable on demand form an integral part of an entity's cash management. In these circumstances, bank overdrafts are included as a component of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn. |

Some of the general implications of these definitions and requirements to the statement of cash flows include the following:

* You need to ensure that what is being presented in the cash FSLI meets the definition of cash.
* If the audit entity has cash equivalents, you need to ensure that the statement of cash flow reconciles to cash and cash equivalents.
  + It is important to understand the entity’s cash management intentions to ensure proper classification of any cash equivalents. For instance, a short-term investment may not meet the definition of a cash equivalent if it is held as part of an investment portfolio and it is not held for purpose of meeting short-term cash commitments.
  + Also, a cash equivalent might be presented separately from cash in the statement of financial position (e.g., in the investment FSLI). Should that be the case, it would still need to be included in the “cash and cash equivalents” total that the statement of cash flows reconciles to. Sufficient details should be disclosed, either in the notes or on the statement of cash flows, to enable the user to understand the reconciliation of “cash and cash equivalents”.
* Cash and cash equivalents presented on the statement of cash flows may not directly tie to the cash and cash equivalents on the statement of financial position, as some components might be presented under a different FSLI (e.g. a bank overdraft might be presented as a liability). Similar to what is mentioned above, sufficient details should be disclosed, either in the notes or on the statement of cash flows, to enable the user to understand the reconciliation of “cash and cash equivalents”.

### Know your entity!

The absolute best way to make sure that you are considering all adjustments that are required is to consider all of the significant types of transactions that go through a statement of financial position or statement of operations account. Let’s stick with the PPE account to make things simple. On the surface, PPE seems straight-forward. Closing balance = opening balance + additions – depreciation/impairment – disposals. Additions are going to be purchased with cash and disposals are going to be sold for cash so the only thing left has already been talked about! Don’t stop reading just yet! Consider an entity that has expanded their operations and therefore paid a contractor to build and install new equipment. It is entirely possible at year-end that the entity will have received a significant amount of capital items that they have yet to pay for (i.e. equipment received and not yet paid for). If the equipment is included on the balance sheet, but has not been paid for yet, it is a non-cash item (no money has traded hands) and should not be included in the investing activities section on the statement of cash flows. So as you can see, there is no magic formula for each account. You really need to know your entity and the originating transaction in order to effectively identify which adjustments are needed to arrive at the appropriate amounts on the statement of cash flows.

To help you on your way, Appendix A presents some examples of things to look out for, but in no way should this be considered an exhaustive list.

### Common errors

A list of common errors can be found in Appendix B.

### Best practices

A list of best practices can be found in Appendix C.

### Conclusion

The statement of cash flows is as important as the statement of financial position and the statement of operations. When an error is identified on the statement of financial position or the statement of operations, you also need to assess the potential impact on the statement of cash flows. If the entity does not elect to correct the misstatement, the audit team’s assessment should not only focus on the statement of operations or statement of financial position, but due consideration should also be given to the statement of cash flows.

As mentioned above, the best way to ensure that the audit entity’s statement of cash flows reflects the true cash inflows and outflows is to know your entity, the transactions it enters into, the composition of the FSLIs and the entity’s process to prepare the statement of cash flows. Never assume that a line on the statement of cash flows that ties directly to the statement of financial position or statement of operations is an appropriate way to tie out your cash flow! Think about the types of transactions that are in each FSLI and ask yourself if you can trace the transactions to the bank statement!

