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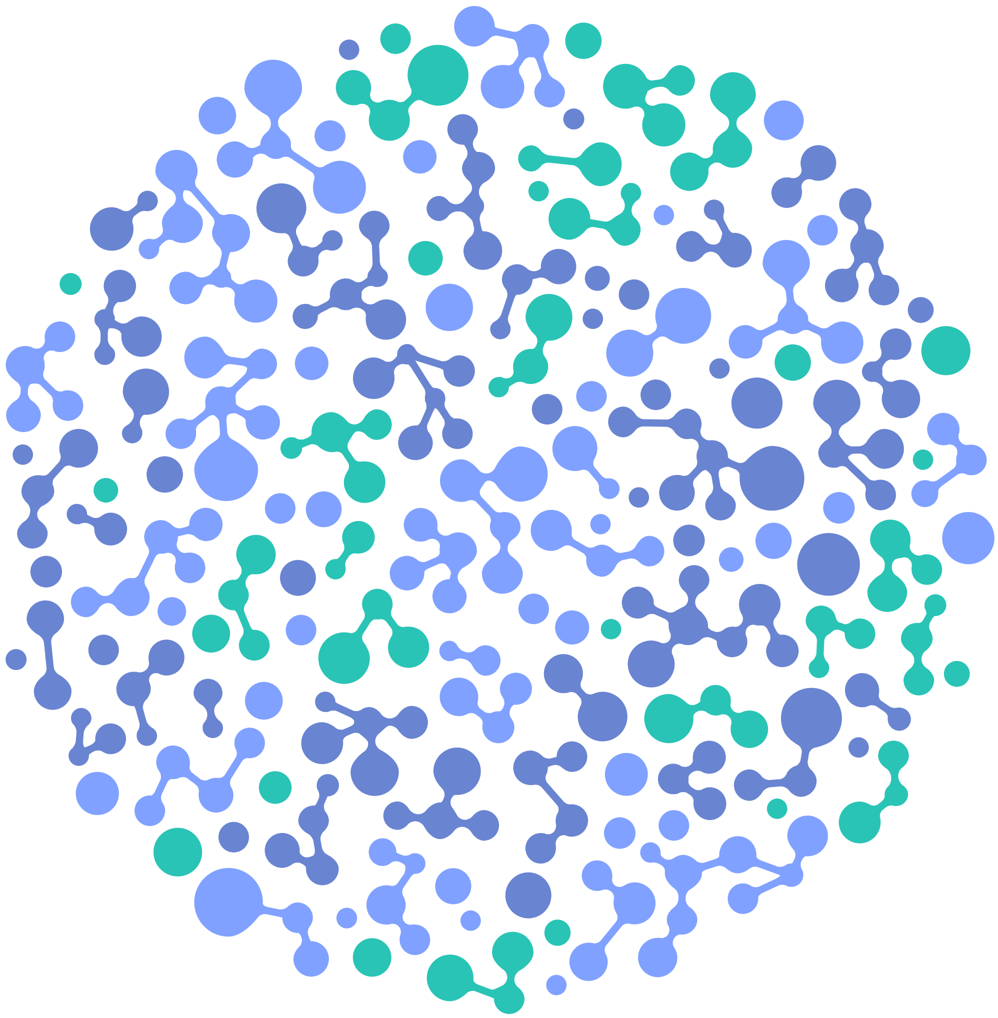

Life Sciences Industry Accounting Guide

Statement of Cash Flows

March 2021

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Preface

The life sciences ecosystem encompasses a wide array of entities that discover, develop, and manufacture health care products. Such entities include pharmaceutical manufacturers; biotechnology companies; medical device, diagnostic, and equipment manufacturers; and service companies such as drug distributors, contract research organizations (CROs), contract manufacturing organizations (CMOs), and health technology companies.

Finance and accounting professionals in the industry face complex issues and must exercise significant judgment in applying existing rules to matters such as research and development (R&D) costs, acquisitions and divestitures, consolidation, contingencies, revenue recognition, income taxes, financial instruments, and financial statement presentation and disclosure. The 2021 edition of Deloitte's *Life Sciences Industry Accounting Guide* (the "Guide") addresses these and other relevant topics affecting the industry this year. It includes interpretive guidance, illustrative examples, recent standard-setting developments (through February 28, 2021), and key differences between U.S. GAAP and IFRS® Standards. In addition, this Guide discusses accounting and financial reporting considerations associated with the coronavirus disease 2019 ("COVID-19") pandemic that apply specifically to the life sciences industry.

Appendix B lists the titles of standards and other literature we cited, and Appendix C defines the abbreviations we used.

We hope this Guide is helpful in navigating the various accounting and reporting challenges that life sciences entities face. We encourage clients to contact their Deloitte team for additional information and assistance.

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Chapter 7 — Statement of Cash Flows

7.1 Introduction

While the accounting principles underlying the statement of cash flows have been in place for many years, challenges in interpretation and preparation have consistently made the statement of cash flows one of the leading causes of restatements and comments from the SEC staff for life sciences entities. In Section 7.2 below, we highlight issues commonly encountered by life sciences entities that are associated with the classification of cash flows as operating, investing, or financing. For more information as well as insights into topics not addressed below, see Deloitte's *A Roadmap to the Preparation of the Statement of Cash Flows*.

7.2 Industry Issues

7.2.1 Foreign Currency Cash Flows

The global nature of life sciences entities often gives rise to transactions that are denominated in a foreign currency and to businesses that operate in foreign functional currency environments. For example, the product supply chain structure for many life sciences entities involves the movement of materials and products across international borders throughout the manufacturing life cycle, giving rise to many transactions that are exposed to changes in the exchange rate.

An entity should report the cash flow effect of transactions denominated in a foreign currency by using the exchange rates in effect on the date of such cash flows. As noted in ASC 830-230-45-1, instead of using the actual exchange rate on the date of a foreign currency transaction, an entity may use an "appropriately weighted average exchange rate" for translation "if the result is substantially the same as if the rates at the dates of the cash flows were used."

A consolidated entity with operations whose functional currencies are foreign currencies may use the following approach when preparing its consolidated statement of cash flows:

- Prepare a separate statement of cash flows for each foreign operation by using the operation's functional currency.
- Translate the stand-alone cash flow statement prepared in the functional currency of each foreign entity into the reporting currency of the parent entity.
- Consolidate the individual translated statements of cash flows.

The effects of exchange rate changes, or translation gains and losses, are not the same as the effects of transaction gains and losses and should not be presented or calculated in the same manner.

Effects of exchange rate changes may have a direct impact on cash receipts and payments but do not directly result in cash flows themselves.

