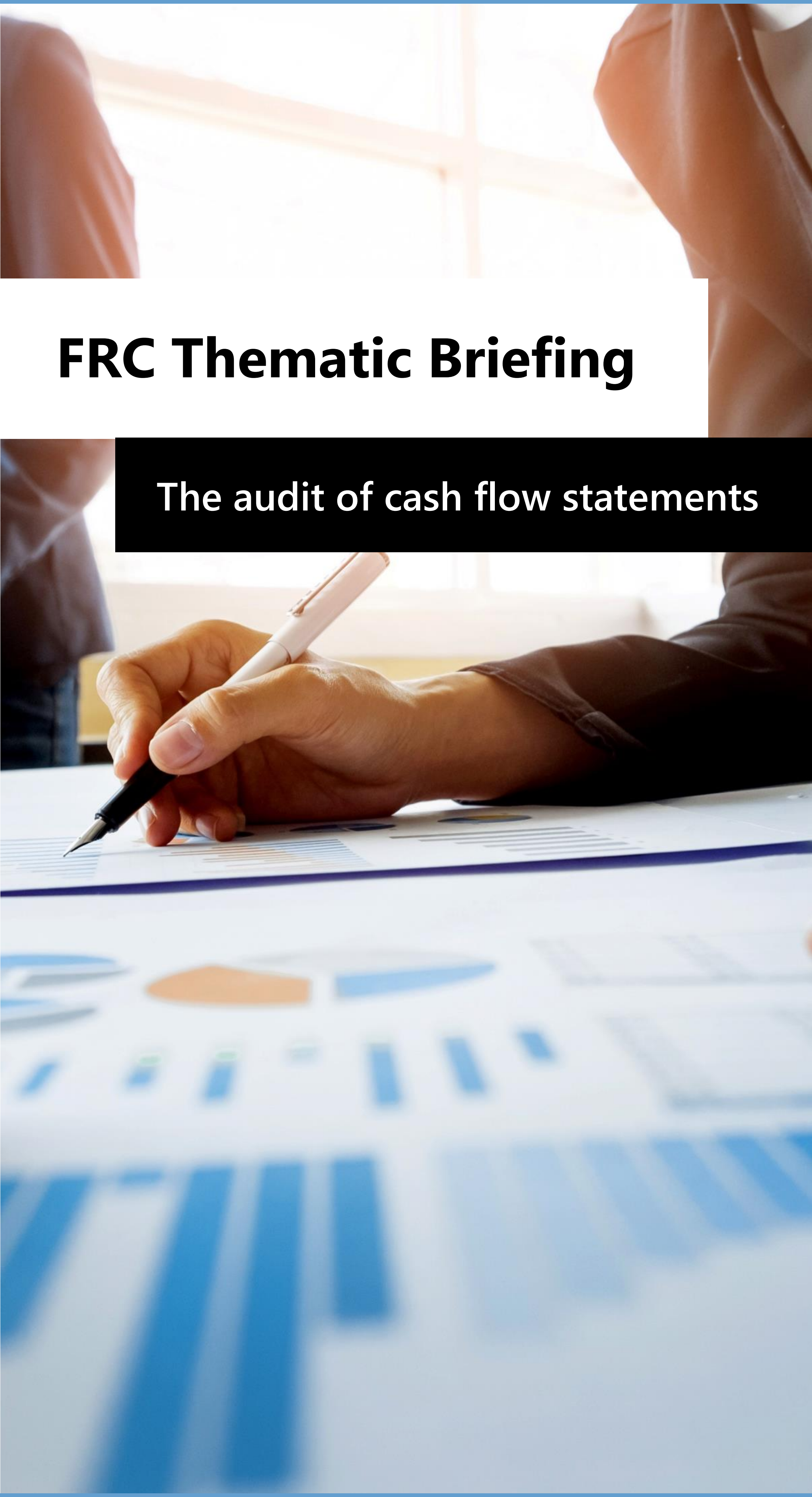
Financial Reporting Council

FRC Thematic Briefing

The audit of cash flow statements



May 2021

Contents

Introduction

“Errors in cash flow statements remain a recurring issue in Constructive Engagement cases. The steps taken by audit firms to strengthen the audit of cash flow statements as shown on page 5 are a good response to prevent the need for restatements and errors occurring.

I recommend that all audit firms should look carefully at how they undertake the audit of cash flow statements.”

David Rule
FRC Executive Director of Supervision

The cash flow statement is a primary statement with as much prominence as the income statement or balance sheet and the users of financial statements expect companies and their auditors to identify and correct material misstatements within the cash flow statement prior to publication.

