Statement of cash flows

Handbook

US GAAP

February 2023

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Contents

A statement of importance

The statement of cash flows is a central component of an entity's financial statements. Potentially misunderstood and often an afterthought when financial statements are being prepared, it provides key information about an entity's financial health and its capacity to generate cash.

The underlying principles in Topic 230 (Statement of Cash Flows) seem straightforward. Cash flows are classified as either operating, financing or investing activities depending on their nature. But identifying the appropriate activity category for the many types of cash flows can be complex and regularly attracts SEC scrutiny. The composition of cash and cash equivalents also often raises questions.

This complexity is compounded by the fact that every transaction recorded through the financial statements needs to be assessed for its impact on the statement of cash flows. This is even true for transactions that do not involve cash. Yet, there has not been significant standard setting in this area since 2016 when the EITF clarified a series of classification issues and changed the presentation of restricted cash and cash equivalents. Therefore, diverse presentation practices remain.

Against that backdrop, the statement of cash flows is coming into the spotlight again. As the FASB and SEC focus on providing evermore useful information to financial statement users, they have specifically mentioned the statement of cash flows as a way to provide that information. Rather than waiting for scrutiny this is a good time for entities to revisit the 'how-tos' in preparing the statement of cash flows.

This Handbook provides an in-depth look at statement of cash flows classification issues and noncash disclosure requirements. We've organized it by transaction type, making it easier to identify the answers to the common and not so common questions that you may have. And for practical issues where the guidance remains unclear, we offer our position on how to classify many of these cash flows.

We hope you will find this Handbook to be a useful tool in preparing your own statement of cash flows.

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Department of Professional Practice, KPMG LLP

About this publication

The purpose of this Handbook is to assist you in understanding the standard on the statement of cash flows, Topic 230, and provisions in other Topics that affect the statement of cash flows.

Organization of the text

Each chapter of this Handbook includes excerpts from the FASB's Accounting Standards Codification® and overviews of the relevant requirements. Our in-depth guidance is explained through Q&As that reflect the questions we encounter in practice. We include examples to explain key concepts.

Our commentary is referenced to the Codification and to other literature, where applicable. The following are examples:

— 230-10-45-1 is paragraph 45-1 of ASC Subtopic 230-10

— 815-10-45-13 is paragraph 45-13 of ASC Subtopic 815-10

— ASU 2016-15.BC38 is paragraph 38 of the basis for conclusions to ASU 2016-15

— FAS 95.BC53 is paragraph 53 of the basis for conclusions to FAS 95

— IAS 20.24 is paragraph 24 of International Accounting Standard 20, Accounting for Government Grants and Disclosure of Government Assistance

— S-X Rule 10-01 is Rule 10-01 of SEC Regulation S-X

— SAB Topic 6.G is SEC Staff Accounting Bulletin Topic 6.G

— FRM 6710.3 is section 6710.3 of the SEC Financial Reporting Manual

— FRR 220 is section 220 of the SEC Financial Reporting Releases

— C&DI 102.05 is Question 102.05 of the SEC's Compliance and Disclosure Interpretations: Non-GAAP Financial Measures

— CA&DI II.C.2 is topic II.C.2 of the SEC's Current Accounting and Disclosure Issues in the Division of Corporation Finance

— FR-65 FN 11 is footnote 11 of the SEC's Final Rule: Conditions for Use of Non-GAAP Financial Measures

— TQA 1300.03 is section 1300.03 of the AICPA's Technical Questions and Answers

— AAG-DEP.6 is chapter 6 of the AICPA's Audit and Accounting Guide for Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies

— AAG-NFP Ex 3-1 is Exhibit 3-1 of the AICPA's Audit and Accounting Guide for Not-For-Profit Entities

— 2006 AICPA Conf is the 2006 AICPA National Conference on Current SEC and PCAOB Developments

Pending content

This Handbook includes a number of Accounting Standards Updates that are not yet effective for all entities (see chapter 1). This pending content is dealt with as follows in the excerpts from the Codification.

— **Effective for public business entities only.** The Codification excerpts reflect these amendments – i.e. the Codification is reproduced as if the pending content were currently effective for all entities.

— **Not yet effective for any entities (except early adopters).** Pending content is labeled as such with a reference to the relevant effective dates and transition information.

Terminology

Throughout this Handbook, we use the term **income statement** to describe the statement of net income as defined in Topic 225, *Income Statement* (i.e. excluding items of OCI) and the term **balance sheet** to describe the statement of financial position as defined in Topic 210, *Balance Sheet*.

Throughout this Handbook, we use the phrase '**cash flows from**' to describe categories within the statement of cash flows, regardless of whether we are describing a cash inflow or a cash outflow (e.g. cash flows from operating activities).

When describing cash flows without explicit reference to a category within the statement of cash flows, we use the following terminology:

— **Cash outflows for** is used to describe cash outflows.

— **Cash inflows from** is used to describe cash inflows.

When describing a scenario where either a cash outflow or a cash inflow can result, we use the phrase '**cash flows from/for**'.

February 2023 edition

This edition of our Handbook includes new and updated interpretations based on our continued practical experience with entities applying Topic 230. Guidance added in this edition is identified with ** and guidance that has been significantly updated or revised is identified with #. The Index of changes identifies all significant changes.

Abbreviations

We use the following abbreviations in this Handbook:

AFS	Available-for-sale
CARES	Coronavirus Aid, Relief, and Economic Security (Act)
CCP	Central clearing party
CTM	Collateralized-to-market
CD	Certificate of deposit

EBP	Employee benefit plan
HTM	Held-to-maturity
IPR&D	In-process research and development
NFP	Not-for-profit entity
NCI	Noncontrolling interest
OCI	Other comprehensive income
PP&E	Property, plant and equipment
PPP	Paycheck Protection Program
R&D	Research and development
ROU	Right-of-use (asset)
STM	Settled-to-market
VIE	Variable interest entity

1. Recent ASUs

The FASB has issued a number of recent updates that modify the guidance on the statement of cash flows or our interpretation of that guidance. The beginning of each chapter discusses the recent ASUs reflected in that chapter.