Because unrealized transaction gains and losses arising from the remeasurement of foreign-currency-denominated monetary assets and liabilities on the balance sheet date are included in the determination of net income, such amounts should be presented as a reconciling item between net income and net cash from operating activities (either on the face of the statement under the indirect method or in a separate schedule under the direct method).

Subsequently, any cash flows arising from the settlement of the foreign-currency-denominated asset and liability should be presented in the statement of cash flows as an operating, investing, or financing activity on the basis of the nature of such cash flows.

Translation gains and losses, however, are recognized in other comprehensive income (OCI) and are not included in the cash flows from operating, investing, or financing activities.

The effects of exchange rate changes on cash should be shown as a separate line item in the statement of cash flows as part of the reconciliation of beginning and ending cash balances. This issue is discussed in paragraph 101 of the Basis for Conclusions of FASB Statement 95, which states, in part:

> The effects of exchange rate changes on assets and liabilities denominated in foreign currencies, like those of other price changes, may affect the amount of a cash receipt or payment. **But exchange rate changes do not themselves give rise to cash flows, and their effects on items other than cash thus have no place in a statement of cash flows.** To achieve its objective, a statement of cash flows should reflect the reporting currency equivalent of cash receipts and payments that occur in a foreign currency. Because the effect of exchange rate changes on the reporting currency equivalent of cash held in foreign currencies affects the change in an enterprise's cash balance during a period but is not a cash receipt or payment, the Board decided that **the effect of exchange rate changes on cash should be reported as a separate item in the reconciliation of beginning and ending balances of cash**. [Emphasis added]

In a manner consistent with the implementation guidance in ASC 830-230-55-15, the effect of exchange rate changes on cash and cash equivalents is the sum of the following two components:

1. For each foreign operation, the difference between the exchange rates used in translating functional currency cash flows and the exchange rate at year-end multiplied by the net cash flow activity for the period measured in the functional currency.
2. The fluctuation in the exchange rates from the beginning of the year to the end of the year multiplied by the beginning cash balance denominated in currencies other than the reporting currency.

For more information about foreign currency accounting and reporting matters, see Deloitte's *A Roadmap to Foreign Currency Transactions and Translations*.

7.2.2 Transactions Associated With Acquisitions

The life sciences industry continues to experience significant M&A activity, and transactions associated with acquisitions affect a company's statement of cash flows in a number of ways.

For additional considerations related to an entity's accounting for a business combination, see Deloitte's *A Roadmap to Accounting for Business Combinations*.

7.2.2.1 Presentation of Acquisition-Related Costs

When consummating a business combination, an acquirer frequently incurs acquisition-related costs such as advisory, legal, accounting, valuation, and professional and consulting fees. Except for certain debt and equity issuance costs, ASC 805 requires that an entity expense all such acquisition-related costs as incurred. The costs of issuing debt or equity securities as part of a business combination are recognized in accordance with other applicable accounting literature.

In the deliberations before the issuance of FASB Statement 141(R) (codified in ASC 805), the Board determined that acquisition-related costs are not considered part of the fair value exchange between the buyer and seller of the business; rather, they are separate transactions in which the buyer pays for services that it receives. Further, the definition of "operating activities" in the ASC master glossary states, in part, that "[c]ash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income." Because acquisition-related costs accounted for under ASC 805 are expensed and affect net income, these costs should be reflected as operating cash outflows in the statement of cash flows.

7.2.2.2 Debt in a Business Combination

The classification in the statement of cash flows of cash paid to settle the acquiree's debt in a business combination should be consistent with the acquirer's treatment of the debt in acquisition accounting (i.e., whether the debt was treated as a liability assumed in acquisition accounting). If the acquirer concludes that it assumes the acquiree's debt as part of the business combination, the acquirer will generally present the extinguishment as a financing activity (in a manner consistent with how it would present the repayment of a debt obligation outside of a business combination). Conversely, if the acquirer concludes that it does not assume the acquiree's debt as part of the business combination that was subsequently extinguished, the acquirer will generally present the extinguishment as an investing activity (in a manner consistent with how it would present cash consideration paid in a business combination).

Example 7-1

Acquirer Does Not Assume Acquiree's Debt

Company A acquires Company B in a business combination. Before the acquisition, B had $1 million in outstanding debt owed to a third-party bank. Company A pays the seller $5 million in cash and repays the $1 million debt upon the closing of the business combination. Company A concludes that it did not assume B's debt (i.e., that it repaid the debt on B's behalf). As of the acquisition date, B's net assets recognized in accordance with ASC 805 are $4 million. Company A calculates the goodwill resulting from the acquisition of B as follows:

Cash consideration paid to the seller	$ 5,000,000
Repayment of B's debt	1,000,000
Total consideration transferred to acquire B	6,000,000
Less: B's net assets under ASC 805	(4,000,000)
Goodwill	$ 2,000,000

Because A did not assume B's debt, the total consideration transferred is $6 million in cash. Therefore, A should present the $6 million as an investing outflow in its statement of cash flows.

Example 7-2

Acquirer Assumes Acquiree's Debt

Assume the same facts as in Example 7-1, except that Company A concludes that it assumed Company B's debt. As a result, B's net assets recognized in accordance with ASC 805 are $3 million (i.e., $4 million less $1 million in debt). Company A calculates the goodwill resulting from the acquisition of B as follows:

Consideration transferred to acquire B	$ 5,000,000
B's net assets under ASC 805, excluding debt assumed	4,000,000
Add: liability assumed for B's debt	(1,000,000)
Less: B's total net assets under ASC 805	(3,000,000)
Goodwill	$ 2,000,000

Because A assumed B's debt, the consideration transferred is $5 million in cash paid to the seller, and the $1 million to repay B's debt is a liability assumed in the acquisition accounting. Therefore, A should present $5 million as an investing outflow and $1 million as a financing outflow in its statement of cash flows.

7.2.2.3 Contingent Consideration Classified as a Liability

It is common in business combinations entered into by life sciences companies for a portion of the consideration to be contingent on future events. ASC 805 requires the acquirer to recognize the acquisition-date fair value of the contingent consideration arrangement as part of the consideration transferred in exchange for the acquiree. The contingent consideration arrangement is classified either as a liability or as equity in accordance with applicable U.S. GAAP. In transactions involving life sciences companies, contingent consideration is frequently classified as a liability.

