COMPLIANCE WEEK
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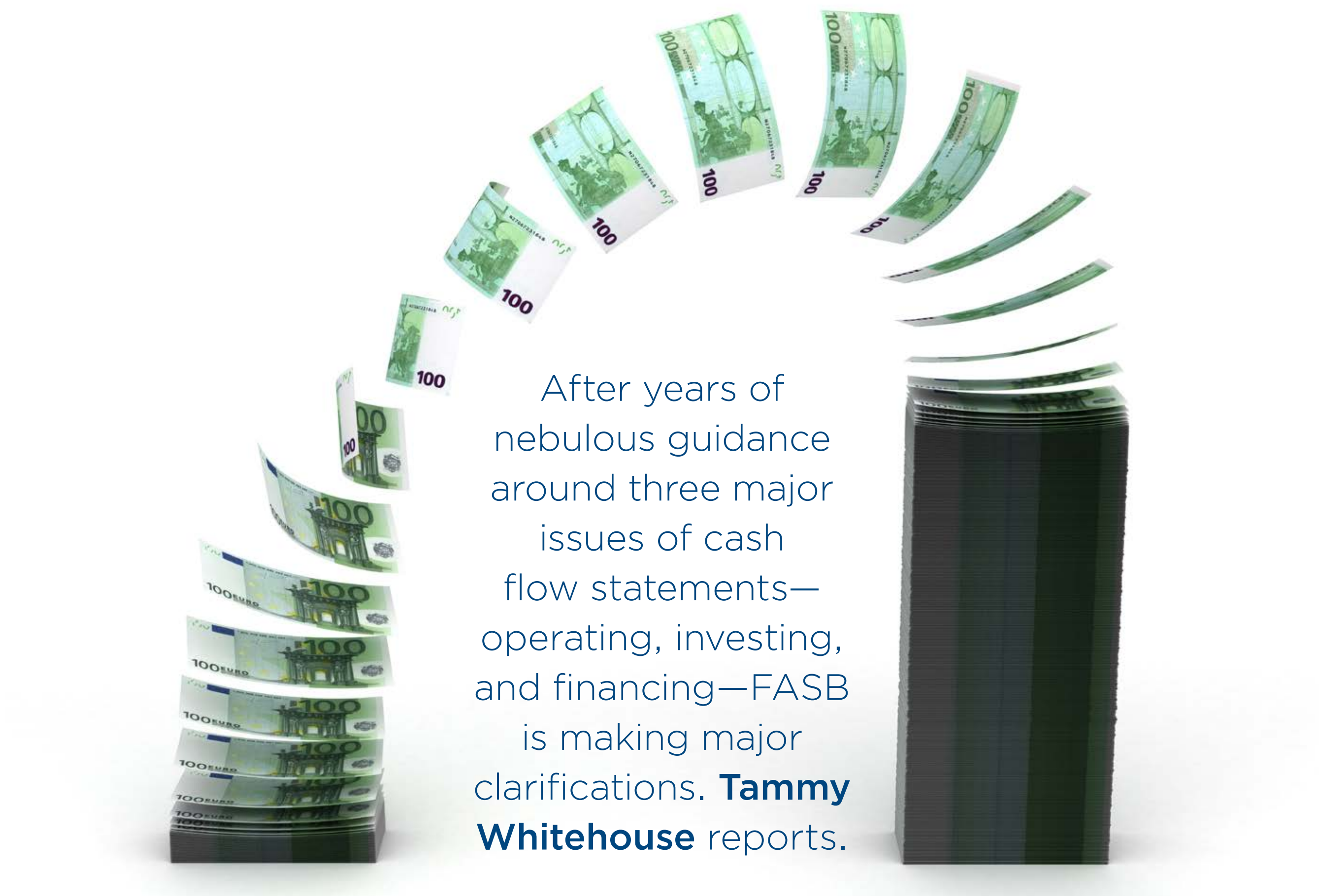
FASB adopts eight new cash flow classification rules



After years of nebulous guidance around three major issues of cash flow statements—operating, investing, and financing—FASB is making major clarifications. **Tammy Whitehouse** reports.

The ugly stepchild of financial statements, and one of the more common causes of restatement, will be getting a bit of a makeover in the coming year as companies adopt new rules around how to classify cash moving in and out of the organization in the statement of cash flows.

The Financial Accounting Standards Board adopted Accounting Standards Update No. 2016-15 to address eight specific cash flow classification issues that companies historically have handled in different ways, botching comparability for users of financial statements. The new accounting pronouncement is meant to lay out more explicit requirements around historical accounting rules that provided only scant principles about how to classify cash flows into the three major categories in the cash flow statement—operating, investing, and financing.