This chapter provides a brief overview of these ASUs and their effective dates. The summary of early adoption is based on the position as of the date of this Handbook, and not when the ASU was first issued.

Item significantly updated in this edition: #

ASU	Title
2016-02[1]	Leases (Topic 842)
2016-13[1]	Financial Instruments—Credit Losses (Topic 326)
2018-15	Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract
2019-01	Leases (Topic 842): Codification Improvements
2020-04[1]**#**	Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting
2021-10	Government Assistance (Topic 832): Disclosures by Business Entities about Government Assistance

Note:
1. Includes related ASUs effective concurrently, not individually listed.

ASU 2016-02: Leases

Overview

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), which introduced a new model that requires lessees to recognize most leases on-balance sheet. Lessor accounting remains substantially similar to legacy US GAAP (Topic 840).

Given the significant impact of the FASB's new leases standard (particularly for lessees), this Handbook includes two chapters for leases.

— Chapter 14 related to the new leases standard (Topic 842).

— Chapter 14A related to the legacy leases standard (Topic 840).

For an in-depth understanding of the requirements of Topic 842, see KPMG Handbook, Leases, and our leases resource page on Financial Reporting View.

Effective dates and transition

	Public business entities and certain NFPs and EBPs [1 2]	Other entities
Effective date:	Annual and interim periods in fiscal years beginning after December 15, 2018.	— Annual periods in fiscal years beginning after December 15, 2021. — Interim periods in fiscal years beginning after December 15, 2022.
Early adoption:	Permitted.	
Transition:	An entity may adopt the new leases standard using one of two transition methods. — **Comparative method.** The cumulative effect of adoption is recognized in the opening balance of retained earnings of the earliest period presented, and comparative periods are recast. — **Effective date method.** The cumulative effect of adoption is recognized in the opening balance of retained earnings as of the date of initial application, and comparative periods are not recast.	

Notes:

1. This includes (1) NFPs that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market, and (2) EBPs that file or furnish financial statements with or to the SEC.
2. For NFPs that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market that have not yet issued (made available for issuance) their financial statements as of June 3, 2020, the original effective date mentioned here has been deferred by one year.

ASU 2016-13: Current expected credit losses

Overview

In June 2016, the FASB issued ASU 2016-13, Financial Instruments—Credit Losses (Topic 326), which amended guidance on reporting credit losses for assets measured at amortized cost basis and available-for-sale debt securities.

This ASU affects entities holding financial assets and net investment in leases that are not measured at fair value through net income. The amendments affect loans, debt securities, trade receivables, net investments in leases, off-balance sheet credit exposures, reinsurance receivables, and any other financial assets not excluded from the scope that have the contractual right to receive cash.

For an in-depth understanding of the requirements of Topic 326, see KPMG Handbook, Credit impairment.

Effective dates and transition

	SEC filers that are not eligible to be smaller reporting companies[1]	Other entities
Effective date:	Annual and interim periods in fiscal years beginning after December 15, 2019.	Annual and interim periods in fiscal years beginning after December 15, 2022.
Early adoption:	Permitted.	
Transition:	**Cumulative effect method.** The cumulative effect of adoption is recognized in the opening balance of retained earnings as of the beginning of the year of adoption, and comparative periods are not recast. Prospective application is required for certain assets.	

Note:

1. The Consolidated Appropriations Act permits certain financial institutions to temporarily defer applying the credit losses standard to the earlier of the date the COVID-19 national emergency comes to an end, and December 31, 2022. See KPMG publication, Accounting and reporting impacts of the CARES Act and subsequent COVID-19 relief.

ASU 2018-15: Implementation costs for cloud computing arrangements

Overview

In August 2018, the FASB issued ASU 2018-15, Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract, which aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal use software (and hosting arrangements that include an internal use software license).

ASU 2018-15 provides specific guidance to classify cash outflows for cloud computing implementation costs (see Question 7.4.30).

For more information about ASU 2018-15, see KPMG Defining Issues, FASB issues ASU on accounting for implementation costs of cloud computing arrangements.

Effective dates and transition

	Public business entities	Other entities
Effective date:	Annual and interim periods in fiscal years beginning after December 15, 2019.	— Annual periods in fiscal years beginning after December 15, 2020. — Interim periods in fiscal years beginning after December 15, 2021.

<table>
<tr><th></th><th>Public business entities</th><th>Other entities</th></tr>
<tr><td>Early adoption:</td><td colspan="2">Permitted, including adoption in an interim period.</td></tr>
<tr><td>Transition:</td><td colspan="2">An entity may adopt the ASU using one of two transition methods:
— Retrospectively; or
— Prospectively, to all implementation costs for activities performed on or after the effective date, including costs for (1) new cloud computing arrangements entered into on or after the effective date and (2) existing cloud computing arrangements entered into before the effective date.</td></tr>
</table>

ASU 2019-01: Leases (Topic 842) – Codification improvements

Overview

In February 2019, the FASB issued ASU 2019-01, Leases (Topic 842): Codification Improvements, which requires lessors that are depository or lending institutions in the scope of Topic 942 to present the:

- principal portion of lessee payments received from sales-type or direct financing leases as cash flows from **investing** activities; and
- interest portion as cash flows from **operating** activities.

This codifies current practice under Topic 942 that had previously conflicted with Topic 842.