If the acquiring entity determines that the contingent consideration arrangement should be classified as a liability, the initial fair value of the contingent consideration as of the acquisition date should be reflected as a **noncash** investing activity. In accordance with ASC 230-10-50-3, this arrangement should be either disclosed narratively or summarized in a schedule because no cash consideration is transferred on the acquisition date. It should not be reflected in investing activities. In subsequent periods, the contingent consideration liability must be remeasured at fair value as of each reporting date until the contingency is resolved, with the changes recognized as an expense in the determination of earnings (unless the change is the result of a measurement-period adjustment or the arrangement is a hedging instrument for which ASC 815 requires changes to be recognized in OCI). Because the subsequent fair value adjustment enters into the determination of the acquiring entity's net income and is a noncash item, it should be reflected as a reconciling item between net income and cash flows from operating activities in the statement of cash flows.

If the contingent consideration is satisfied in either cash or cash equivalents upon resolution of the contingency, the classification of payments made to settle the contingent consideration liability should be determined on the basis of when such payments are made in relation to the date of the business combination. Essentially, classification of the payments depends on whether they are made soon after the acquisition in a business combination transaction. While ASC 230 does not define the term "soon after," we generally believe that this term would apply to payments made within three months or less of the acquisition date. This view is also consistent with paragraph BC16 of ASU 2016-15, which states, in part, that "some Task Force members believe that a payment for contingent consideration that was made soon after a business combination is an extension of the cash paid for the business acquisition (an investing activity), if that payment for contingent consideration was made within a relatively short period of time after the acquisition date (for example, three months or less)." Therefore, because a payment made on or soon after the business combination date (to settle the liability related to contingent consideration) is viewed as an extension of the business combination, such payments made soon after the date of the business combination are presented as investing activities in the acquirer's statement of cash flows in accordance with ASC 230-10-45-13(d).

Conversely, contingent consideration payments that are not made on the acquisition date or soon after the business combination are not viewed as an extension of the business combination. Therefore, such payments should be separated and presented as:

- *Financing cash flows* — The cash paid to settle the contingent consideration liability recognized at fair value as of the acquisition date (including measurement-period adjustments), less payments made soon after the business combination date, should be reflected as a cash outflow for financing activities in accordance with ASC 230-10-45-15(f).
- *Operating cash flows* — The cash payments not made soon after the business combination date that exceed those classified as financing activities should be reflected as a cash outflow for operating activities in accordance with ASC 230-10-45-17(ee).

As indicated in paragraph BC14 of ASU 2016-15, the separation of contingent consideration payments not made soon after the business combination date is consistent with the approach most entities used before the ASU was issued. Paragraph BC14 further notes that this approach is the one that is most closely aligned with certain principles in ASC 230.

These principles include:

- The cash paid to settle the contingent consideration liability recognized at fair value as of the acquisition date (including measurement-period adjustments) should be reflected as a cash outflow for financing activities in the statement of cash flows. Effectively, the acquiring entity financed the acquisition and the cash outflow therefore represents a subsequent payment of principal on the borrowing and should be reflected in accordance with ASC 230-10-45-15(f).
- The remaining portion of the amount received/paid (i.e., the changes in fair value of the contingent consideration liability after the acquisition date) should be reflected as a cash inflow/outflow from operating activities because the fair value adjustments were recognized in earnings. If the amount paid to settle the contingent consideration liability is less than the amount recorded on the acquisition date (i.e., the fair value of the contingent consideration decreased), the entity would only reflect the portion of the liability that was paid as a cash outflow for financing activities. The difference between the liability and the amount paid is a fair value adjustment. This adjustment enters into the determination of the acquiring entity's net income and is a noncash item, so it should be reflected as a reconciling item between net income and cash flows from operating activities in the consolidated statement of cash flows.

Example 7-3

On December 1, 20X2, Company A (a calendar-year-end private company) acquires 100 percent of Company B for $1 million. The purchase agreement includes a contingent consideration arrangement under which A agrees to pay additional cash consideration if the earnings of B (which will be operated as a separate subsidiary of A) exceed a specified target for the year ended December 31, 20X3. Company A classifies the contingent consideration arrangement as a liability and records the contingent consideration liability at its acquisition-date fair value amount, provisionally determined to be $500,000.

On April 15, 20X3, A finalizes its valuation of the contingent consideration liability. Therefore, A estimates the acquisition-date fair value of the contingent consideration liability to be $600,000 and records a measurement-period adjustment for $100,000 (the measurement-period adjustment related to facts and circumstances that existed as of the acquisition date), with an offsetting adjustment to goodwill.

Company B achieves the performance target for the year ended December 31, 20X3; accordingly, A determines that it must pay $750,000 to B's former owners to settle the contingent consideration arrangement. For the year ended December 31, 20X3, A recognizes $150,000 ($750,000 – $600,000) in earnings to reflect the subsequent remeasurement of the contingent consideration liability to fair value. On January 31, 20X4, A settles the obligation.

No payments to settle the liability for contingent consideration were made soon after the business acquisition date.

Company A would present the following amounts in its statement of cash flows for the years ended:

- *December 31, 20X2* — The provisional accrual of $500,000 would be reflected as a **noncash** investing activity and would be either disclosed narratively or summarized in a schedule.
- *December 31, 20X3* — The adjustment to the provisional accrual of $100,000 would be reflected as a **noncash** investing activity and would be either disclosed narratively or summarized in a schedule. The subsequent remeasurement adjustment to the contingent consideration liability of $150,000 would be reflected as a reconciling item between net income and cash flows from operating activities.
- *December 31, 20X4* — Of the $750,000 paid, $600,000 represents the amount to settle the contingent consideration liability recognized at fair value as of the acquisition date (including measurement-period adjustments) and should be reflected as a cash outflow for financing activities. The remaining portion of the $750,000 paid (i.e., the $150,000 change in fair value of the contingent consideration liability after the acquisition date) should be reflected as a cash outflow for operating activities because the fair value adjustments were recognized in earnings.

Example 7-4

Assume the same facts as in Example 7-3 except that when B achieves the performance target for the year ended December 31, 20X3, A determines that it only needs to pay $550,000 to B's former owners to settle the contingent consideration arrangement. For the year ended December 31, 20X3, A recognizes a credit of $50,000 ($550,000 – $600,000) in earnings to reflect the subsequent remeasurement of the contingent consideration liability to fair value.

Company A would present the same amounts as those in Example 7-3 in its statement of cash flows for the year ended December 31, 20X2. Company A would then present the following amounts for the years ended:

- *December 31, 20X3* — The adjustment to the provisional accrual of $100,000 would be reflected as a **noncash** investing activity and would be either disclosed narratively or summarized in a schedule. The subsequent remeasurement adjustment to the contingent consideration liability of $50,000 would be reflected as a reconciling item between net income and cash flows from operating activities.
- *December 31, 20X4* — The entire amount of the $550,000 paid represents the amount to settle the contingent consideration liability recognized at fair value as of the acquisition date (including measurement-period adjustments) and should be reflected as a cash outflow for financing activities.

