Clarification Proposed on Classification of Certain Cash Receipts & Payments

On January 29, 2016, the Financial Accounting Standards Board (FASB) proposed several amendments affecting how entities report changes in cash and cash equivalents during a period; these are the first changes since the issuance of Statement No. 95, *Statement of Cash Flows*, in 1987. The proposed Accounting Standards Update (ASU), *Statement of Cash Flows (Topic 230), Classification of Certain Cash Receipts and Cash Payments (a consensus of the FASB Emerging Issues Task Force)*, is expected to decrease diversity in practice by providing classification guidance on seven targeted transaction types. The proposal also clarifies when an entity should separate and classify cash receipts and cash payments into multiple cash flows classes versus aggregating them into one class based on predominance.

The proposed ASU would apply to all entities, including both business entities and not-for-profit entities required to present a statement of cash flows under Topic 230. If finalized, entities would apply the guidance retrospectively to all periods presented, unless deemed impractical. The effective date and ability to early adopt will be determined after the Emerging Issues Task Force (EITF) considers stakeholder feedback. FASB is seeking feedback on the proposal, including why the proposed classifications should or shouldn't be finalized and any alternative classification recommendations. Comments are due by March 29, 2016.

Proposed Classifications

Cash Payments for Debt Prepayment or Debt Extinguishment Costs

Often a borrower is contractually required to pay the lender a fee to prepay or extinguish debt. The fee often represents approximation of the interest that will not be paid and penalties and other lender costs. The proposal would require classification of payments made for debt prepayment or extinguishment costs as cash outflows from financing activities. The proposal is in alignment with current guidance in Topic 230, which requires in part that entities classify repayments of amounts borrowed and payments for debt issue costs as financing activities.

Cash Payments at Settlement of Zero-Coupon Bonds

Issuers of a zero-coupon bond accrete the bond up to its redemption value through recognition of interest expense, which the issuer pays at maturity. Due to its multiple components, the proposal would require classification as cash outflows from operating activities the portion that is attributable to interest; the remainder, representing principal, would be classified as cash outflows from financing activities. This guidance is in alignment with current guidance in Topic 230, which requires in part the classification of cash payments to lenders or other creditors for interest as operating activities and repayments of amounts borrowed as financing activities. In addition, the issuer of a zero-coupon bond classifies the cash proceeds as a financing inflow.

Cash Payments Made by an Acquirer, If Not Paid Soon After a Business Combination Occurred, for the Settlement of a Contingent Consideration Liability

The proposal would require classification of payments made up to the amount of the contingent consideration liability—including measurement-period adjustments—as cash flows from financing activities; any excess payments would be classified as cash flows from operating activities. FASB considers payments up to the amount of the contingent liability recognized at the acquisition date fair value as payments on a contractual obligation to pay the seller, analogous to seller-financed debt. Along those lines, the proposed requirements align with current guidance in Topic 230, which says entities should classify repayments of amounts borrowed as financing activities. Payment on the portion of the liability remeasured to fair value and recognized in earnings would be classified as cash flows from operating activities.

Proceeds Received from Settlement of Insurance Claims (Excluding Proceeds Received from Corporate-Owned Life Insurance Policies & Bank-Owned Life Insurance Policies)

The proposal would require classification based on the nature of the insurance coverage, *i.e.*, the nature of the loss. Existing guidance in Topic 230 states in part that cash inflows from operating activities should include proceeds of insurance settlements, except those directly related to investing or financing activities, such as from destruction of a building. For example, inventory and business interruption claims generally would be classified as operating activities, while manufacturing facility and equipment claims generally would be classified as investing activities or a combination of investing and operating activities. Entities would **not** take into consideration the planned use of the insurance proceeds or consideration that maintaining an insurance policy is an operating function when considering classification.

Proceeds Received from Settlement of Corporate-Owned Life Insurance Policies, Including Bank-Owned Life Insurance Policies

Life insurance policies are purchased by entities for a variety of purposes, including funding the cost of providing employee benefits and protecting against the loss of key individuals. They're attractive funding mechanisms due to the tax-free receipt of death benefits and tax-free buildup of cash surrender value, *i.e.*, accumulation of investment income. Considering that many entities primarily purchase corporate- and bank-owned life insurance policies as investment vehicles, FASB proposes entities classify proceeds received from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies, as an investing activity.

In practice, stakeholders classify premium payments on corporate-owned life insurance policies in investing activities, in operating activities or in a combination of both. The proposal permits but does not require aligning the classification of proceeds received with the classification of premiums paid.

Distributions Received by an Investor from Equity-Method Investees

The proposal would require entities to classify distributions from equity method investees (presumed returns **on** investment) as cash inflows from operating activities. An exception occurs when the investor's cumulative distributions received, less distributions received in prior periods determined to be returns **of** investment, exceed cumulative equity in earnings recognized by the investor. When an excess occurs, the entity would classify the current-period distribution up to this excess (presumed to be a return **of** investment) as cash inflows from investing activities. The proposal doesn't address equity method investments measured using the fair value option.

Payments on Transferor's Beneficial Interest in Securitized Trade Receivables

Current guidance in Topic 230 requires in part that entities classify cash proceeds from the sale of a security as cash flows from investing activities. In congruent fashion, the proposed amendments would require the holder of the retained interest in securitized trade receivables to classify its share of the collections of principal payments as cash inflows from investing activities. At inception of the securitization, the transferor would disclose its beneficial interest in the securitized financial assets as a noncash activity.

Separating Identifiable Cash Flows & Application of the Predominance Principle

Classification of cash receipts and payments would be determined first by applying specific guidance in Topic 230 and other applicable topics. Absent specific guidance, a reporting entity would determine each separately identifiable source or use based on the nature of the underlying cash flow. Using existing principles, the entity would classify cash receipts and disbursements as financing, investing or operating activities for each nature separately identified.

Clarification Proposed on Classification of Certain Cash Receipts & Payments

In situations in which cash receipts and payments have aspects of more than one class of cash flows and those aspects cannot be separately identified by their nature, classification would be based on the activity likely to be the predominant source or use of cash flows for the item. Entities may consider several factors in determining the predominant source or use, including historical cash flows, projected cash flows and short period.

Entities would not be required to disclose components when aggregating cash receipts and payments into one class of cash flows based on the basis of predominance.

The proposal aims to decrease diversity in practice where current U. S. generally accepted accounting principles (GAAP) either are unclear or don't provide specific guidance on cash flow transactions included in the proposed update. Reasonable judgment still will be required, e.g., when separating cash receipts and cash payments and allocating cash flows—and in situations of insurance claims—allocating lump-sum settlement proceeds to determine classification based on the nature of each loss.

On the Horizon: Restricted Cash

The initial project on the statement of cash flows included cash flows from the establishment and release of restricted cash, often as transfers between restricted cash and unrestricted cash (cash and cash equivalents). Significant diversity remains in classification and presentation of changes in restricted cash on the statement of cash flows, precipitated at least in part by the lack of definition of "restricted cash" in GAAP. FASB added restricted cash to its agenda as a separate EITF project. Discussions about restricted cash will resume in March 2016.

For more information on how these proposed changes could affect your organization, contact your BKD advisor.

Contributor

Connie Spinelli
Director
303.861.4545
cspinelli@bkd.com