Effective dates and transition

<table>
<tr><th></th><th>Public business entities and certain NFPs and EBPs[1]</th><th>Other entities</th></tr>
<tr><td>Effective date:</td><td>Annual and interim periods in fiscal years beginning after December 15, 2019.</td><td>— Annual periods in fiscal years beginning after December 15, 2021.
— Interim periods in fiscal years beginning after December 15, 2022.</td></tr>
<tr><td>Early adoption:</td><td colspan="2">Permitted concurrent with, or at any time after, the adoption of ASC 842.</td></tr>
<tr><td>Transition:</td><td colspan="2">Entities that adopt the ASU after adopting Topic 842 retrospectively adopt the ASU from:
— their Topic 842 adoption date, if using the effective date transition method; or
— the beginning of the earliest period presented in their post-Topic 842 adoption financial statements, if using the comparative transition method.</td></tr>
</table>

Note:
1. This includes (1) NFPs that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the-counter market, and (2) EBPs that file or furnish financial statements with or to the SEC.

ASU 2020-04: Reference rate reform#

Overview

In March 2020, the FASB issued ASU 2020-04, Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting, which provided temporary optional guidance to ease the potential accounting burden associated with transitioning away from reference rates such as LIBOR that are expected to be discontinued.

For more information about Topic 848, see KPMG Handbook, Reference rate reform.

Effective dates and transition

	All entities
Effective date:	As of the beginning of the interim period that includes March 12, 2020 (e.g. January 1, 2020 for calendar year-end companies) or any date thereafter.
Early adoption:	Not permitted.
Transition:	— The ASU applies prospectively to contract modifications and hedging relationships. — The one-time election to sell and/or transfer debt securities classified as HTM may be made at any time after March 12, 2020.
Sunset date:	The optional relief generally does not apply to contract modifications made, sales and transfers of HTM debt securities, and hedging relationships entered into or evaluated after, December 31, 2024. **Fair value hedges.** Certain aspects of the optional expedients may be applied for the remaining life of the hedging relationship (i.e. after December 31, 2024). **Cash flow hedges – effectiveness assessment expedients.** An entity discontinues using the expedients at the earliest of: — date that neither the hedged item nor the hedging instrument reference a rate that is expected to be discontinued; — January 1, 2025; or — date the entity elects to cease applying the expedient.

ASU 2021-10: Disclosures by business entities about government assistance

Overview

In November 2021, the FASB issued ASU 2021-10, Disclosures by Business Entities about Government Assistance, which creates Topic 832 (government assistance) and requires business entities to disclose information about certain government assistance they receive. The disclosure requirements are for annual periods only.

For more information about ASU 2021-10, see KPMG Defining Issues, FASB approves new disclosures for government assistance.

Effective dates and transition

	All entities except NFP entities and EBPs
Effective date:	Annual periods in fiscal years beginning after December 15, 2021.
Early adoption:	Permitted.
Transition:	The disclosure requirements can be applied either prospectively or retrospectively.

2. Objective and scope

Detailed contents

2.1 How the standard works

Topic 230 contains guidance on reporting cash flows in an entity's financial statements. The objective of a statement of cash flows is to describe the sources and use of cash during a period because this information is not readily available when reviewing the balance sheet or income statement.

All business entities and NFPs, other than those specific exceptions noted in Topic 230, are required to present a statement of cash flows for each period in which an income statement is presented in a complete set of financial statements.

The guidance in this Handbook applies to NFPs, unless a specific provision in Topic 230 explicitly exempts NFPs or the subject matter does not apply to an NFP. See chapter 22 for incremental guidance specific to NFPs.

2.2 Objective

Excerpt from ASC 230-10

10-1 The primary objective of a statement of cash flows is to provide relevant information about the **cash** receipts and cash payments of an entity during a period.

10-2 The information provided in a statement of cash flows, if used with related disclosures and information in the other financial statements, should help investors, creditors, and others (including donors) to do all of the following:

a. Assess the entity's ability to generate positive future net cash flows
b. Assess the entity's ability to meet its obligations, its ability to pay dividends, and its needs for external financing
c. Assess the reasons for differences between net income and associated cash receipts and payments
d. Assess the effects on an entity's financial position of both its cash and noncash investing and financing transactions during the period.

> Form and Content

45-1 A statement of **cash** flows shall report the cash effects during a period of an entity's operations, its investing transactions, and its financing transactions.

Topic 230 contains guidance on reporting cash flows in an entity's financial statements. The objective of a statement of cash flows is to provide details on the changes in cash, cash equivalents and amounts generally described as restricted cash and restricted cash equivalents during a period. [230-10-10-1, 45-4]

In accordance with this objective, cash receipts and payments are classified as cash flows from **operating**, **investing** or **financing** activities in the statement of cash flows. **Noncash** investing and financing activities are separately disclosed. See chapter 4 for discussion of classification in the statement of cash flows. [230-10-45-1, 50-3]

2.3 Scope

Excerpt from ASC 230-10

> Entities

15-2 The guidance in the Statement of Cash Flows Topic applies to all entities, including both business entities and not-for-profit entities (NFPs), with specific exceptions noted below. The phrase *investors, creditors, and others* includes donors. The terms *income statement* and *net income* apply to a business entity; the terms *statement of activities* and *change in net assets* apply to an NFP.

15-3 A business entity or NFP that provides a set of financial statements that reports both financial position and results of operations shall also provide a statement of cash flows for each period for which results of operations are provided.