7.2.2.4 Acquired IPR&D Assets With No Alternative Future Use

The acquisition of IPR&D assets as part of either a business combination or an asset acquisition is common in the life sciences industry. In accordance with ASC 730, IPR&D assets acquired in an asset acquisition rather than in a business combination should be expensed as of the acquisition date unless such assets have an alternative future use, in which case they should be capitalized. All IPR&D assets acquired in a business combination should initially be capitalized regardless of whether they have an alternative future use. See Chapter 4 for additional information.

We have observed diversity in practice related to how cash payments for IPR&D assets acquired in an asset acquisition are reported in the statement of cash flows when such assets have no alternative future use. While some entities classify the cash payments in operating activities, other entities classify them in investing activities. Given the lack of authoritative guidance on this matter and the diversity in practice, we believe that it is acceptable for an entity to present cash payments related to the IPR&D assets acquired in an asset acquisition that have no alternative use as either operating or investing activities. This election is an accounting policy matter that an entity should consistently apply to similar arrangements and disclose if material.

Considerations related to the classification as operating or investing activities include:

- *Operating activities* — Classification in operating activities of cash outflows for IPR&D assets acquired in an asset acquisition that do not have an alternative future use is supported by the following:
  - ASC 230 does not specifically define such cash outflows as investing or financing activities.
  - Since such cash outflows are immediately expensed, they represent “the cash effects of transactions and other events that enter into the determination of net income” in a manner consistent with the definition of operating activities in the ASC master glossary.
- *Investing activities* — Classification in investing activities of cash outflows for IPR&D assets acquired in an asset acquisition that do not have an alternative future use is supported by the following Q&A in paragraph 5.12 of the AICPA Accounting and Valuation Guide *Assets Acquired to Be Used in Research and Development Activities*:

  > *Question 1:* How should an acquiring entity classify in its statement of cash flows an R&D charge associated with the costs of IPR&D projects acquired as part of an asset acquisition that have no alternative future use?
  >
  > *Answer:* Best practices suggest that an acquiring entity should report its cash acquisition of assets to be used in R&D activities as an investing outflow in its statement of cash flows. In this regard, an acquiring entity should treat assets acquired to be used in R&D activities similar to how it reports other acquired assets in the statement of cash flows. Although acquired IPR&D may lack an alternative future use and, therefore, would be expensed immediately, it is still an asset for cash flow statement purposes.
  >
  > When arriving at cash flows from operating activities under the indirect method of reporting cash flows, best practices suggest that an acquiring entity should add back to net income the costs of assets acquired to be used in R&D activities that are charged to expense. That adjustment is necessary to eliminate from operating cash flows those cash outflows of assets acquired to be used in R&D activities that are reflected in investing activities.

  In addition, if the cash outflows are treated as investing activities, the cash flow reporting of IPR&D assets acquired in a business combination would be aligned with that of IPR&D assets acquired in an asset acquisition.

7.2.2.5 Settlement of Acquired Liabilities After a Business Combination

After an acquisition, the acquirer may make payments to settle a liability legally assumed in a business combination. The cash outflow related to the settlement of the liability could be classified as an operating, investing, or financing activity depending on the nature of the payment. The payment should be classified as it would have been in the absence of the business combination. For example:

- If the payment was for inventory purchased on account, it would represent an operating cash outflow.
- If the payment was for PP&E that was purchased on account and was paid within three months of its original purchase date, it would represent an investing cash outflow.
- If the payment was in connection with a debt obligation legally assumed in an acquisition that remained outstanding after the acquisition, it would represent a financing cash outflow. However, as described in Section 7.2.2.2, if the payment is related to debt extinguished in conjunction with a business combination, the entity must consider certain facts and circumstances of the business combination to determine the appropriate presentation in its statement of cash flows.

7.2.3 Stock Compensation

The complexity of stock compensation arrangements often leads to additional presentation issues related to a life sciences entity's statement of cash flows. Two of the more common issues encountered by life sciences entities are addressed below.

7.2.3.1 Settlement of Equity-Classified Share-Based Payment Awards

When settling an equity-classified share-based payment award, an entity presents the settlement in its statement of cash flows on the basis of whether the amount paid to settle the award is greater than or less than the fair-value-based measure of the award on the settlement date:

- *Amount paid to settle the award does not exceed the fair-value-based measure of the award on the settlement date* — In accordance with ASC 718-20-35-7, if the cash paid to repurchase the equity-classified award does not exceed the fair-value-based measure of the award on the repurchase date, the cash paid to repurchase the award is charged to equity. That is, repurchase of the equity-classified award is viewed as reacquisition of the entity's equity instruments. Accordingly, the cash paid to reacquire the entity's equity instruments is presented as a cash outflow for financing activities under ASC 230-10-45-15(a), which indicates that payments of dividends or other distributions to owners, including outlays to reacquire the entity's equity instruments, are cash outflows for financing activities.
- *Amount paid to settle the award exceeds the fair-value-based measure of the award on the settlement date* — If the cash paid to repurchase the equity-classified award exceeds the fair-value-based measure of the award on the repurchase date, the cash paid in excess of the fair-value-based measure of the award is viewed as compensation for additional employee services and is recognized as additional compensation cost. Accordingly, if the equity-classified award is repurchased for an amount in excess of the fair-value-based measure, the portion of the cash paid to reacquire the entity's equity instruments that equals the fair-value-based measure of the award is presented as a cash outflow for financing activities under ASC 230-10-45-15(a). The portion of the cash paid in excess of the fair-value-based measure, for additional employee services, is presented as a cash outflow for operating activities under ASC 230-10-45-17(b), which notes that cash payments to employees for services are cash outflows for operating activities.

Example 7-5

Company A is making a tender offer to repurchase $20 million of common stock in the aggregate (the stock was originally distributed as share-based compensation awards) from its current employees. On the basis of an independent third-party valuation, A concludes that the purchase price paid to the employees for the common stock exceeds the fair value of the common stock by a total of $4.5 million. In accordance with ASC 718-20-35-7, the amount paid to employees up to the fair value of common stock acquired should be recognized in equity as a treasury stock transaction and should therefore be presented as a cash outflow for financing activities. The $4.5 million that was paid in excess of the fair value of the common stock constitutes compensation expense and is therefore presented as a cash outflow for operating activities.

