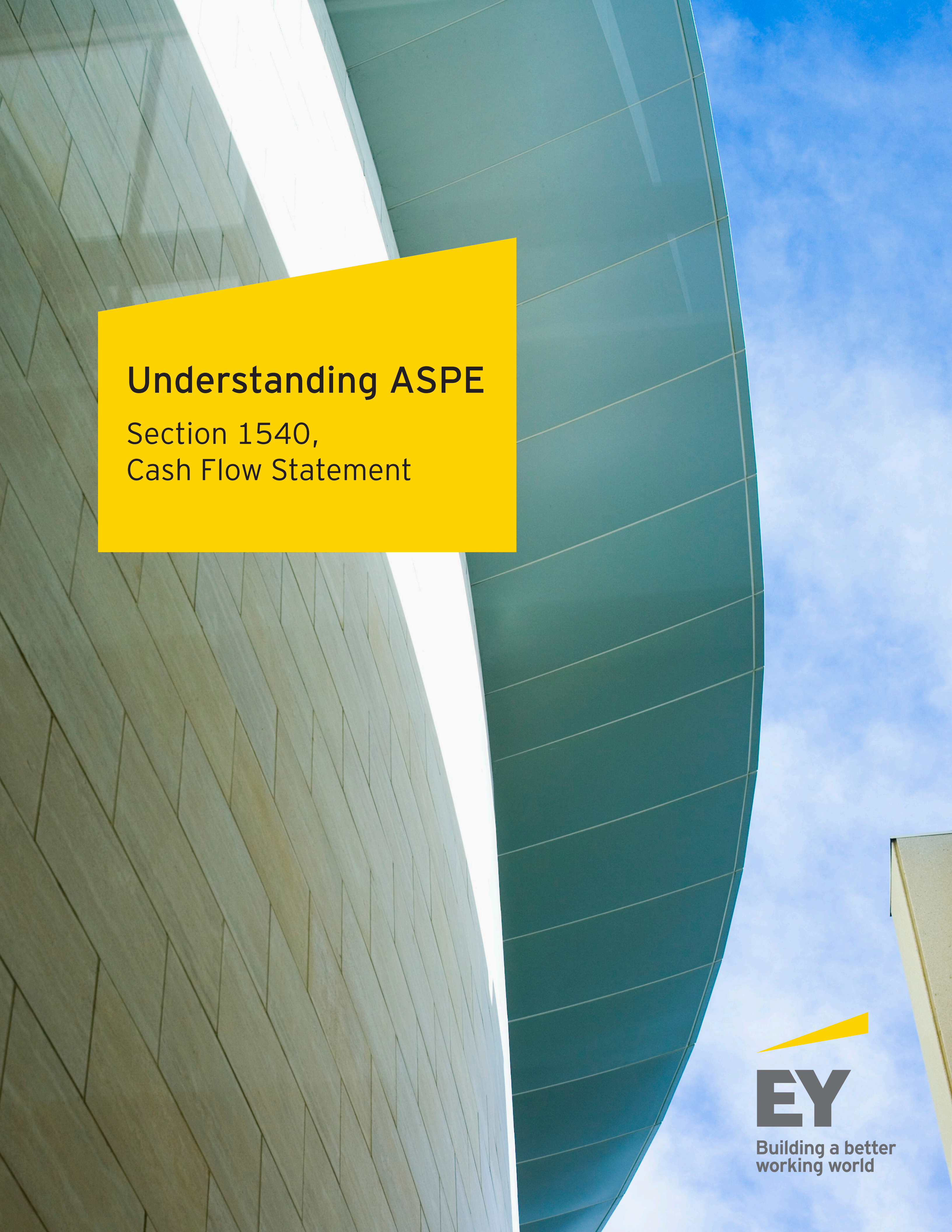
Understanding ASPE

Section 1540, Cash Flow Statement



Eight questions for private business owners: Cash Flow Statement

A better working world begins with better questions. Asking better questions leads to better answers. To help preparers of financial statements with Canadian accounting standards for private enterprises ("ASPE") Section 1540, *Cash Flow Statement*, we've summarized the key aspects of the Section and offer relevant practical considerations for private mid-market companies through answering eight commonly asked questions.

Question 1

What is a cash equivalent?