15-4 The guidance in this Topic does not apply to the following entities:

a. A statement of cash flows is not required to be provided by a defined benefit pension plan that presents financial information in accordance with the provisions of Topic 960. Other employee benefit plans that present financial information similar to that required by Topic 960 (including the presentation of plan investments at fair value) also are not required to provide a statement of cash flows. Employee benefit plans are encouraged to include a statement of cash flows with their annual financial statements when that statement would provide relevant information about the ability of the plan to meet future obligations (for example, when the plan invests in assets that are not highly liquid or obtains financing for investments).
b. Provided that the conditions in (c) are met, a statement of cash flows is not required to be provided by the following entities:
   1. An investment company within the scope of Topic 946 on investment companies.
   2. Subparagraph superseded by Accounting Standards Update No. 2013-08.
   3. A common trust fund, variable annuity account, or similar fund maintained by a bank, insurance entity, or other entity in its capacity as a trustee, administrator, or guardian for the collective investment and reinvestment of funds.
c. For an investment company specified in (b) to be exempt from the requirement to provide a statement of cash flows, all of the following conditions must be met:
   1. Subparagraph superseded by Accounting Standards Update No. 2013-08.
   2. During the period, substantially all of the entity's investments were carried at **fair value** and classified in accordance with Topic 820 as Level 1 or Level 2 measurements or were measured using the practical expedient in paragraph 820-10-35-59 to determine their fair values and are redeemable in the near term at all times.
   3. The entity had little or no debt, based on the average debt outstanding during the period, in relation to average total assets. For the purpose of determining average debt outstanding, obligations resulting from redemptions of shares by the entity from unsettled purchases of securities or similar assets, or from covered options written generally may be excluded. However, any extension of credit by the seller that is not in accordance with standard industry practices for redeeming shares or for settling purchases of investments shall be included in average debt outstanding.
   4. The entity provides a statement of changes in net assets.

All business entities and NFPs, other than those specific exceptions noted in Topic 230, are required to present a statement of cash flows for each period in which an income statement is presented in a complete set of financial statements. [230-10-15-2 – 15-3]

Examples of entities that are not required to present a statement of cash flows are defined benefit pension plans that prepare financial information under Topic 960, other employee benefit plans that present financial information similar to that required by Topic 960, and certain investment companies.

Question 2.3.10

Is a statement of cash flows required if only a balance sheet or an income statement, but not both, is presented?

Interpretive response: No. A statement of cash flows is an essential element of a complete set of financial statements, which also includes a balance sheet and an income statement. When read in conjunction with the income statement, the statement of cash flows enables a user to understand the differences between net income and associated cash receipts and payments. When read in conjunction with the balance sheet, the statement of cash flows enables a user to understand the effects of cash and noncash investing and financing activities on the entity's financial position. [230-10-10-2, 15-3]

In the rare situation that an entity presents only a balance sheet or only an income statement, it need not present a statement of cash flows because such presentation would not constitute a complete set of financial statements. Further, the auditor is not required to comment on its absence. [TQA 1300.05]

Question 2.3.20

Is a statement of cash flows required for both the current and prior periods if only the current balance sheet is presented with comparative income statements?

Interpretive response: Yes. An entity is required to present a statement of cash flows for all periods for which it presents an income statement, even if it presents only the current balance sheet. [230-10-15-3, TQA 1300.03]

Question 2.3.30

Is a subsidiary or division required to present a separate statement of cash flows if it presents a separate balance sheet and income statement?

Interpretive response: We believe the requirement to present a statement of cash flows for all periods for which separate income statements are presented also extends to a subsidiary or division of an entity that presents a separate balance sheet and income statement.

Question 2.3.40

Is an investment company required to provide a statement of cash flows?

Interpretive response: It depends on whether the investment company meets certain conditions.

Investment companies include entities regulated under the Investment Company Act of 1940 and other entities that possess the characteristics of an investment company. [946-10-15-4 – 15-9]

All investment companies are required to provide a statement of changes in net assets. Net assets and changes in those net assets provide relevant information about the investing and financing activities of investment companies to assist users in understanding those assessments because many investment companies use net asset value per share to determine the price of shares redeemed and sold. Although the purpose and format of a statement of changes in net assets differ from those of a statement of cash flows, much of the information contained in those statements is similar. [946-205-45-1]

Therefore, such entities are exempt from providing a statement of cash flows if the following conditions are met. [230-10-15-4]

— During the period, substantially all of the entity's investments were carried at fair value and classified as Level 1 or Level 2 measurements in the fair value hierarchy or were measured using the practical expedient to determine their fair values under Topic 820, and are redeemable in the near term at all times.

— The entity had little or no debt (based on the average debt outstanding during the period) in relation to average total assets.

To determine average debt outstanding, obligations resulting from the entity's redemptions of shares from unsettled purchases of securities or similar assets, or from covered options written generally may be excluded. However, any extension of credit by the seller that is not in accordance with standard industry practice for redeeming shares or for settling purchases of investments is included in average debt outstanding.

3. Format of the statement

Detailed contents

New item added in this edition: **

3.1 How the standard works

A statement of cash flows is designed to describe the sources and use of cash during a period and to reconcile net income to net cash flows from operating activities. There are two acceptable formats for conveying this information – the direct method and the indirect method.

Recent ASUs reflected in this chapter

This chapter reflects the amendments of ASU 2016-02, Leases (Topic 842).

See chapter 1 for an overview of this ASU and its transition requirements. Excerpts from the Codification included in this chapter reflect these amendments – i.e. the Codification is reproduced as if the pending content were currently effective for all entities.

3.2 Reconciliation of net income to net cash flows from operating activities

Excerpt from ASC 230-10

> Form and Content

45-2 A reconciliation of net income and net cash flow from **operating activities**, which generally provides information about the net effects of operating transactions and other events that affect net income and operating cash flows in different periods, also shall be provided.

An entity is required to provide a reconciliation of net income to net cash flows from operating activities. This reconciliation is required regardless of the method (direct or indirect) used to present the statement of cash flows. [230-10-45-2, 45-29]

In the reconciliation, net income is adjusted for items that do not affect net cash flows from **operating** activities in that period. [230-10-45-28, 45-29]

Type of adjustment	Common examples
Deferrals of past operating cash receipts and payments	Changes during the period in: — Inventory — Contract liabilities
Accruals of expected future operating cash receipts and payments	Changes during the period in: — Receivables — Payables
Noncash items reflected in net income (including items whose cash effects are related to investing or financing cash flows)	— Depreciation of PP&E — Amortization of finite lived intangible assets — Amortization of premiums and discounts on debt (including debt issuance costs) — Impairment losses — Provision for losses from uncollectible receivables — Share-based compensation expense — Provision for deferred income taxes — Pick-up of earnings and losses from equity method investees — Unrealized foreign currency transaction gains or losses — Gains or losses from sale of PP&E — Gains or losses from settlement of asset retirement obligations — Gains or losses from extinguishment of debt — Noncash interest expense

Illustrations of the reconciliation are in section 3.3.20 (direct method) and section 3.3.30 (indirect method).