7.2.3.2 Settlement of Liability-Classified Share-Based Payment Awards

In accordance with ASC 718-30, the grant-date fair-value-based measure and any subsequent changes in the fair-value-based measure of a liability-classified award through the date of settlement are recognized as compensation cost. Accordingly, the cash paid to settle the liability-classified award is effectively payment for employee services and is presented as a cash outflow for operating activities under ASC 230-10-45-17(b).

Note that an entity may enter into an agreement to repurchase (or offer to repurchase) an equity-classified award for cash. Depending on the facts and circumstances, the agreement to repurchase (or offer to repurchase) may be accounted for as either (1) a settlement of the equity-classified award or (2) a modification of the equity-classified award that changes the award's classification from equity to liability, followed by a settlement of the now liability-classified award.

If the agreement to repurchase (or offer to repurchase) is considered a settlement of an equity-classified award, the cash paid to reacquire the entity's equity instruments is presented in a manner consistent with the equity awards discussed in Section 7.2.3.1. If the agreement to repurchase (or offer to repurchase) is considered a modification of the equity-classified award that changes the award's classification from equity to liability, the cash paid to settle the liability-classified award should be presented in the statement of cash flows in a manner similar to the conclusion above. That is, under ASC 230-10-45-17(b), the cash paid to settle the liability-classified award is effectively payment for employee services and is presented as a cash outflow for operating activities.

7.2.4 Government Grants

Government grants are a form of government assistance that may be granted to PBEs or private companies either to encourage those entities to fulfill certain objectives (e.g., providing a financial grant to an entity to fund cancer research) or to assist them during times of crisis (e.g., providing relief under the CARES Act). Generally, a recipient of a government grant is not expected to repay the grant provided that the recipient complies with the grant's conditions.

Not all government assistance is provided to a recipient in the form of a cash payment. For example, a government grant could be in the form of tax credits. In these situations, an entity must determine whether the tax credits are refundable.

Refundable tax credits (e.g., qualifying R&D credits in certain countries and state jurisdictions and alternative fuel tax credits for U.S. federal income tax) do not depend on an entity's ongoing tax status or tax position, allowing an entity to receive a refund despite being in a taxable loss position. Consequently, the refundable tax credits are similar to government grants and are generally accounted for similarly. The discussions below address such tax credits as well as other government grants. For more information on the accounting for refundable tax credits, see Deloitte's *A Roadmap to Accounting for Income Taxes*.

Tax credits whose realization ultimately depends on taxable income (e.g., investment tax credits and R&D) are not refundable. Such tax credits are recognized as a reduction of income tax, should be accounted for in accordance with ASC 740, and are not discussed in this section. Entities are encouraged to consult with their accounting advisers when it is not clear whether tax credits are refundable.

In determining the appropriate cash flow presentation of government grants (that are not tax credits recognized as a reduction of income tax and accounted for in accordance with ASC 740), it is important to consider the nature of the grants since government assistance can take many different forms. We consider government grants related to long-lived assets to be capital grants and grants related to income to be income grants, as discussed below. However, some government grants may have aspects of both capital grants and income grants (i.e., the grant may be intended to subsidize the purchase of long-lived assets and certain operating costs). Therefore, entities subject to multiple conditions should carefully assess the grant received and should consider the guidance in Section 7.2.6.1 of this Guide.

7.2.4.1 Capital Grant

The classification of a capital grant in the statement of cash flows depends on the timing of the cash receipt compared with the timing of the associated costs to which the grant is related. If an entity receives the cash from the grant after it has incurred the capital costs, it would be appropriate to present the cash inflow from the government in the same category (i.e., investing) as the original payment for the associated long-lived asset.

However, if the grant funding is received before the expenditures have been incurred, it would be appropriate for the entity to present that cash inflow as a financing activity, because receiving the cash before incurring the related cost would be similar to receiving a refundable loan advance or to an NFP's receipt of a contribution of a refundable advance that, according to the donor's stipulation, is restricted for capital investment. ASC 230-10-45-14(c) requires that the following be classified as cash inflows from financing activities:

> Receipts from contributions and investment income that by donor stipulation are restricted for the purposes of acquiring, constructing, or improving property, plant, equipment, or other long-lived assets or establishing or increasing a donor-restricted endowment fund.

In addition, when the entity incurs the costs in accordance with the conditions of the government grant, it should disclose the existence of a noncash financing activity resulting from the fulfillment of the grant requirements.

Example 7-6

Entity C is entitled to receive $100 million in tax credits upon completing a new manufacturing facility and obtaining a certificate of occupancy from the local authority. Because C does not need to incur a tax liability to collect the tax credits, the tax credits are refundable and are not within the scope of ASC 740.

On December 31, 20X1, C starts the construction of the facility and presents the capital expenditures as an investing activity in its statement of cash flows. On December 31, 20X2, C completes the manufacturing facility and pays the remaining total construction costs. On January 1, 20X3, C obtains the certificate of occupancy and receives the $100 million in tax credits.

In this example, because the construction costs are classified as an investing activity in C's statement of cash flows and the payments are made before the receipt of the grant, C would present the grant monies as an investing activity in its statement of cash flows for 20X3.

Example 7-7

Assume the same facts as in Example 7-6 except that the grant monies are received before any capital expenditures are incurred. Entity C would record the grant monies as an asset with a corresponding liability on the balance sheet. The receipt of the grant would be reflected as a financing cash inflow in the statement of cash flows in accordance with ASC 230-10-45-14(c).

7.2.4.2 Income Grant

Similarly, if an entity receives an income grant as reimbursement for qualifying operating expenses, the grant would be presented in the statement of cash flows as an operating activity if it was received after the operating expenses were incurred. However, some entities may believe that when cash is received before the qualifying operating expenses are incurred, it would be appropriate to present the cash inflow as a financing activity for the advance in a manner consistent with the guidance for capital grants above. Alternatively, others may believe that it is acceptable to present the cash inflow as an operating activity if the entity expects to comply with the terms of the grant (e.g., an advance on future payroll taxes credit) so that both the inflow and outflow are presented in the operating category. Given the absence of explicit guidance, we believe that either approach is acceptable. An entity's election of one of the above approaches is a matter of accounting policy that the entity should disclose and apply consistently in similar arrangements.

Example 7-8

Entity P is awarded a government grant to receive up to $50 million of aggregate funding for certain R&D activities. The intent of the government grant is for P to perform R&D activities to achieve the grant's stated objectives. Grant funding is provided after qualifying R&D costs are incurred by P.