# Appendix A—Non-exhaustive list of areas to consider

* Gross vs. net transactions
  + Consider an entity that settles on a net basis with some 3rd parties. At the end of every month, the clerk totals the debits and credits of each account. If the account is in a debit position, he or she prepares a letter to be sent to the 3rd party to indicate the amount to be settled net. At year-end, the clerk prepares a direct statement of cash flow by totalling all of the credits and putting this total in “cash paid to suppliers” and all of the debits go into “cash received from customers”. Without the knowledge of the client’s net settlement arrangement, there would be no way to detect the true cash transactions because your statement of cash flows would still balance. Unfortunately, the statement of cash flows would be misstated because it would not be reflecting the true cash that was actually paid or received during the year.
* Netting is only allowed under very specific circumstances
  + PS 1201.120 and IAS 7.22 provide the relevant guidance for the only times when cash inflows and cash outflows may be presented on a net basis.
* New type of transactions
  + Whenever the entity enters into a new type of transaction, it should assess whether related cash flows should be presented within operating, financing or investing activities. Depending on the nature of the transaction, it is possible that the same transaction impacts more than one section.
* One time receivables/payables at year-end
  + This may be problematic for a statement of cash flows prepared using either the direct or indirect method. If using the indirect method, it is important to understand the nature of the receivable/payable so that is adjusted in the correct section of the statement of cash flow (e.g. a receivable or a payable related to an investing activity would need to be adjusted for within the investing activities section). If using the direct method, it might be very easy for an entity to accidentally forget to eliminate a one-time receivable/payable if it is not part of the usual accruals adjusted for when preparing the statement of cash flows. So keep your eye out for any non-recurring accruals at year-end. In addition, review the listing of accruals for any accrual recorded in AP that relates to revenue (e.g. credit note to be paid to a customer) or in AR that relates to expenses (e.g. reimbursement related to expenses paid) and ensure it is being appropriately reflected in the statement of cash flows. Due to the nature of how the statement of cash flows is prepared under the direct method, these items might easily be included within the wrong section.
* Transactions with no impact on the statement of financial position
  + It is possible that the statement of cash flows is impacted even if there are no related FSLIs in the statement of financial position. For example, an entity could issue debt at the beginning of the year and repay this debt at the end of the year. Even if there are no debt balances presented on the statement of financial position as at the beginning or end of the year, there could still be significant cash inflows and outflows during the year that must presented in the statement of cash flows.
* PPE received but not yet paid for
  + If the entity has received an item of PPE and recognized it as an asset, but has not yet paid for the item, this would be considered a non-cash transaction which should not be presented in the statement of cash flows (but which might be subject to note disclosure requirements of PS 1201.124 / IAS 7.43).
* Opening accruals
  + Remember that scenario of PPE received but not yet paid for? Well if that happened this year end, it probably happened last year end as well. So be on the lookout for significant accounts payable and accrued liabilities for prior year PPE acquisitions that were sitting in your opening statement of financial position, which were then paid by the entity during the current year. That payment in the current year is a cash flow for the acquisition of the PPE (i.e. it is an investing/capital activity). A common mistake when following the indirect method is to present it within operating activities as part of the increase/decrease in accounts payable and accrued liabilities. This would also be true for any other accruals related to investing or financing activities.
* Purchase and sale of investments
  + Similar to the gross vs. net transactions, if the entity totals all of the debits and credits in the investment account and records the debits balance on the statement of cash flows under investing as “cash paid for the purchases of investments”, and all of the credits as “cash received for the sale of investments”, this practice does not take into consideration any entries that were made to amortize the discount/premium on the investment which are non-cash. This could also result in non-cash transactions (dividend in shares, new shares issued as a result of a spin-off or merger, etc.) being incorrectly presented as cash transactions.
* Holdbacks
  + This is the amount that a client withholds at the time of paying an invoice to a contractor. For example, when a client pays a $100 bill but holds $5 pending final acceptance, the cash outflow is then $95. The client will present $95 on the statement of cash flows as acquisition of fixed assets. The balance of $5 should only be presented in the statement of cash flows when paid. Also, if the $5 holdback amount is presented as a separate Holdback account on the statement of financial position, the balance of the Holdback account constitutes cash at year-end.
* Cash held in a foreign currency
  + Unrealized gains and losses arising from changes in foreign currency exchange rates are not cash flows. Net impact on cash held in a foreign currency should be presented outside of operating, financing and investing activities, generally within the reconciliation of the opening to closing cash and cash equivalents balances located at the bottom of the statement of cash flows. Also, if using the indirect method, the operating activities should be adjusted as well by the same amount.
* Payments or receipts in a foreign currency
  + Any payments or receipts made in a foreign currency should be converted to the entity’s functional currency by applying the exchange rate at the date of the cash flow, and not at the date of when the A/R or A/P was initially recorded.
* Interest income
  + Under IFRS, entities make a policy choice to present interest received as an operating or an investing activity. If interest received is presented as an investing activity rather than an operating activity, there is an adjustment to operating activities required if the indirect method is used. This adjustment should also consider changes in accrued interest income, so that it reflects the actual cash inflow during the year.
* Large multi-year capital investment projects
  + It is important to understand the set-up of the financing aspect of the project. It is possible that some items, such as costs for issuance of bonds, are being capitalized and would be considered financing activities and not investing activities.
* Any expense/gain related to a revaluation, impairment, bad debt expense and provisions
  + These are all types of non-monetary transactions that may not occur frequently. Depending on the method used by the entity to present its cash flows from operating activities, adjustments might be required. For PSAS preparers, consideration should also be given to investing activities if they are related to capital assets, to ensure that none of these entries impact the amounts presented in investing activities.
* In-kind/Barter transactions and contributed assets
  + These types of transactions are non-monetary in nature and do not impact the statement of cash flows. Also, if the indirect method is used and the in-kind transaction is related to a capital asset, an adjustment to operating activities might need to be made.
* Acquisition of capital assets by means of a finance lease
  + On the statement of financial position, this would have an impact on the capital assets and on the finance lease obligation FSLIs, but these would not represent an actual cash outflow. Payments of the finance lease obligations would be the cash outflow, which would include both reimbursement of capital (which would be a financing activity) and payment of interest (which would be either an operating or a financing activity, as per the entity’s consistently applied presentation approach for interest payments).
* Entity using the indirect method with amounts in other comprehensive income
  + If the indirect method is used and the entity starts with “net results”, ensure items impacting other comprehensive income (OCI) are properly removed from the reconciliation of operating activities. For example, if your entity starts with “net results” and has post-employment benefits, only non-OCI items should be presented in the year‑over‑year change related to post-employment benefits. Another option is that the entity presents total cash payments and benefit expenses recognized in net results for line items related to post-employment benefits. Both methods should give the same results.