See Question 14.2.85 for guidance on how lessees should present in the reconciliation the periodic reduction in the ROU asset carrying amount and the change in lease liability for operating leases.

Question 3.2.10

What is the starting point in the reconciliation of net income to net cash flows from operating activities?

Interpretive response: Consolidated net income, i.e. including earnings attributable to controlling and noncontrolling interests, is the starting point in the reconciliation of net income to net cash flows from operating activities. [810-10-45-19]

3.3 Direct vs indirect method

3.3.10 Overview

Topic 230 allows an entity to prepare its statement of cash flows under either the direct or indirect method. Although Topic 230 encourages entities to use the direct method, most entities apply the indirect method. [230-10-45-25]

Although the presentation of **operating** cash flows differs between the two methods, both methods result in the same amount of net cash flows from **operating** activities. Additionally, the presentation of **investing** and **financing** activities are identical under both methods.

3.3.20 Direct method

Excerpt from ASC 230-10

> Classification

>> Reporting Operating, Investing, and Financing Activities

45-25 In reporting cash flows from operating activities, entities are encouraged to report major classes of gross cash receipts and gross cash payments and their arithmetic sum—the net cash flow from operating activities (the direct method). (Paragraphs 230-10-55-1 through 55-4 and paragraph 230-10-55-21, respectively, discuss and illustrate a method by which those major classes of gross operating cash receipts and payments generally may be determined indirectly.) Entities that do so shall, at a minimum, separately report the following classes of operating cash receipts and payments:

a. Cash collected from customers, including lessees, licensees, and the like
b. Interest and dividends received. Interest and dividends that are donor restricted for long-term purposes as included in the list of **financing activities** and paragraph 230-10-45-14(c) are not part of operating cash receipts.
c. Other operating cash receipts, if any
d. Cash paid to employees and other suppliers of goods or services, including suppliers of insurance, advertising, and the like
e. Interest paid, including the portion of the payments made to settle zero-coupon debt instruments that is attributable to accreted interest related to the debt discount or the portion of the payments made to settle other debt instruments with coupon interest rates that are insignificant in relation to the **effective interest rate** of the borrowing that is attributable to accreted interest related to the debt discount
f. Income taxes paid
g. Other operating cash payments, if any.

Entities are encouraged to provide further breakdowns of operating cash receipts and payments that they consider meaningful and feasible. For example, a retailer or manufacturer might decide to further divide cash paid to employees and suppliers (category (d) in the preceding paragraph) into payments for costs of inventory and payments for selling, general, and administrative expenses.

> Reconciliation of Net Income and Net Cash Flow from Operating Activities

45-30 If an entity other than an NFP uses the direct method of reporting net cash flow from operating activities, the reconciliation of net income to net cash flow from operating activities shall be provided in a separate schedule.

Under the direct method, major classes of gross cash receipts and payments and their arithmetic sum are reported to determine net cash flows from **operating** activities. To illustrate how **operating** cash flows (prepared on the cash basis of accounting) relate to net income (prepared on the accrual method of accounting), the direct method requires a reconciliation of net income to net cash flows from operating activities to be presented in a separate schedule. [230-10-45-25, 45-30]

Topic 230 lists the classes of **operating** cash flows an entity is expected to present at a minimum under the direct method. Further breakdown of categories is encouraged if doing so may result in more meaningful information for users of the financial statements. [230-10-45-25]

Excerpt from ASC 230-10

>> Example 1: Direct and Indirect Method for a Manufacturing Entity

55-10 The following is a statement of cash flows for the year ended December 31, 19X1, for Entity A, a U.S. corporation engaged principally in manufacturing activities. This statement of cash flows illustrates the direct method of presenting cash flows from operating activities, as encouraged in paragraph 230-10-45-25.

Entity A
Consolidated Statement of Cash Flows
For the Year Ended December 31, 19X1

Cash flows from operating activities:		
Cash received from customers	$ 13,850	
Cash paid to suppliers and employees	(12,000)	
Dividend received from affiliate	20	
Interest received	55	
Interest paid (net of amount capitalized)	(220)	
Income taxes paid	(325)	
Insurance proceeds received for business interruption	5	
Cash paid to settle lawsuit for patent infringement	(30)	
Net cash provided by operating activities		$ 1,355
Cash flows from investing activities:		
Proceeds from sale of facility	600	
Payment received on note for sale of plant	150	
Insurance proceeds received for damage to equipment	10	
Capital expenditures	(1,000)	
Payment for purchase of Entity B, net of cash acquired	(925)	
Net cash used in investing activities		(1,165)
Cash flows from financing activities:		
Net borrowings under line-of-credit agreement	300	
Principal payments under finance lease obligation	(125)	
Proceeds from issuance of long-term debt	400	
Proceeds from issuance of common stock	500	
Dividends paid	(200)	
Net cash provided by financing activities		875
Net increase in cash, cash equivalents and restricted cash		1,065
Cash, cash equivalents, and restricted cash at beginning of year		600
Cash, cash equivalents, and restricted cash at end of year		$ 1,665

Reconciliation of net income to net cash provided by operating activities:

Net income		$ 760
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	$ 445	
Provision for losses on accounts receivable	200	
Gain on sale of facility	(80)	
Undistributed earnings of affiliate	(25)	
Payment received on installment note receivable for sale of inventory	100	
Gain on insurance proceeds received for damage to equipment	(10)	
Change in assets and liabilities net of effects from purchase of Entity B:		
Increase in accounts receivable	(215)	
Decrease in inventory	205	
Increase in prepaid expenses	(25)	
Decrease in accounts payable and accrued expenses	(250)	
Increase in interest and income taxes payable	50	
Increase in deferred taxes	150	
Increase in other liabilities	50	
Total adjustments		595
Net cash provided by operating activities		$ 1,355