Entity P records R&D expenses as period expenses and classifies the cash outflows for the R&D expenses as an operating activity in its statement of cash flows. Therefore, P should classify the cash inflows from receipt of grant monies as an operating activity in its statement of cash flows.

7.2.5 Cash Proceeds From Insurance Claims

ASC 230-10-45-21B states that "[c]ash receipts resulting from the settlement of insurance claims, excluding proceeds received from corporate-owned life insurance policies and bank-owned life insurance policies, shall be classified on the basis of the related insurance coverage (that is, the nature of the loss)." In addition, for lump-sum settlements, "an entity shall determine the classification on the basis of the nature of each loss included in the settlement." The purpose of such clarifications is to provide financial statement users with more relevant information.

For example, insurance settlement proceeds received as a result of a claim made in connection with the destruction of productive assets should be classified as cash inflows from investing activities because the settlement proceeds could be analogous to proceeds received on the sale of such assets. However, proceeds received as a result of claims related to a business interruption should be classified as operating activities.

7.2.6 Classification of Certain Cash Receipts and Cash Payments

7.2.6.1 More Than One Class of Cash Flows

Certain cash receipts and payments may have aspects of more than one class of cash flows. Paragraph BC39 of ASU 2016-15 provides guidance on "when an entity should separate cash receipts and cash payments and classify them into more than one class of cash flows . . . and when an entity should classify the aggregate of those cash receipts and payments into one class of cash flows based on predominance." The classification of cash receipts and payments that have aspects of more than one class of cash flows should be determined in accordance with the following three-step approach:

- *Step 1* — Determine whether there is explicit guidance in ASC 230 or other U.S. GAAP on the classification of the related cash receipts and cash payments. If so, apply such guidance; if not, proceed to step 2.
- *Step 2* — Determine whether cash flows contain separately identifiable components (i.e., determine whether each separate source and use of cash can be identified on the basis of the nature of the underlying transactions). If so, classify each separately identifiable source or use of cash as operating, investing, or financing activities in accordance with the guidance in ASC 230 or other U.S. GAAP. If not, proceed to step 3.
- *Step 3* — Determine classification on the basis of the predominant nature of sources and uses of cash flows.

An entity should classify cash outflows and inflows in a consistent manner even if doing so creates asymmetry with how the transaction is presented in the balance sheet and income statement. When such asymmetry exists, an entity should include appropriate disclosures that explain such differences.

An entity should not default to classification based on predominance. Unless an entity can conclude that sources or uses of cash payments or receipts are not separately identifiable, the entity must first allocate amounts of each cash receipt or payment that has aspects of more than one class of cash flows on the basis of the nature of the underlying cash flows for each separately identifiable source or use of cash. However, because the guidance does not define the term "separately identifiable," entities must use judgment when applying the guidance.

For additional information on the application of this three-step approach, see Section 6.4 of Deloitte's *A Roadmap to the Preparation of the Statement of Cash Flows*.

7.2.6.2 Classification of Cash Flows of Repayments of Zero-Coupon Bonds and Other Debt Instruments With Coupon Interest Rates That Are Insignificant in Relation to the Effective Interest Rate of the Borrowing

An entity that issues zero-coupon bonds to an investor records the proceeds from the bonds' issuance as a financing cash inflow. The bonds are accreted to their redemption value in accordance with the "interest" method,[1] as described in ASC 835 (i.e., the carrying amount of the bonds increases from issuance until maturity [or earlier if prepayment is allowed] for the accrued interest to arrive at the bonds' redemption value). On the maturity date (or earlier if prepayment is allowed), the entity repays (1) the original proceeds (the principal amount of the bonds) and (2) the accrued interest from the date of issuance. Before the bonds' maturity (or the date of prepayment, if earlier), the interest expense is presented in the statement of cash flows as a reconciling item between net income and cash flows from operating activities, since no interim cash payments are made for the periodic accrual of interest.

At redemption, the cash paid to settle the interest component is reflected as a cash outflow from operating activities in the statement of cash flows in accordance with ASC 230-10-45-17 and ASC 230-10-45-25 as the accrued interest is recognized in earnings. The cash paid to settle the principal is reflected as a cash outflow from financing activities in the statement of cash flows in accordance with ASC 230-10-45-15.

In addition to zero-coupon bonds, the guidance in ASC 230-10-45-15, ASC 230-10-45-17, and ASC 230-10-45-25 also applies to other debt instruments "with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing that is attributable to the principal." The objective of including these other debt instruments (rather than all debt instruments) is to improve comparability related to entities' presentation of economically similar transactions.

Connecting the Dots

ASC 230 does not define the term "insignificant" or otherwise provide guidance on what would constitute insignificant coupon rates. Consequently, entities that issue other debt instruments with coupon rates that are insignificant in relation to the effective interest rate attributable to the principal will most likely need to exercise greater judgment in evaluating the portion of the rates that is insignificant. We generally believe that an entity should determine whether an interest rate is insignificant by looking to the market. For example, a 1 percent coupon rate may not be insignificant if the market rate is 2 percent. However, an entity may conclude that a 1 percent coupon rate is insignificant compared with a market rate of 10 percent and that the 1 percent rate is therefore within the scope of ASC 230-10-45-15, ASC 230-10-45-17, and ASC 230-10-25.

7.2.6.3 Distributions From Equity Method Investments

ASC 230 distinguishes between returns of investment, which should be classified as cash inflows from investing activities (see ASC 230-10-45-12(b)), and returns on investment, which should be classified as cash inflows from operating activities (see ASC 230-10-45-16(b)). Accordingly, to make the appropriate classification in the statement of cash flows, entities must determine whether distributions received from an equity method investee represent a "return on" or a "return of" the related investment.

ASC 230-10-45-21D indicates that there are two acceptable methods for determining whether distributions from equity method investments are returns on investment or returns of investment. Under the first method (the "cumulative earnings" approach), distributions are presumed to be returns

[1] ASC 835-30-35-4 states that "[o]ther methods of amortization may be used if the results obtained are not materially different from those that would result from the interest method."

on investment. When classifying the related cash flows under this approach, an entity should compare cumulative (i.e., since inception) distributions received by the investor, less distributions received in prior periods that were determined to be returns of investment, with the investor's cumulative equity in earnings. Cumulative distributions received that do not exceed cumulative equity in earnings represent returns on investment and should be classified as cash inflows from operating activities. Cumulative distributions received in excess of the investor's cumulative equity in earnings represent returns of investment and therefore should be classified as cash inflows from investing activities.