# Appendix B—Common errors

Consider the below “What could go wrongs” and include audit procedures within the related FSLI audit programs to mitigate the risk.

Material line items not disaggregated or disclosed. (IAS 1.30)

Disclosure of the entity’s policy for determining the composition of cash and cash equivalents not provided. (IAS 7.46)

Cash flows from investing activities not presented on a gross basis. (IAS 7.21)

Nature of restrictions on cash balances not disclosed. (IPSAS 2.59)

Investments inappropriately presented as cash and cash equivalents (PS 1200.05)

Cash inflows shown as cash outflows and vice versa;

Cash flows include non-cash transactions (IAS 7.43, PS 4200.52, PS 1201.125);

Repayment of capital lease obligations presented within capital activities instead of financing activities (PS 4200.52);

Write-off of tangible capital assets netted within capital activities rather than presented as a non-cash adjustment within operating activities (PS 4200.52);

Incorrect classification of restricted cash received for capital purchases as a capital activity instead of a financing activity for a GNPO (PS 4200.52);

Restricted cash not classified correctly (PS 4200.52);

Using the direct method, not separately disclosing material transfer payments made or received (PS 1201.112);

No disclosure of interest paid or included as a financing activity rather than an operating activity (PS 1201.114);

Material gross cash flows that did not meet the requirements to be presented on a net basis (PS 1201.119).

# Appendix C—Best practices

* When obtaining an understanding of the flow of transactions for different FSLIs, consider obtaining an understanding of the transactions up to when the payment is made or received including how it is recorded in the general ledger to assess whether there are any specific implications for the statement of cash flows.
* The statement of cash flows could be reviewed during the planning or interim phases of the audit. For example, if an entity publishes quarterly financial statements, a team member could meet with management to discuss the process followed by the entity to prepare the latest quarterly statement of cash flows, along with any relevant controls if it was determined that the same process is followed to prepare the year-end financial statements.
* Within the FSLI audit programs, consider including related cash flow audit procedures to ensure that the auditor performing the work has the necessary understanding of the underlying transactions to ensure appropriate presentation and disclosure.
* Consider having specific transactions or line items in the statement of cash flows reviewed by the audit team members with the detailed knowledge. All cash flow line items could be audited within their respective section and another auditor could be responsible for the overview of the statement of cash flows.
* Consider raising the importance of the statement of cash flows during team planning meetings.
* In some cases, the statement of cash flows may be received towards the end of the audit. Consider emphasizing to management the importance of providing the statement of cash flows, along with all supporting documentation, at the same time as the rest of the financial statements. In addition, the audit team should not wait until the end of the audit to start auditing the statement of cash flows.
* Consider compiling a list of non-cash transactions during the audit which could serve as a completeness check when auditing the statement of cash flows.
* When reviewing any accounting position papers (e.g. adoption of a new standard, change in accounting policies, etc.), the audit team should consider whether there should be a section that deals specifically with the statement of cash flows.
* Whenever there is a financial system change or a change to the chart of accounts, the audit team should assess whether the change could have an impact on the statement of cash flows.
* Tailor your audit programs based on the specifics of your entity and on the list of items to consider in Appendix A and of the most common errors noted in Appendix B.
* Whenever your entity has investments, review the details of these investments to see whether there are any short-term, highly liquid securities. If so, assess whether these meet the definition of cash equivalents and assess the potential impact on the statement of cash flows.
* Review Appendices A and B and prepare a detailed list of questions for your audit entity based on what is relevant for your audit. Ask your entity to answer not only the “what” (e.g. in which line cash flow hedges are adjusted), but also the “how” (e.g. how these are recorded by the entity and how they ensure that the amount is appropriate).
* In some cases, it is possible to reconcile some amounts presented in the statement of cash flows in more than one way. Ask your entity to identify these instances and demonstrate the accuracy of amounts presented in the statement of cash flows by showing the results obtained in both ways. Using this method could demonstrate further evidence that nothing was missed.