Applying the direct method indirectly

Excerpt from ASC 230-10

>> Indirectly Determining Amounts of Operating Cash Receipts and Payments

55-1 Given sufficiently detailed information, major classes of operating **cash** receipts and payments may be determined indirectly by adjusting revenue and expense amounts for the change during the period in related asset and liability accounts. For example, cash collected from customers may be determined indirectly by adjusting sales for the change during the period in receivables from customers for the entity's delivery of goods or services. Likewise, cash paid to suppliers and employees may be determined indirectly by adjusting cost of sales and expenses (exclusive of depreciation, interest, and income taxes) for the change during the period in inventories and payables for operating items. That procedure, of course, requires the availability of information concerning the change during the period in the appropriate classes of receivables and payables. The more detailed the categories of operating cash receipts and payments to be reported, the more complex the procedure for determining them. For the resulting operating cash receipts and payments to be accurate, the effects of all noncash entries to accounts receivable and payable, inventory, and other balance sheets accounts used in the calculation shall be eliminated. For example, the change in accounts receivable would have to be determined exclusive of any bad debt write-offs and other noncash charges and credits to customer accounts during the period.

55-2 Amounts of operating cash receipts and payments at the minimum level of detail specified in paragraph 230-10-45-25 often may be determined indirectly without incurring unduly burdensome costs over those involved in appropriately applying the indirect method. For example, determining net cash flow from **operating activities** by the indirect method requires the availability of the total amount of operating receivables. That is, any receivables for investing or financing items shall be segregated. Within the total amount of operating receivables, information on receivables from customers for an entity's delivery of goods or services may well be available separately from those for interest and dividends. Thus, it may be possible to determine indirectly cash collected from customers and interest and dividends received using much the same information needed to determine net cash flow from operating activities using the indirect method.

55-3 The same procedure may be used to determine cash paid to suppliers and employees. Determining net cash flow from operating activities by the direct method requires the availability of the total amount of payables pertaining to operating activities. Within that amount, payables to suppliers and employees may well be available separately from those for interest and taxes. However, determining operating cash payments in more detail than the minimum specified in paragraph 230-10-45-25 might involve significant incremental costs over those already required to apply the indirect method because information on subcategories of payables to suppliers and employees may not be available.

55-4 Many entities may well be able to determine amounts of operating cash receipts and payments at the minimum level of detail that this Subtopic encourages (see paragraph 230-10-45-25) indirectly at reasonable cost by the procedure discussed in paragraphs 230-10-55-1 through 55-3. But few, if any, entities have experimented with the procedure, and the degree of difficulty encountered in applying it undoubtedly would vary depending on the nature of an entity's operations and the features of its current accounting system.

Many entities do not use the direct method because they do not collect information on cash flows based on the required classes of **operating** cash flows. However, Topic 230 suggests techniques for identifying **operating** cash flows for these classes indirectly rather than developing a separate accounting system that classifies **operating** cash flows directly.

These techniques for identifying **operating** cash flows indirectly are explained in paragraphs 230-10-55-1 to 55-4. For example, one class of **operating** cash inflows required to be presented under the direct method is cash collected from customers. This amount can be determined by adjusting the sales number reported in the income statement by the change in the customer receivables, contract asset and contract liability accounts during the period that resulted from the delivery of goods or services. For example, the sales number is reduced by any increase in customer receivables and increased by any decrease in customer receivables. [230-10-55-1]

However, an entity should have an accounting system capable of identifying the necessary adjustments. In this example, the entity’s accounting system should distinguish between a change in customer receivables due to the delivery of goods and services and a change due to bad debt writeoffs, which is a noncash item that is excluded from the computation of cash collected from customers. [230-10-55-1]

Although an entity’s accounting system may be able to identify necessary adjustments to cash collected from customers, it may be more difficult for the accounting system to identify adjustments to some of the other required classes of **operating** cash flows.

Question 3.3.05**

How does bankruptcy affect the statement of cash flows?

Interpretive response: When an entity is in bankruptcy, reorganization items are disclosed separately within the **operating**, **investing** and **financing** activities in the statement of cash flows. It is easier to meet this requirement if the statement of cash flows is presented under the direct method. If the indirect method is used, the entity discloses details of cash receipts and payments directly resulting from bankruptcy proceedings either in a supplementary schedule or in the notes to financial statements. [852-10-45-13, 50-6A]

This requirement is further discussed in section 4.13.40 in KPMG Handbook, Accounting for bankruptcies. For presentation of cash balances during bankruptcy, see Question 6.4.45.

3.3.30 Indirect method

Excerpt from ASC 230-10

> Reconciliation of Net Income and Net Cash Flow from Operating Activities

45-28 Entities that choose not to provide information about major classes of operating cash receipts and payments by the direct method as encouraged in paragraph 230-10-45-25 shall determine and report the same amount for net cash flow from operating activities indirectly by adjusting net income of a business entity or change in net assets of a not-for-profit entity (NFP) to reconcile it to net cash flow from operating activities (the indirect or reconciliation method). That requires adjusting net income of a business entity or change in net assets of an NFP to remove both of the following:

a. The effects of all deferrals of past operating cash receipts and payments, such as changes during the period in inventory, deferred income, and the like, and all accruals of expected future operating cash receipts and payments, such as changes during the period in receivables and payables. Adjustments to net income of a business entity or change in net assets of an NFP to determine net cash flow from operating activities shall reflect accruals for interest earned but not received and interest incurred but not paid. Those accruals may be reflected in the statement of financial position in changes in assets and liabilities that relate to investing or financing activities, such as loans or deposits. However, interest credited directly to a deposit account that has the general characteristics of **cash** is a cash outflow of the payor and a cash inflow of the payee when the entry is made.
b. All items that are included in net income of a business entity or change in net assets of an NFP that do not affect net cash provided from, or used for, operating activities such as depreciation of property, plant, and equipment and amortization of finite-life intangible assets. This includes all items whose cash effects are related to investing or financing cash flows, such as gains or losses on sales of property, plant, and equipment and discontinued operations (which relate to investing activities), and gains or losses on extinguishment of debt (which relate to financing activities).

