PROFESSOR’S DISCUSSION MATERIALS

Objectives of the Case

This case gives students an opportunity to apply the guidance in ASC 505, ASC 230, and IAS 7 when determining how to account for tender offers to employees to repurchase stock and the presentation of such transactions in the statement of cash flows.

Applicable Professional Pronouncements

ASC 230-10, Statement of Cash Flows: Overall (ASC 230-10)

ASC 505-30, Equity: Treasury Stock (ASC 505-30)

IFRS 2, Share-based Payment (IFRS 2)

IAS 7, Statement of Cash Flows (IAS 7)

Background

ASC 505-30 addresses how a company should account for treasury shares purchased at a stated price significantly more than the current market price of the shares. ASC 505-30-50-3 states:

A repurchase of shares at a price significantly in excess of the current market price creates a presumption that the repurchase price includes amounts attributable to items other than the shares repurchased. A repurchase of shares at a price significantly in excess of the current market price may require an entity to allocate amounts to other elements of the transaction under the requirements of paragraph 505-30-30-2.

To overcome the presumption that there is value to something other than the shares purchased, the transaction generally must be with an unrelated party, there cannot be other relationships, such as a revenue or co-branding relationship between the two parties, and the transaction cannot be with an employee.

ASC 230 provides guidance for reporting cash flows in general-purpose financial statements. ASC 230-10-45-10 states:

A statement of cash flows shall classify cash receipts and cash payments as resulting from investing, financing, or operating activities.

In situations in which U.S. GAAP clearly requires the separate accounting treatment of multiple elements of the same transaction, their treatment within the statement of cash flows should also be bifurcated according to the nature of each element within the transaction.

Presentation guidance for the statement of cash flows in ASC 230-10-45-7 states that “information about the gross amounts of cash receipts and cash payments during a period is [generally] more relevant than information about the net amounts of cash receipts and payments.” Net presentation may only be acceptable and appropriate in certain situations, as described in ASC 230-10-45 (see discussion below).
Discussion 1 — Gross Versus Net Treatment Within the Statement of Cash Flows

Gross presentation is appropriate in this situation.

ASC 230-10-45-7 states:

Generally, information about the gross amounts of cash receipts and cash payments during a period is more relevant than information about the net amounts of cash receipts and payments. However, the net amount of related receipts and payments provides sufficient information not only for cash equivalents, as noted in paragraph 230-10-45-5, but also for certain other classes of cash flows specified in paragraphs 230-10-45-8 through 45-9 and paragraph 230-10-45-28.

Further, ASC 230-10-45-8 and 45-9 state:

45-8 For certain items, the turnover is quick, the amounts are large, and the maturities are short. For certain other items, such as demand deposits of a bank and customer accounts payable of a broker-dealer, the entity is substantively holding or disbursing cash on behalf of its customers. Only the net changes during the period in assets and liabilities with those characteristics need be reported because knowledge of the gross cash receipts and payments related to them may not be necessary to understand the entity’s operating, investing, and financing activities.

45-9 Providing that the original maturity of the asset or liability is three months or less, cash receipts and payments pertaining to any of the following qualify for net reporting for the reasons stated in the preceding paragraph:

a. Investments (other than cash equivalents)

b. Loans receivable

c. Debt.

For purposes of this paragraph, amounts due on demand are considered to have maturities of three months or less. For convenience, credit card receivables of financial services operations—generally, receivables resulting from cardholder charges that may, at the cardholder’s option, be paid in full when first billed, usually within one month, without incurring interest charges and that do not stem from the entity’s sale of goods or services—also are considered to be loans with original maturities of three months or less.

The above guidance to permit net presentation within the statement of cash flows does not apply to the circumstances within this fact pattern. In addition, Justified Wages Inc. (the “Company”) acted as a principal in both transactions (the cash was physically paid and received by the Company), and the transaction constituted a repurchase and subsequent sale as opposed to the Company purchasing the common stock from employees on behalf of the independent investor, Well-to-Do Inc. (WTD) (acting as an agent). On the basis of the guidance above, the cash outflow related to the repurchase of the common stock from the employees and the subsequent cash inflow from the reissuance of those shares to WTD should be presented on a gross basis in the statement of cash flows.
Discussion 2 — Classification Within the Statement of Cash Flows

Accounting Alternatives

Alternative 1 — The portion of the $10 million (i.e., $2.6 million) that was recognized as compensation expense should be presented as a cash outflow from operating activities. The remaining portion (i.e., $7.4 million) should be presented as a cash outflow from financing activities.

The tender offer conducted by the Company is similar to a multiple-element transaction, which requires separate recognition for each element of such a transaction. This transaction is similar to other types of multiple-element transactions. For example, a reporting entity may acquire a software license and a one-year, postcontract customer support contract in a single arrangement that requires a single cash payment. In this example, the reporting entity would be required to capitalize the portion of the payment related to the acquisition of the software license as the acquisition of property, plant, and equipment, while the portion of the payment related to the postcontract customer support would be recognized as a prepaid maintenance expense. The cash flow statement presentation should appropriately reflect each element of the transaction irrespective that it was conducted in a single transaction.

The tender offer conducted by the Company has a compensation element pertaining to the consideration paid by the Company greater than the fair value of the common stock. The balance of consideration paid by the Company for the reacquisition of its common stock is the equity element.

ASC 230-10-45-15 states, in part:

All of the following are cash outflows for financing activities:

a. Payments of dividends or other distributions to owners, including outlays to reacquire the entity’s equity instruments.

In addition, ASC 230-10-45-17 states, in part:

All of the following are cash outflows for operating activities: . . .

b. Cash payments to other suppliers and employees for other goods or services.