Since October 2020, the FRC's Audit Firm Supervision team and the Case Examiner work together to identify where audit quality concerns can be appropriately and satisfactory addressed without a full investigation and enforcement action. This process is called Constructive Engagement. This work is carried out under the FRC's Audit Enforcement Procedure (AEP) and associated guidance[1] and is overseen by the FRC's Conduct Committee.

The Annual Enforcement Review[2] 2020 sets out the results of FRC’s 2019-20 constructive engagement work. Cash flow statement cases made up 3 (9%) of the cases we resolved through constructive engagement during 2019-20 and we have dealt with a further 8 (17%) cases during 2020-21. Whilst our constructive engagement work has shown that audit firms have taken appropriate steps where errors have been identified, the increase in cases during 2020-21 suggests that further action is needed by firms to improve the overall quality of the audit of cash flow statements to prevent the need for restatements and errors occurring.

In recent years, the FRC’s corporate reporting reviews[3] have frequently found basic errors in cash flow statements, including of FTSE 350 companies, that were evident from a desktop review of the accounts. Most have related to misclassification between operating, investing, and financing activities and the majority led to overstatement of operating cashflows.

In November 2020, the Thematic Review: Cash flow and liquidly disclosures[4] provided further insights into the comprehensiveness and quality of cash flow disclosures throughout the annual report and accounts, including compliance with the requirements of IAS 7 ‘Statement of Cash Flows’.

In combination with other primary statements and disclosures, cash flows are considered within the FRC’s Audit Quality Review scoping.

This Thematic Briefing shows the results of our own analysis from Constructive Engagement key findings and how audit firms have strengthened the audit of cash flow statements. In Appendix 1, there is a summary of historical cash flow statement errors identified in the FRC Thematic Review: Cash flow and liquidity disclosures.

1 https://www.frc.org.uk/auditors/enforcement-division/audit-enforcement-procedure
2 https://www.frc.org.uk/getattachment/d299042a-f14f-40eb-8889-7b44818cf53b/Annual-Enforcement-Review.pdf
3 https://www.frc.org.uk/accountants/corporate-reporting-review/annual-activity-reports
4 https://www.frc.org.uk/getattachment/291351f7-db47-4d36-8dbc-7fcdea764d73/Cash-flow-review-FINAL.pdf

Key findings

Cases involving the cash flow statement have increased between 2019-20 and 2020-21 from 9% to 17% of cases resolved through Constructive Engagement.

The cash flow statement provides users of the financial statements with an understanding of the generation, availability, and use of cash, and in supporting analysis of future expectations. The cash flow statement is a primary statement, but it does not always get the necessary amount of audit input as other primary statements.

As the cash flow statement movements are linked to other audited primary financial statements, this can manifest itself in the amount of audit work performed not being sufficient to reach an appropriate audit opinion or to identify matters that should be corrected/reported to those charged with governance.

A common root cause is:

- Internal consistency checks by the audit team across the financial statements are not picking up basic errors in the cash flow statement. This may also result in classification errors between sections of the cash flow statement.

Other root causes include:

- The audit team did not always adequately challenge management on the accounting policies applied and disclosures made affecting the cash flow statement.
- Guidance available to the audit team to deal with technical and complex judgements was not always sufficient or embedded through staff awareness methods and training.
- The review process did not always identify and adequately respond to matters identified in the audit.
- The use of spreadsheets and the manual nature of cash flow workings by companies increases the complexity of auditing the consolidated cash flow statement.

The table on page 4 records case examples and enhancement actions taken by audit firms arising in cash flow statement cases. As part of Constructive Engagement, we have engaged with the relevant audit firms to agree how the audit of cash flow statements can be strengthened. A summary of how audit firms have enhanced the audit of cash flow statements is discussed on page 5.

Further examples of historical cash flow statement errors, taken from the FRC Thematic Review: Cash flow and liquidity disclosures, are shown in Appendix 1.