As stated in paragraph 1540.06 (b), a cash equivalent is a short-term, highly liquid investment that is readily convertible to a known amount of cash and is subject to an insignificant risk of change in value. Cash equivalents are held for the purpose of meeting short-term cash commitments, rather than for investing and earning large amounts of interest. Cash that is restricted for current use is not classified as a cash equivalent because it cannot be used to pay current obligations.

As described in paragraph 1540.10, bank borrowings are generally considered to be financing activities. However, in some cases, bank overdrafts that are repayable on demand form an integral part of an enterprise's cash management. Bank overdrafts may be included as a component of cash and cash equivalents when the bank balance fluctuates frequently from being positive to overdrawn.

Question 2

How are cash flows classified?

Cash flows are classified into three categories: operating activities, investing activities, and financing activities. The category that a cash flow falls under depends on how it was generated. Operating, investing, and financing activities are presented separately on the statement of cash flows. Doing this allows readers of the financial statements to have a good idea of the impact each activity has on the enterprise. A single transaction may have multiple cash flow aspects that are classified differently. For example, interest payable on a loan is classified as an operating activity, while the principal repayments are categorized as a financing activity.

Question 3

What is the difference between an operating, investing and financing activity?

The three different types of activities correspond to different activities of the business. Operating activities are the principal revenue-producing activities of the enterprise and all other activities that are not investing or financing activities. Examples included cash receipts from the sale of goods and rendering of services, cash payments to suppliers for goods and services, cash receipts and payments of interest and dividends included in the determination of net income and cash payments and refunds of income and other taxes. Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. Examples include cash payments to acquire capital and other long-term assets. Financing activities are activities that result in changes in the size and composition of the equity capital and borrowings of the enterprise. Examples include cash proceeds from issuing equity instruments, cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short or long-term borrowings, cash repayments of amounts borrowed and cash payments of dividends and interest charged to retained earnings. Section 1540 contains an illustrative example that goes through many of the different types of cash flows and their presentation on the statement of cash flows.

Question 4

What is the difference between the direct method and indirect method of presenting cash flows from operating activities?

Entities can use either the direct or indirect method for reporting cash flows from operating activities. Paragraph 1540.21 indicates that an enterprise is encouraged to use the direct method. Under the direct method, the major classes of gross cash receipts and gross cash payments are presented. Under the indirect method, the net cash flow from operating activities is determined by adjusting net income or loss for the effects of non-cash items included in net income (e.g. amortization, future income taxes, unrealized foreign exchange gains/ losses, etc.), changes in working capital balances and cash flows associated with investing or financing activities.

Question 5

When can cash flows be presented on a net basis?

Generally, the major classes of gross cash receipts and gross cash payments are presented. However, cash flows can be presented on a net basis in certain circumstances as described in paragraph 1540.25. Cash flows from the following activities may be reported on a net basis:

(a) Cash receipts and payments on behalf of customers when the cash flows reflect activities of the customer rather than those of the enterprise (e.g. funds held for customers by an investment enterprise or rents collected on behalf of, and paid to, the owners of properties);

(b) Cash receipts and payments for which the turnover is quick, the amounts are large, and the maturities are short (e.g. principal amounts relating to credit card customers, the purchase and sale of trading assets and other short-term borrowings, for example, those that have a maturity period of three months or less).

Question 6

How are foreign currency cash flows reported?

As described in paragraph 1540.27, cash flows arising from transactions in a foreign currency shall be recorded in an enterprise's reporting currency by applying the foreign currency amount to the exchange rate between the reporting currency and the foreign currency at the date of the cash flow. As noted in paragraph 1540.30, unrealized gains and losses arising from changes in foreign currency exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash equivalents denominated in a foreign currency is reported in the cash flow statement in order to reconcile cash and cash equivalents at the beginning and the end of the period.

Question 7

How does a business combination or a disposal of a business unit impact the statement of cash flows?