45-29 The reconciliation of net income of a business entity to net cash flow from operating activities described in paragraph 230-10-45-28 shall be provided regardless of whether the direct or indirect method of reporting net cash flow from operating activities is used. However, NFPs that use the direct method of reporting net cash flows from operations are not required to provide a reconciliation of change in net assets to net cash flow from operating activities. Additional guidance for NFPs is found in Subtopic 958-230. The reconciliation shall separately report all major classes of reconciling items. For example, major classes of deferrals of past operating cash receipts and payments and accruals of expected future operating cash receipts and payments, including, at a minimum, changes during the period in receivables pertaining to operating activities, in inventory, and in payables pertaining to operating activities, shall be separately reported. Entities are encouraged to provide further breakdowns of those categories that they consider meaningful. For example, changes in receivables from customers for an entity's sale of goods or services might be reported separately from changes in other operating receivables.

45-31 If the indirect method is used, the reconciliation may be either reported within the statement of cash flows or provided in a separate schedule, with the statement of cash flows reporting only the net cash flow from operating activities.

45-32 If the reconciliation is presented in the statement of cash flows, all adjustments to net income of a business entity or change in net assets of an NFP to determine net cash flow from operating activities shall be clearly identified as reconciling items.

> Interest and Income Taxes Paid

50-2 If the indirect method is used, amounts of interest paid (net of amounts capitalized), including the portion of the payments made to settle zero-coupon debt instruments that is attributable to accreted interest related to the debt discount or the portion of the payments made to settle other debt instruments with coupon interest rates that are insignificant in relation to the **effective interest rate** of the borrowing that is attributable to accreted interest related to the debt discount, and income taxes paid during the period shall be disclosed.

Under the indirect method – also known as the reconciliation method – net cash flows from **operating** activities are determined by adding back or deducting from net income those items that do not affect cash from operations (see section 3.2) during the period. [230-10-45-28 – 45-29]

The predominant practice is to present this reconciliation on the face of the statement of cash flows; however, it is acceptable to present the reconciliation in a separate schedule in the notes to the financial statements. If presented on the face of the statement of cash flows, all adjustments to net income should be clearly identified as reconciling items. In contrast, if presented separately in the notes to the financial statements, net cash flows from **operating** activities should be presented as a single line item in the statement of cash flows. [230-10-45-31 – 45-32]

Under the indirect method, amounts of interest paid (net of amounts capitalized) (see section 12.2.40) and income taxes paid during the period are disclosed, either on the face of the statement of cash flows or in the notes to the financial statements. [230-10-50-2]

Excerpt from ASC 230-10

>> Example 1: Direct and Indirect Method for a Manufacturing Entity

55-13 The following is Entity A's statement of cash flows for the year ended December 31, 19X1, prepared using the indirect method, as described in paragraph 230-10-45-28.

Entity A
Consolidated Statement of Cash Flows
For the Year Ended December 31, 19X1

Cash flows from operating activities:		
Net income		$ 760
Depreciation and amortization	$ 445	
Provision for losses on accounts receivable	200	
Gain on sale of facility	(80)	
Undistributed earnings of affiliate	(25)	
Payment received on installment note receivable for sale of inventory	100	
Gain on insurance proceeds received for damage to equipment	(10)	
Change in assets and liabilities net of effects from purchase of Entity B:		
Increase in accounts receivable	(215)	
Decrease in inventory	205	
Increase in prepaid expenses	(25)	
Decrease in accounts payable and accrued expenses	(250)	
Increase in interest and income taxes payable	50	
Increase in deferred taxes	150	
Increase in other liabilities	50	
Total adjustments		595
Net cash provided by operating activities		1,355
Cash flows from investing activities:		
Proceeds from sale of facility	600	
Payment received on note for sale of plant	150	
Insurance proceeds received for damage to equipment	10	
Capital expenditures	(1,000)	
Payment for purchase of Entity B, net of cash acquired	(925)	
Net cash used in investing activities		(1,165)
Cash flows from financing activities:		
Net borrowings under line-of-credit agreement	300	
Principal payments under finance lease obligation	(125)	
Proceeds from issuance of long-term debt	400	
Proceeds from issuance of common stock	500	
Dividends paid	(200)	
Net cash provided by financing activities		875
Net increase in cash, cash equivalents, and restricted cash		1,065
Cash, cash equivalents, and restricted cash at beginning of year		600
Cash, cash equivalents, and restricted cash at end of year		$ 1,665

Question 3.3.10

How does a primary beneficiary present its statement of cash flows when a consolidated VIE's assets and liabilities are separately presented on its balance sheet?

Background: If a VIE's assets can only be used to settle its obligations, and the VIE's creditors do not have recourse to the general credit of the primary beneficiary, the VIE's assets and liabilities are presented separately on the balance sheet of the primary beneficiary. Specifically, the primary beneficiary presents – in separate captions or parenthetically – the assets and liabilities of the primary beneficiary and the consolidated VIE for each caption on its balance sheet. [810-10-45-25]

Interpretive response: We believe the primary beneficiary's consolidated statement of cash flows should be based on the consolidated balances of assets and liabilities presented on the balance sheet – i.e. the sum of the amounts for the primary beneficiary and the VIE. This is notwithstanding the requirement under Subtopic 810-10 to present certain assets and liabilities of the VIE separately. This presentation is the same if the primary beneficiary presents the separate VIE amounts parenthetically on its consolidated balance sheet.

3.3.40 Change in the presentation method

Question 3.3.20

May an entity change its presentation method?