On the basis of the guidance above, the portion of the $10 million (i.e., $2.6 million) that was recognized as compensation expense should be presented as a cash outflow from operating activities. The remaining portion (i.e., $7.4 million) should be presented as a cash outflow from financing activities because it represents an equity transaction.

Alternative 2 — The entire consideration paid by the Company for the tender offer (i.e., $10 million) should be presented as a cash outflow from financing activities.

The tender offer conducted by the Company has a compensation element and a financing element pertaining to the repurchase of the common stock; therefore, the tender offer has aspects of more than one class of cash flow. ASC 230-10-45-22 through 45-23, state:
45-22 Certain cash receipts and payments may have aspects of more than one class of cash flows. The classification of those cash receipts and payments shall be determined first by applying specific guidance in this Topic and other applicable Topics. In the absence of specific guidance, a reporting entity shall determine each separately identifiable source or each separately identifiable use within the cash receipts and cash payments on the basis of the nature of the underlying cash flows, including when judgment is necessary to estimate the amount of each separately identifiable source or use. A reporting entity shall then classify each separately identifiable source or use within the cash receipts and payments on the basis of their nature in financing, investing, or operating activities.

45-22A In situations in which cash receipts and payments have aspects of more than one class of cash flows and cannot be separated by source or use (for example, when a piece of equipment is acquired or produced by an entity to be rented to others for a period of time and then sold), the appropriate classification shall depend on the activity that is likely to be the predominant source or use of cash flows for the item.

45-23 Another example where cash receipts and payments include more than one class of cash flows involves a derivative instrument that includes a financing element at inception, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments, because the borrower’s cash flows are associated with both the financing element and the derivative instrument. For that derivative instrument, all cash inflows and outflows shall be considered cash flows from financing activities by the borrower.

Using the “predominance principle” explained in the guidance above, an argument could be made that the tender offer, irrespective of the multiple elements, is primarily a financing transaction because the intent of the Company was to repurchase its common stock. Thus, the consideration paid for the tender offer should be entirely presented as a cash outflow from financing activity.

Solution

In this scenario, Alternative 1 is the acceptable approach. The examples in ASC 230-10-45-22 and 45-23 do not accurately reflect the fact pattern because they pertain to situations in which U.S. GAAP does not require separate accounting treatment of multiple elements of the same transaction. The above examples within the Codification appear to address situations in which there is uncertainty regarding the nature of the cash flow because future events are unknown (e.g., whether an asset acquired will be rented or sold in the future). In the Company’s fact pattern, there is no such uncertainty. Further, U.S. GAAP requires separate accounting of the multiple elements of the tender offer conducted by the Company. Therefore, the examples above do not provide a basis for treating the entire cash payment to employees as a cash outflow for financing activities, and Alternative 2 is rejected.

Since U.S. GAAP clearly requires separate accounting treatment of multiple elements of the tender offer conducted by the Company, the presentation within the statement of cash
flows of each of these elements should follow the respective accounting treatment. Thus *Alternative 1* is appropriate.

**Discussion 3 — Presentation of the Amounts Paid to Employees in the Statement of Cash Flows Prepared Under IFRSs**

IAS 7 is the primary source of guidance under IFRSs for determining how to present information about the cash flows of an entity within the financial statements.

Similarly to the guidance within ASC 718-20-35-7, paragraph 25 of IFRS 2 states, in part:

[I]f an entity settles a grant of equity instruments to which paragraph 24 has been applied . . .

b. any payment made on settlement shall be accounted for as the repurchase of equity instruments, ie as a deduction from equity, except to the extent that the payment exceeds the intrinsic value of the equity instruments, measured at the repurchase date. Any such excess shall be recognised as an expense.

Thus, even under IFRSs, the Company would have recorded a debit to equity and compensation expense in the amounts of $7.4 million (representing the fair value of the common stock) and $2.6 million (representing the excess of purchase price over fair value), respectively, and a credit to cash to record the repurchase of common stock from its employees.

Similarly to U.S. GAAP, IAS 7 generally requires entities to present information about cash receipts and cash payments during a period on a gross basis. However, in certain circumstances, IAS 7 permits certain cash flow activities to be presented on a net basis.

Paragraph 22(b) of IAS 7 states that cash flows may be reported on a net basis for “cash receipts and payments for items in which the turnover is quick, the amounts are large, and the maturities are short.”

This guidance is consistent with the provisions of ASC 230-10-45-8. Further, paragraph 23A of IAS 7 provides the following examples of cash receipts and payments that may be presented net under the criteria set forth in paragraph 22(b) of IAS 7:

a. principal amounts relating to credit card customers;

b. the purchase and sale of investments; and

c. other short-term borrowings, for example, those which have a maturity period of three months or less.

On the basis of the guidance above, the cash outflow related to the repurchase of the common stock from the employees and the subsequent cash inflow from the reissuance of those shares to WTD should be presented on a gross basis in the statement of cash flows.
In addition, the presentation in the statement of cash flows of the purchase price paid to the employees to repurchase the common stock would also be consistent between U.S. GAAP and IFRSs.

Paragraph 12 of IAS 7 states:

A single transaction may include cash flows that are classified differently. For example, when the cash repayment of a loan includes both interest and capital, the interest element may be classified as an operating activity and the capital element is classified as a financing activity.

Paragraph 14(d) of IAS 7 states that “cash payments to and on behalf of employees” is an example of cash flows from operating activities.

In addition, paragraph 17(b) of IAS 7 states that “cash payments to owners to acquire or redeem the entity’s shares” is an example of cash flows from financing activities.

On the basis of the guidance above, and similarly to U.S. GAAP, the portion of the $10 million (i.e., $2.6 million) that was recognized as compensation expense should be presented as a cash outflow from operating activities. The remaining portion (i.e., $7.4 million) should be presented as a cash outflow from financing activities.