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Heads Up

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Eight Ways to Sunday
FASB Proposes Guidance on Cash Flow Classification

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Introduction

On January 29, 2016, the FASB issued a proposed ASU[1] that would amend ASC 230[2] to add or clarify guidance on the classification of certain cash receipts and payments in the statement of cash flows. While ASC 230 provides some guidance on certain cash payments and receipts that are classified as operating, investing, or financing activities, it lacks consistent principles for evaluating the classification of cash payments and receipts in the statement of cash flows. This has led to diversity in practice and, in certain circumstances, financial statement restatements.

Comments on the proposal are due by March 29, 2016.

Key Provisions of the Proposed ASU

The proposed ASU results from consensuses reached by the FASB's Emerging Issues Task Force (EITF) on eight issues related to cash flows. Key provisions of the proposed amendments are summarized below.

Cash Flow Issues	Proposed Amendments
Debt prepayment or debt extinguishment costs	Cash payments for debt prepayment or extinguishment costs (including third-party costs, premiums paid, and other fees paid to lenders) would be classified as cash outflows for financing activities.
Settlement of zero-coupon bonds	At settlement, the cash outflows of a zero-coupon bond would be classified in operating and financing activities. The cash payment of the accreted interest would be classified in operating activities, while the cash payment attributable to the original proceeds (i.e., the principal) would be classified in financing activities.
Contingent consideration payments made after a business combination	Contingent consideration payments that were not made soon after a business combination would be separated and classified in operating and financing activities. Cash payments up to the amount of the contingent consideration liability recognized as of the acquisition date, including any measurement-period adjustments, would be classified in financing activities, while any excess cash payments would be classified in operating activities.

[1] FASB Proposed Accounting Standards Update, *Classification of Certain Cash Receipts and Cash Payments* — a Consensus of the FASB Emerging Issues Task Force.

[2] FASB Accounting Standards Codification Topic 230, *Statement of Cash Flows*.

Cash Flow Issues	Proposed Amendments
Proceeds from the settlement of insurance claims	Cash proceeds from the settlement of insurance claims would be based on the nature of the insurance coverage (i.e., nature of the loss). For insurance proceeds received in a lump-sum settlement, an entity would determine the classification on the basis of the nature of each loss included in the settlement.
Proceeds from the settlement of corporate-owned life insurance (COLI) policies and bank-owned life insurance (BOLI) policies	Cash proceeds from the settlement of COLI and BOLI polices would be classified in investing activities. However, an entity would be permitted, but not required, to align the classification of premium payments on COLI and BOLI policies with the classification of COLI and BOLI proceeds (i.e., payments for premiums may be classified as investing, operating, or a combination thereof).
Distributions received from equity method investees	An entity would classify distributions received by an equity method investee in operating activities or investing activities (or both) by applying a cumulative-earnings approach. Under this approach, cash distributions received are presumed to be returns on investment (i.e., operating cash inflows) unless the amount of cumulative distributions received, less distributions received in prior periods that were determined to be returns of investment, exceed the entity's cumulative equity in earnings. When an excess is computed through this calculation, the current-period distribution up to the excess is viewed as a return of investment and classified as cash inflows from investing activities. The proposal does not address equity method investments measured under the fair value option.
Beneficial interests in securitization transactions	A transferor's beneficial interests received as proceeds from the securitization of an entity's financial assets would be disclosed as a noncash activity. Subsequent cash receipts of beneficial interests from the securitization of an entity's trade receivables would be classified as cash inflows from investing activities.
Separately identifiable cash flows and application of the predominance principle	The guidance would clarify when an entity would (1) separate cash flows of a single item into more than one class of cash flows or (2) aggregate multiple cash flows into one class of cash flows on the basis of predominance.

For summaries of the decisions reached by the EITF on these issues, see Deloitte's June 2015, September 2015, and November 2015 *EITF Snapshot* newsletters.

Editor's Note: The FASB's objective in the proposed ASU is to eliminate the diversity in practice related to the classification of certain cash receipts and payments. As a result, there could be significant changes for some entities under the proposed guidance, particularly with respect to the issues discussed below.

Settlement of Zero-Coupon Bonds

The lack of guidance on the classification of payments to settle zero-coupon bonds in the statement of cash flows has led to diversity in the classification of the cash payment made by a bond issuer at the settlement of a zero-coupon bond. Some entities bifurcate the settlement payment between the principal (the amount initially received by the entity) and accreted interest. In those situations, the portion of the repayment related to principal is classified in financing activities, and the portion related to accreted interest is classified in operating activities. However, other entities do not bifurcate the settlement payment between principal and accreted interest and present the entire repayment as financing activities.

Under the proposed ASU, entities would be required to bifurcate the repayment of zero-coupon bonds into principal and accreted interest, with the principal portion classified in financing activities and the accreted interest portion classified in operating activities. As a result, entities that currently classify the entire repayment of zero-coupon bonds in financing activities will need to identify the portion of such payments that are related to accreted interest and apply the provisions of the proposed ASU accordingly.

Distributions Received From Equity Method Investees

While ASC 230 distinguishes between returns of investment (which should be classified as inflows from investing activities) and returns on investment (which should be classified as inflows from operating activities), there is diversity in practice related to determining whether distributions received from equity method investees (EMIs) represent a return on or return of investment. Some entities make this determination by applying a cumulative-earnings approach, while others evaluate the nature of each distribution.

Entities that currently determine the classification of an EMI distribution by using an approach other than one based on cumulative earnings as described in the proposed ASU will need to (1) evaluate whether their previous conclusions are consistent with the results of applying the cumulative-earnings approach and (2) apply the provisions of the proposed ASU accordingly.

Beneficial Interests in Securitization Transactions

There is no specific guidance in ASC 230 on how to classify cash receipts associated with beneficial interests in securitization transactions. As a result, entities have classified the subsequent cash receipts from payments on beneficial interests obtained by the transferor in a securitization of the transferor's trade receivables as either operating activities or investing activities in the statement of cash flows. Although there is diversity in practice, we believe that entities have predominately presented cash receipts from payments on a transferor's beneficial interests in securitized trade receivables as a cash inflow from operating activities. Accordingly, the proposal to present such cash receipts as a cash inflow from investing activities could change practice significantly.

More Than One Class of Cash Flow

ASC 230 acknowledges that certain cash inflows and outflows may have characteristics of more than cash flow class (e.g., financing, investing, or operating) and states that the "appropriate classification shall depend on the activity that is likely to be the predominant source of cash flows for the item." Although ASC 230 gives examples illustrating the application of the predominance principle,[3] entities often have difficulty applying the guidance.

[3] See ASC 230-10-45-22 and 45-23.

As a result, when cash flows have aspects of more than one cash flow class, the proposed ASU requires that entities first determine the classification of those cash receipts and payments by applying the specific guidance in ASC 230 and other applicable ASC topics. Further, the proposed ASU notes that "[i]n 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." The proposed ASU goes on to observe that "[i]n 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, the appropriate classification shall depend on the activity that is likely to be the predominant source or use of cash flows for the item." However, because the proposed ASU does not define the term "separately identifiable" in this context, we believe that challenges may be presented related to identifying separately identifiable cash receipts and payments as well as applying the term "predominant."

Transition and Effective Date

Entities would be required to apply the amendments retrospectively to all prior periods presented unless doing so would be impracticable, in which case they would apply the guidance prospectively as of the earliest date practicable. The FASB will discuss an effective date and whether to permit early adoption after considering stakeholder feedback on the proposal.

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