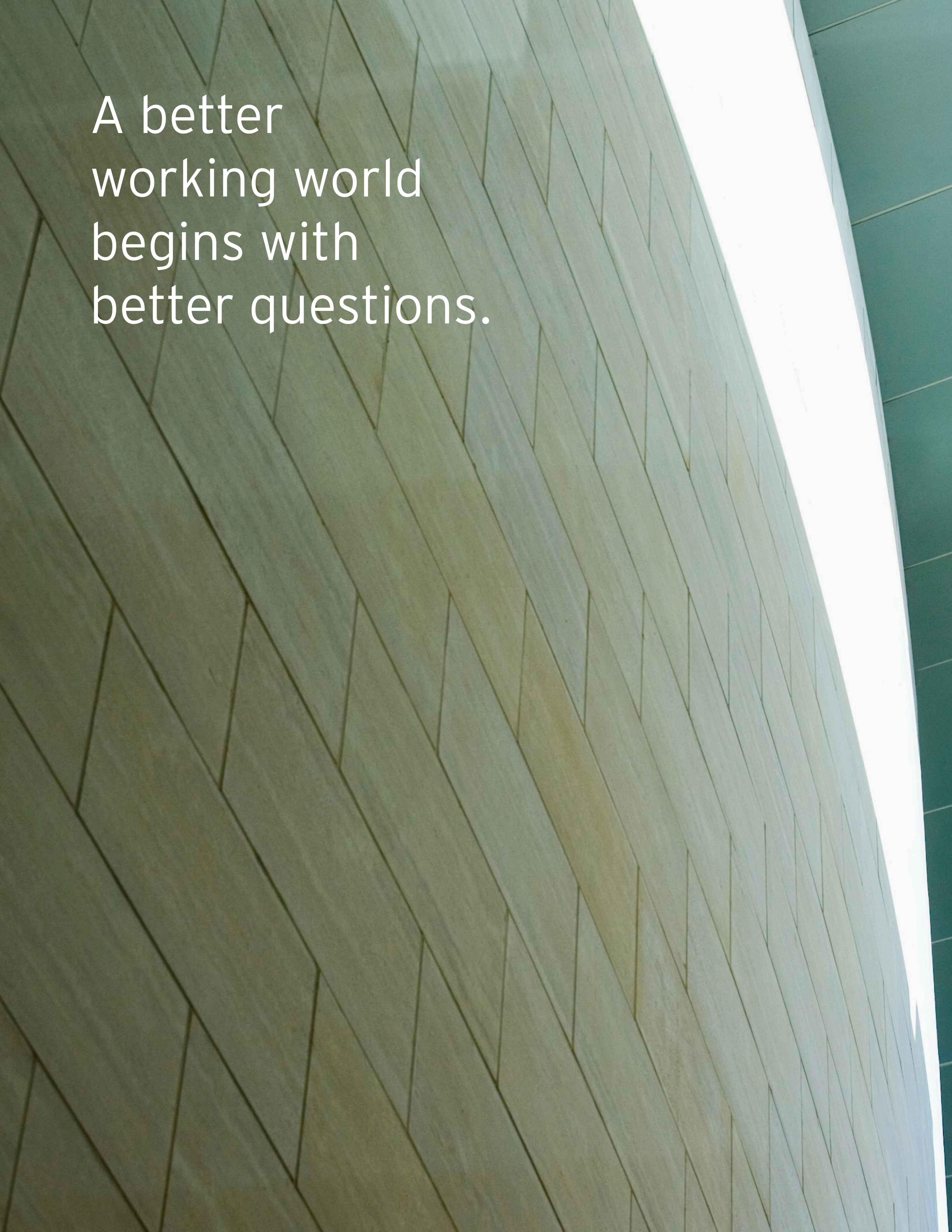
Paragraph 1540.38 indicates that the aggregate cash flows arising from each of business combinations and disposals of business units shall be presented separately and classified as cash flows from investing activities. This is done to help distinguish those cash flows from the cash flows arising from the other operating, investing, and financing activities.

Question 8

How do non-cash transactions impact the statement of cash flows?

As described in paragraph 1540.41, investing and financing transactions that do not require the use of cash or cash equivalents are excluded from the statement of cash flows. As further indicated in paragraph 1540.48, investing and financing transactions that do not require the use of cash or cash equivalents should be disclosed in the notes to the financial statements in a way that provides all the relevant information about these investing and financing activities. Examples of non-cash transactions include the acquisition of assets by directly assuming liabilities, the acquisition of assets by means of a capital lease, the acquisition of an enterprise in exchange for shares of the acquirer, and the conversion of debt to equity.

To learn more about these items or for application guidance, please contact our Private Mid-Market practice at **privatecompanyinfo@ca.ey.com**.


A better
working world
begins with
better questions.

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