Companies are required to revise their current classification practices to conform to the new requirements in 2018, but they should also stay tuned for more change on the horizon. FASB is still deciding what to do with a ninth issue involving restricted cash that was originally addressed by its Emerging Issues Task Force but without a clear consensus about how to resolve it. And even further on the horizon, FASB is considering whether to take a more comprehensive look at the statement of cash flows to see whether still more guidance is warranted.

Described by some as an afterthought in the preparation of financial statements, the statement of cash flow has not gotten the same attention from regulators and standard set ters as the balance sheet or income statement. "Especially the classification of cash flow into operating, investing, and financing has gotten much, much less attention—hardly any at all," says Chuck Mulford, director of the Financial Reporting and Analysis Lab at Georgia Tech, who focuses much of his research on cash flow.

The original accounting standard governing the cash flow statement, Statement No. 95, now contained in the Accounting Standards Codification as Topic 230, is nearly 30 years old, says Mulford. "When Statement 95 came out, cash flow classification wasn't as important as it is today," he says. "There's much more analyst focus on operating cash flow and free cash flow, so we just can't have inconsistent classification."

Over the past decade, the cash flow statement has been one of the leading areas of financial restatements, says Dennis Howell, a senior consultation partner in Deloitte's national office of accounting services. "One of the root causes of cash flow restatements relates to the lack of detailed guidance for specific transactions and inconsistent principles contained in ASC 230," he says.

Once adopted, the new guidance should streamline classification, says Howell, who focuses specifically on cash flow issues. "It should reduce diversity in practice and hopefully contribute to a reduction in restatements in cash flows," he says.

Adoption of the new requirements will not require the same kind of accounting change management exercise companies are likely already undertaking due to earlier FASB standards around revenue recognition or leasing. "Companies will need to determine a couple of things," says Howell. "How will internal controls need to be revised, and to what extent will IT systems need to be changed to track issues that have not been tracked before?"

Many of the eight separate issues addressed in the new standard are focused on transactions or events that don't occur regularly or even frequently for most companies, says Mark Scoles, partner-in-charge of accounting principles at Grant Thornton. A notable exception is how to reflect distributions from equity method investments. "For companies that have equity investments, if they are getting regular distributions on an ongoing basis, that's one they might have to deal with," he says.

A few more potential game changers include guidance on debt prepayment or extinguishment costs and guidance on the settlement of zero-coupon debt instruments or other similar instruments, says Angela Newell, a partner at BDO USA. "Those can be bigger dollars," she says. "When you think about the cost to repay or extinguish debt, that can be a significant charge."

Howell at Deloitte also believes companies could see some significant change in adopting the classification guidance around beneficial interests in securitization transactions. "We believe a number of companies have predominantly presented this as operating activities," while the new guidance says it should be presented as investing activity, he says. "That will reduce operating cash flow."

While seven of the eight issues addressed in the recent guidance are relatively straightforward, one is a bit more principles-based, says Ken Miller, a partner in the national office at PwC. It's referred to as the "predominance" principle. "That's the one that has gotten my phone ringing off the hook," he says.

Essentially, the principle tells companies how to classify cash flows into the three separate categories when a given transaction might include elements of more than one class of cash flow. "The issue is people don't even understand what it says," Miller says.

Experts are not completely certain what aggregate effect companies can expect in classifications with adoption of the new guidance. "That is the ultimate question," says Miller. "A lot of these are one-offs, and some go in different directions. My thinking is it's going to make operating cash flows higher, but it's not totally clear."

Mulford agrees some of the guidance will cause classifications to shift, but it's not clear whether it will cause big swings in numbers as a result. "Some will report more operating cash flow, some less," he says. "I don't think we'll generally see rising amounts of cash flow. We'll see refined reporting. It will tend to wash out."

FASB put out for comment an additional proposed update to accounting standards that would require companies to explain changes during the period in the total of cash, cash equivalents, and any amounts described by the company as restricted cash. The board has not set a timetable for finalizing that guidance.

FASB's EITF originally looked at restricted cash as part of the recently finalized guidance, but decided to call it out for separate rulemaking. "Restricted cash has been the one issue presented as having the most diversity in practice," says Howell. "Part of the challenge is restricted cash is not even defined in U.S. GAAP."

With this guidance still outstanding and FASB continuing to consider whether further rules are warranted, companies can expect more change in cash flow classification down the road, says Howell. "I don't think companies should consider these two projects as the conclusion of standard setting for the cash flow statement," he says. ■

KEY PROVISIONS

The ASU is a result of consensuses reached by 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 by Deloitte.

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

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 policies and bank-owned life insurance policies

Cash proceeds from the settlement of COLI and BOLI polices 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

An entity is required to make an accounting policy election to classify distributions received from equity method investees under either of the following methods:

» **Cumulative-earnings approach** — 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.

» **Nature of the distribution approach** — 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.

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.

The amendments do 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 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.

Source: Deloitte