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FASB Issues Guidance on Cash Flow Classification

by Nick Tricarichi and Stephen McKinney, Deloitte & Touche LLP

Introduction

On August 26, 2016, the FASB issued [ASU 2016-15](#),¹ which amends ASC 230² to add or clarify guidance on the classification of certain cash receipts and payments in the statement of cash flows. ASC 230 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. Therefore, the FASB issued the ASU with the intent of reducing diversity in practice with respect to eight types of cash flows.

Key Provisions of the ASU

The ASU is a result of consensus reached by the FASB's Emerging Issues Task Force (EITF) on issues related to the eight types of cash flows. Key provisions of the amendments are summarized below.

¹ FASB Accounting Standards Update No. 2016-15, *Classification of Certain Cash Receipts and Cash Payments* — a consensus of the FASB Emerging Issues Task Force.

² For titles of FASB Accounting Standards Codification (ASC) references, see Deloitte's "[Titles of Topics and Subtopics in the FASB Accounting Standards Codification](#)."

Cash Flow Issues	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) must “be classified as cash outflows for financing activities.”
Settlement of zero-coupon bonds	The cash outflows for the settlement of a zero-coupon bond must be bifurcated into operating and financing activities. The portion of the cash payment related to accreted interest should be classified in operating activities, while the portion of the cash payment related to the original proceeds (i.e., the principal) should 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 (on the basis of the consummation date) must 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, should be classified in financing activities, while any excess cash payments should be classified in operating activities.
Proceeds from the settlement of insurance claims	Cash proceeds from the settlement of insurance claims should be classified on the basis of the nature of the loss. For insurance proceeds received in a lump-sum settlement, an entity should 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 policies must be classified in investing activities. However, an entity is 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	<p>An entity is required to make an accounting policy election to classify distributions received from equity method investees under either of the following methods:</p> <ul style="list-style-type: none"> • <i>Cumulative-earnings approach</i> — Under this approach, distributions are presumed to be returns on investment and classified as operating cash inflows. However, if the 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, such excess is a return of capital and should be classified as cash inflows from investing activities. • <i>Nature of the distribution approach</i> — Under this approach, each distribution is evaluated on the basis of the source of the payment and classified as either operating cash inflows or investing cash inflows. <p>If an entity whose chosen policy is the nature of the distribution approach cannot apply the approach because it does not have enough information to determine the appropriate classification (i.e., the source of the distribution), the entity must apply the cumulative-earnings approach and report a change in accounting principle on a retrospective basis. The entity is required to disclose that a change in accounting principle has occurred as a result of the lack of available information as well as the information required under ASC 250-10-50-2, as applicable.</p> <p>The amendments do not address equity method investments measured under the fair value option.</p>

(Table continued)

Cash Flow Issues	Amendments
Beneficial interests in securitization transactions	A transferor's beneficial interests received as proceeds from the securitization of an entity's financial assets must be disclosed as a noncash activity. Subsequent cash receipts of beneficial interests from the securitization of an entity's trade receivables must be classified as cash inflows from investing activities.
Separately identifiable cash flows and application of the predominance principle	The guidance provides a three-step approach for classifying cash receipts and payments that have aspects of more than one class of cash flows: <ol style="list-style-type: none"><li data-bbox="829 478 1511 541">1. An entity should first apply specific guidance in U.S. GAAP, if applicable.<li data-bbox="829 548 1511 751">2. If there is no specific guidance related to the cash receipt or payment, an entity should bifurcate the cash payment or receipt into "each separately identifiable source or use [of cash] on the basis of the nature of the underlying cash flows." Each separately identifiable source or use of cash will be classified as operating, investing, or financing activities by applying the guidance in ASC 230.<li data-bbox="829 758 1511 877">3. If the cash payment or receipt cannot be bifurcated, the entire payment or receipt should be classified as operating, investing, or financing activities on the basis of the activity that is likely to be the predominant source or use of cash.

For summaries of the decisions reached by the EITF on these issues, see Deloitte's [June 2015](#), [September 2015](#), [November 2015](#), and [June 2016 EITF Snapshot](#) newsletters.



Editor's Note

The FASB's objective in the 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 revised 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 in financing activities.

Under the ASU, entities are 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 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), it does not prescribe a method for differentiating between the two. With respect to distributions from equity method investees, entities make this determination by applying a cumulative-earnings approach or a nature of the distribution approach. The ASU formalizes each of these methods and allows an entity to choose either one as an accounting policy election.

However, the ASU requires entities that choose the nature of the distribution approach to report a change in accounting principle if the information required under this approach is unavailable with respect to a particular investee. Therefore, while the ASU will not eliminate diversity in practice, entities that are currently applying the nature of the distribution approach should be mindful of the additional information and disclosure requirements under the ASU in electing a method as their accounting policy.

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 predominantly presented cash receipts from payments on a transferor's beneficial interests in securitized trade receivables as a cash inflow from operating activities. Accordingly, the requirement to present such cash receipts as a cash inflow from investing activities could change practice significantly.

Separately Identifiable Cash Flows and Application of the Predominance Principle

ASC 230 acknowledges that certain cash inflows and outflows may have characteristics of more than one 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.

As a result, when cash flows have aspects of more than one cash flow class, the 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 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 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 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."

³ See ASC 230-10-45-22 and 45-23.

Transition and Effective Date

For public business entities, the guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other entities, it is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption will be permitted for all entities. Entities must apply the guidance retrospectively to all periods presented but may apply it prospectively if retrospective application would be impracticable.

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