Under the second method (the "nature-of-the-distribution" approach), an entity evaluates the specific facts and circumstances of each distribution to determine its nature. Unlike the cumulative earnings approach, the nature-of-the-distribution approach does not presume that a distribution is a return on investment; rather, an entity using this approach must conduct an analysis to determine the nature of each distribution and may be required to use significant judgment in making this determination. Examples of distributions that may represent returns of investment include, but are not limited to, liquidating dividends and dividends representing proceeds from the sale of PP&E. These distributions should be classified as cash inflows from investing activities to the extent that they are considered to represent returns of investment.

An entity can elect to apply either of these approaches as an accounting policy and must select a single method for all of its equity method investments. Under either approach, an entity should comply with the disclosure requirements in ASC 235-10-50-1 through 50-6. However, if an entity selects the nature-of-the-distribution approach for its equity method investments but cannot obtain the information it needs to evaluate the nature of the distributions for any individual equity method investment, the entity must report a change in accounting principle retrospectively by applying the "cumulative earnings" approach to any such equity method investment. In other words, an entity is not required to apply the cumulative earnings approach to all of its equity method investments when it is unable to obtain adequate information for certain equity method investments; rather, this approach must only be applied to the equity method investments for which the information could not be obtained.

Connecting the Dots

Although entities are permitted to elect the approach under which distributions may be evaluated, it does not remove the requirement for entities to evaluate whether each distribution from an equity method investment represents a return on investment or a return of investment, particularly when entities elect the nature-of-the-distribution approach. In other words, because the nature-of-the-distribution approach does not presume that a distribution is a return on investment, it requires that an entity analyze each distribution to determine its nature. Further, entities that elect the cumulative earnings approach may generally presume distributions to represent a return on investment, unless such distributions represent returns of investment (i.e., they exceed the investor's cumulative equity in earnings).

In addition, because ASC 230 does not provide guidance on how much information (e.g., the type and sufficiency of investee information) an entity needs to determine the nature of a distribution, an entity that applies the nature-of-the-distribution approach will most likely need to use significant judgment in making this determination. We generally believe that such information should be sufficiently reliable and that the degree of reliability is likely to increase in proportion to the materiality of the distribution.

7.2.7 Presentation of Restricted Cash in the Statement of Cash Flows

An entity should include in its cash and cash-equivalent balances in the statement of cash flows those amounts that are generally described as restricted cash and restricted cash equivalents. Accordingly, changes in restricted cash and restricted cash equivalents that result from transfers between cash, cash equivalents, and restricted cash and restricted cash equivalents should not be presented as cash flow activities in an entity's statement of cash flows. This stipulation is consistent with paragraph BC8 of ASU 2016-18, which states, in part:

> The Task Force believes that internal transfers between cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents do not represent a cash inflow or outflow of the entity because there is no cash receipt or cash payment with a source outside of the entity that affects the sum of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents.

Appendix B — Titles of Standards and Other Literature

AICPA Literature

Accounting and Valuation Guides

Assets Acquired to Be Used in Research and Development Activities

Valuation of Privately-Held-Company Equity Securities Issued as Compensation

Audit and Accounting Guide

Revenue Recognition

Clarified Statements on Auditing Standards

AU-C Section 501, "Audit Evidence — Specific Considerations for Selected Items"

AU-C Section 620, "Using the Work of an Auditor's Specialist"

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Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories

86-2, *Accounting for Options*

Other

AICPA Technical Q&A Section 2260.03, "Other Assets; Legal Expenses Incurred to Defend Patent Infringement Suit"

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ASC 210, *Balance Sheet*

ASC 220, *Income Statement — Reporting Comprehensive Income*

ASC 230, *Statement of Cash Flows*

ASC 235, *Notes to Financial Statements*

ASC 250, *Accounting Changes and Error Corrections*

ASC 260, *Earnings per Share*

ASC 270, *Interim Reporting*

ASC 275, *Risks and Uncertainties*

ASC 280, *Segment Reporting*

ASC 310, *Receivables*

ASC 320, *Investments — Debt and Equity Securities*

ASC 321, *Investments — Equity Securities*

ASC 323, *Investments — Equity Method and Joint Ventures*

ASC 326, *Financial Instruments — Credit Losses*

ASC 330, *Inventory*

ASC 340, *Other Assets and Deferred Costs*

ASC 350, *Intangibles — Goodwill and Other*

ASC 360, *Property, Plant, and Equipment*

ASC 405, *Liabilities*

ASC 410, *Asset Retirement and Environmental Obligations*

ASC 420, *Exit or Disposal Cost Obligations*

ASC 450, *Contingencies*

ASC 460, *Guarantees*

ASC 470, *Debt*

ASC 480, *Distinguishing Liabilities From Equity*

ASC 505, *Equity*

ASC 605, *Revenue Recognition*

ASC 606, *Revenue From Contracts With Customers*

ASC 610, *Other Income*

ASC 705, *Cost of Sales and Services*

ASC 710, *Compensation — General*

ASC 715, *Compensation — Retirement Benefits*

ASC 718, *Compensation — Stock Compensation*

ASC 720, *Other Expenses*

ASC 730, *Research and Development*

ASC 740, *Income Taxes*

ASC 805, *Business Combinations*

ASC 808, *Collaborative Arrangements*

ASC 810, *Consolidation*

ASC 815, *Derivatives and Hedging*

ASC 820, *Fair Value Measurement*

ASC 825, *Financial Instruments*

ASC 830, *Foreign Currency Matters*

ASC 835, *Interest*

ASC 840, *Leases*

ASC 842, *Leases*

ASC 845, *Nonmonetary Transactions*

ASC 848, *Reference Rate Reform*

ASC 855, *Subsequent Events*

ASC 860, *Transfers and Servicing*

ASC 905, *Agriculture*

ASC 915, *Development Stage Entities*

ASC 930, *Extractive Activities — Mining*

ASC 942, *Financial Services — Depository and Lending*

ASC 944, *Financial Services — Insurance*

ASC 946, *Financial Services — Investment Companies*

ASC 948, *Financial Services — Mortgage Banking*

ASC 954, *Health Care Entities*

ASC 958, *Not-for-Profit Entities*

ASC 960, *Plan Accounting — Defined Benefit Pension Plans*

ASC 985, *Software*

ASUs

ASU 2010-27, *Other Expenses (Topic 720): Fees Paid to the Federal Government by Pharmaceutical Manufacturers* — a consensus of the FASB Emerging Issues Task Force

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ASU 2014-02, *Intangibles — Goodwill and Other (Topic 350): Accounting for Goodwill* — a consensus of the Private Company Council

ASU 2014-09, *Revenue From Contracts With Customers (Topic 606)*

ASU 2014-10, *Development Stage Entities (Topic 915): Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810,* Consolidation