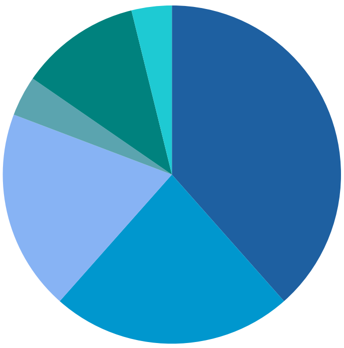
Cash flow statement cases

Issues arising	Case examples	Other matters arising in other cases
Composition of cash and cash equivalents	An overseas subsidiary with cash pooling arrangements netted off bank overdrafts against cash balances. The component and group audit did not identify the originating error. Whilst this is primarily a balance sheet matter, the impact affected presentation and disclosure in the cash flow statement. **Enhancement actions** The firm updated its guidance for component and group auditors. The work performed by component auditors over cash and cash equivalents is also now reviewed by the group auditor. **Further guidance** The treatment of cash pooling arrangements was considered by the IFRS Interpretations Committee ("the Committee") in March 2016[5]. In addition, the Committee also considered the types of borrowings which can be included as a component of cash and cash equivalents in March 2018[6].	The nature of restrictions on cash and cash equivalent balances and the resulting impact on disclosure within the cash flow statement and balance sheet. Determining whether a balance meets the definition of a cash equivalent.
Classification errors that mainly occurred between operating activities at the expense of investing activities	The audit team did not apply the requirements of the audit programme to consider non-cash transactions that do not give rise to an investing activity cash flow. In addition, the impact of late adjustments made to the accounts and the cash flow statement resulted in the audit team not giving enough attention to the final cash flow statement presented. The review process did not detect the errors. **Enhancement actions** The firm assigned the cash flow statement audit work to more senior members of the audit team. The audit work performed showed a greater emphasis on audit evidence recorded and was subject to enhanced supervision and review by the audit firm. Further training was provided to audit teams. A management letter point on the capacity and capability of the finance team was reported to those charged with governance.	Acquisition costs treated as investing rather than operating activities. Costs associated with discontinued operations incorrectly treated as operating activities instead of investing activities. Settlement of conditional provisions related to sale of a business incorrectly classified as investing cash flows rather than operating cash flows.

5 https://cdn.ifrs.org/-/media/feature/news/updates/ifrs-ic/2016/ifric-update-march-2016.pdf
6 https://www.ifrs.org/news-and-events/updates/ifric/2018/ifric-update-march-2018/

How audit firms have strengthened the audit of cash flow statements

Cash flow statement actions taken by firms



- Briefings and training for audit staff
- Change to audit templates/audit programme
- Enhanced review process
- Assign cash flow statement audit work to a more experienced team member
- Cash flow statement approach discussed at planning/team meetings
- Control/process recommendation reported to those charged with governance

The enhancement actions undertaken as a result of our Constructive Engagement activity largely involved amendments to a firm's audit procedures and/or training and guidance to introduce new audit procedures or to reinforce the existing audit methodology and guidance.

Enhancing the review process was also identified as a significant action. Given that the audit of the cash flow statement requires a good understanding of the business, a thorough review of audit procedures performed can also reduce the risk of less experienced staff not identifying errors from change events and internal consistency errors. Late changes to the financial statements are also a factor addressed by this action.

The audit planning phase of the audit is also a good opportunity to consider the audit of the cash flow statement. Factors affecting other primary statements such as the complexity of the group structure, change events, audit team staff mix, and the quality of company's procedures and systems can be addressed by this action.

The actions related to internal control/process recommendations inform those charged with governance of matters arising around the company's capacity and capability to prepare financial statements, including the cash flow statement.

Appendix 1: Summary of historical cash flow statement errors identified in FRC Thematic Review: Cash flow and liquidity disclosures (November 2020)

Error	Correction would impact the following cash flows:		
	Operating	Investing	Financing
Payments of purchase consideration for subsidiary undertakings conditional on the continuing employment of the vendors in the business incorrectly classified as investing cash flows rather than operating cash flows	↓	↑	
Payments for the purchase of businesses incorrectly classified as operating activities rather than investing activities	↑	↓	
Company presented cash outflows on its investment in legal cases and the purchase of property for resale, relating to a case settlement, within investing activities. However, the cash inflow upon settlement of cases was presented within operating activities. Both types of cash outflow should have been presented within operating activities because they arose in respect of the company's principal revenue-producing activities	↓	↑	
Post-acquisition and restructuring cost cash flows included within investing activities rather than operating activities	↓	↑	
Cash flows relating to joint venture funding incorrectly classified as financing rather than investing activities		↓	↑
Advances to joint ventures were presented as operating cash flows rather than investing activities	↑	↓	
Acquisition-related expenses recognised in the income statement incorrectly classified as investing activities rather than operating activities	↓	↑	
Company classified promissory notes as debt, but movements in the balance sheet classified as operating, rather than financing, cash flows	↑		↓
Restructuring cash outflow incorrectly classified as investing activities rather than operating activities	↓	↑	
Incorrect classification of movements in certain restricted cash balances, which were included in financing activities rather than in investing activities		↓	↑

Financial Reporting Council

Financial
Reporting Council
8th Floor
125 London Wall
London EC2Y 5AS

+44 (0)20 7492 2300

www.frc.org.uk