ASU 2014-15, *Presentation of Financial Statements — Going Concern (Subtopic 205-40): Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern*

ASU 2014-16, *Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity* — a consensus of the FASB Emerging Issues Task Force

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ASU 2016-12, *Revenue From Contracts With Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*

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ASU 2017-05, *Other Income — Gains and Losses From the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*

ASU 2017-11, *Earnings per Share (Topic 260); Distinguishing Liabilities From Equity (Topic 480); Derivatives and Hedging (Topic 815): (Part I) Accounting for Certain Financial Instruments With Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests With a Scope Exception*

ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*

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No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*

No. 6, *Elements of Financial Statements*

No. 8, *Conceptual Framework for Financial Reporting — Chapter 8,* Notes to Financial Statements

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No. 2017-210, *Inventory (Topic 330): Disclosure Framework — Changes to the Disclosure Requirements for Inventory*

No. 2017-280, *Consolidation (Topic 812): Reorganization*

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IFRS 3, *Business Combinations*

IFRS 5, *Non-Current Assets Held for Sale and Discontinued Operations*

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IFRS 11, *Joint Arrangements*

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IAS 1, *Presentation of Financial Statements*

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Section 382, "Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change"

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Topic 2, "Other Financial Statements Required"

Topic 3, "Pro Forma Financial Information"

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Item 407, "Corporate Governance"

Item 503, "Prospectus Summary"

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Rule 1-02(w), "Definitions of Terms Used in Regulation S-X (17 CFR part 210); Significant Subsidiary"

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Rule 3-01, "Consolidated Balance Sheet"

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Rule 3-09, "Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons"

Rule 3-10, "Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered"

Rule 3-14, "Special Instructions for Financial Statements of Real Estate Operations Acquired or to Be Acquired"

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Rule 4-08(g), "General Notes to Financial Statements; Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons"

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No 11.A, "Miscellaneous Disclosure; Operating-Differential Subsidies"

No. 13, "Revenue Recognition"

No. 14.B, "Share-Based Payment; Transition From Nonpublic to Public Entity Status"

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Issue 08-6, "Equity Method Investment Accounting Considerations"

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Issue 09-4, "Seller Accounting for Contingent Consideration"

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No. 5, *Accounting for Contingencies*

No. 52, *Foreign Currency Translation*

No. 95, *Statement of Cash Flows*

No. 114, *Accounting by Creditors for Impairment of a Loan* — an amendment of FASB Statements No. 5 and 15

No. 123(R), *Share-Based Payment*

No. 133, *Accounting for Derivative Instruments and Hedging Activities*

No. 141, *Business Combinations*

No. 141(R), *Business Combinations*

No. 160, *Noncontrolling Interests in Consolidated Financial Statements* — an amendment of ARB No. 51

Appendix C — Abbreviations

Abbreviation	Description
AETR	annual effective tax rate
AFS	available for sale
AICPA	American Institute of Certified Public Accountants
AMT	alternative minimum tax
API	active pharmaceutical ingredient
APIC	additional paid-in capital
ASC	FASB Accounting Standards Codification
ASR	accelerated share repurchase
ASU	FASB Accounting Standards Update
BCF	beneficial conversion feature
BEAT	base erosion anti-abuse tax
BEMTA	base erosion minimum tax amount
BPD	branded prescription drug
CAM	critical audit matter
CCF	cash conversion feature
CECL	current expected credit loss
CFC	controlled foreign corporation
CFR	Code of Federal Regulations
CMO	contract manufacturing organization
CODM	chief operating decision maker
CRO	contract research organization
DTA	deferred tax asset
DTL	deferred tax liability
EBITDA	earnings before interest, taxes, depreciation, and amortization
ED	exposure draft

Abbreviation	Description
EDGAR	SEC electronic data gathering, analysis, and retrieval system
EGC	emerging growth company
EITF	Emerging Issues Task Force
EPS	earnings per share
ESPP	employee stock purchase plan
EU	European Union
EUR	euros
FASB	Financial Accounting Standards Board
FDA	Food and Drug Administration
FDII	foreign derived intangible income
FIFO	first in, first out
FIN	FASB Interpretation
FOB	free on board
FRM	SEC Division of Corporation Finance Financial Reporting Manual
FVTOCI	fair value through other comprehensive income
GAAP	generally accepted accounting principles
GILTI	global intangible low-taxed income
GPO	group purchasing organization
HFI	held for investment
HFS	held for sale
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IBNR	incurred but not reported

Abbreviation	Description
IFRS	International Financial Reporting Standard
IIR	investigator-initiated research
IP	intellectual property
IPO	initial public offering
IPR&D	in-process research and development
IRC	Internal Revenue Code
IRS	Internal Revenue Service
ISO	incentive stock option
IT	information technology
LCD	liquid-crystal display
LIBOR	London Interbank Offered Rate
LIFO	last in, first out
M&A	merger and acquisition
MD&A	Management's Discussion & Analysis
MSL	medical science liaison
NFP	not-for-profit entity
NOL	net operating loss
NQSO	nonqualified stock option
NSO	nonstatutory option
OCA	SEC's Office of the Chief Accountant
OCI	other comprehensive income
OECD	Organisation for Economic Co-operation and Development
OEM	original equipment manufacturer
PBE	public business entity
PCAOB	Public Company Accounting Oversight Board

Abbreviation	Description
PCC	Private Company Council
PP&E	property, plant, and equipment
PRV	priority review voucher
PTRS	probability of technical and regulatory success
Q&A	question and answer
QIP	qualified improvement property
R&D	research and development
R&E	research and experimentation
REMS	risk evaluation and mitigation strategy
ROU	right of use
SaaS	software as a service
SAB	Staff Accounting Bulletin
SEC	Securities and Exchange Commission
SME	small to medium-sized entity
SPAC	special-purpose acquisition company
SPPI	solely payments of principal and interest
SRC	smaller reporting entity
S&P 500	Standard & Poor's 500 Index
TD	Treasury Decision
TRG	transition resource group
USD	U.S. dollars
UTB	unrecognized tax benefit
VIE	variable interest entity
VWAP	volume-weighted average daily market price

The following is a list of short references for the Acts mentioned in this Guide:

Abbreviation	Act
CARES Act	Coronavirus Aid, Relief, and Economic Security Act
Exchange Act	Securities Exchange Act of 1934
FAST Act	Fixing America's Surface Transportation Act
JOBS Act	Jumpstart Our Business Startups Act
Securities Act	Securities Act of 1933
2017 Act	Tax Cuts and Jobs Act of 2017