Interpretive response: Yes. Although Topic 230 encourages an entity to report cash flows from **operating** activities by showing the major classes of gross cash receipts and payments under the direct method, it permits both the direct and indirect methods. [230-10-45-25]

If an entity changes its presentation method (e.g. from the indirect method to the direct method), it should recast its prior-period statement of cash flows (if presented), and use the new method for the comparative periods. The notes to the financial statements should also disclose that the entity has recast its prior-period statement of cash flows. We do not believe a preferability assessment under Topic 250 (accounting changes and error corrections) is required. [TQA 1300.20]

In addition, we believe an SEC registrant does not need a preferability letter to change its presentation of cash flows because this change does not rise to the level of a change in accounting principle.

For further guidance see Question 3.2.40 and Question 6.2.20 in KPMG Handbook, Accounting changes and error corrections. [250-10-S99-4]

3.4 Cash flow per share and other liquidity measures

Excerpt from ASC 230-10

> Form and Content

45-3 Financial statements shall not report an amount of cash flow per share. Neither cash flow nor any component of it is an alternative to net income as an indicator of an entity's performance, as reporting per-share amounts might imply. Reporting a contractually determined per-unit amount, such as a per unit amount of cash flow distributable under the terms of a partnership agreement or other agreement between an entity and its owners, is not the same as reporting a cash flow per-share amount intended to provide information useful to all investors and creditors and thus is not precluded by this Subtopic.

Question 3.4.10

May an entity disclose cash flow per share?

Interpretive response: Topic 230 prohibits disclosing cash flow per share or any component of cash flow per share in the financial statements. The rationale for this prohibition is to avoid implying that a cash flow per-share amount is an acceptable alternative to net income per share as an indicator of an entity's financial performance. [230-10-45-3]

In a filing with the SEC, per share non-GAAP financial measures are generally prohibited. The per-share prohibition depends on whether the per-share non-GAAP financial measure can be viewed as a liquidity measure. Per-share measures of liquidity (e.g. cash flow per share) are expressly prohibited in all filings with the SEC. See section 9.2.30 in KPMG Handbook, Earnings per share, and KPMG Issues In-Depth, Non-GAAP financial measures, for additional guidance. [C&DI 102.05, FR-65 FN11]

Question 3.4.20

May an entity present subtotals within the categories in the statement of cash flows?

Interpretive response: Although not explicitly prohibited under Topic 230, we believe subtotals within the operating, investing and financing categories of the statement of cash flows are unnecessary and generally best avoided.

Subtotals have the potential to obscure the information provided or serve as non-GAAP liquidity measures. Additionally, we believe subtotals of gross inflows and outflows to present a net cash flow amount are not appropriate because they circumvent GAAP requirements (see section 3.5). Instead, entities should leverage the example formats in Topic 230. [230-10-45-3]

3.5 Gross vs net cash flows

Excerpt from ASC 230-10

> Form and Content

>> Gross and Net Cash Flows

45-7 Generally, information about the gross amounts of cash receipts and cash payments during a period is more relevant than information about the net amounts of cash receipts and payments. However, the net amount of related receipts and payments provides sufficient information not only for cash equivalents, as noted in paragraph 230-10-45-5, but also for certain other classes of cash flows specified in paragraphs 230-10-45-8 through 45-9 and paragraph 230-10-45-28.

45-8 For certain items, the turnover is quick, the amounts are large, and the maturities are short. For certain other items, such as demand deposits of a bank and customer accounts payable of a broker-dealer, the entity is substantively holding or disbursing cash on behalf of its customers. Only the net changes during the period in assets and liabilities with those characteristics need be reported because knowledge of the gross cash receipts and payments related to them may not be necessary to understand the entity's operating, investing, and financing activities.

45-9 Providing that the original maturity of the asset or liability is three months or less, cash receipts and payments pertaining to any of the following qualify for net reporting for the reasons stated in the preceding paragraph:

a. Investments (other than cash equivalents)
b. Loans receivable
c. Debt.

For purposes of this paragraph, amounts due on demand are considered to have maturities of three months or less. For convenience, credit card receivables of financial services operations—generally, receivables resulting from cardholder charges that may, at the cardholder's option, be paid in full when first billed, usually within one month, without incurring interest charges and that do not stem from the entity's sale of goods or services—also are considered to be loans with original maturities of three months or less.

> Classification

>> Reporting Operating, Investing, and Financing Activities

45-26 Except for items described in paragraphs 230-10-45-8 through 45-9, both investing cash inflows and outflows and financing cash inflows and outflows shall be reported separately in a statement of cash flows – for example, outlays for acquisitions of property, plant, and equipment shall be reported separately from proceeds from sales of property, plant, and equipment; proceeds of borrowings shall be reported separately from repayments of debt; and proceeds from issuing stock shall be reported separately from outlays to reacquire the entity’s stock.

Generally, cash receipts and cash payments are reported on a gross basis in the statement of cash flows. While gross presentation usually provides users more meaningful insight into the business and operations of an entity, there are certain exceptions in which cash receipts and payments can be reported on a net basis. Items that qualify for net reporting must have quick turnover, occur in large amounts and have short maturities (i.e. less than 90 days). For example, gross cash flows may be large in relation to other cash flows because of a large volume of small value transactions. [230-10-45-7 – 45-8]

Examples that typically qualify for net reporting include:

— cash receipts and payments for sales and purchases of trading securities classified in cash flows from **operating** activities;
— balance sheet items where an entity is substantively holding or disbursing cash on behalf of its customers – e.g. customer demand deposits of a bank and customer accounts payable of a broker-dealer; and
— proceeds and repayments of debt that has an original maturity of three months or less.

Question 3.5.10

Should financial institutions present cash flows gross or net?

Interpretive response: It depends. Banks, savings institutions and credit unions may present any of the following cash receipts and payments on a net basis in the statement of cash flows: [942-230-45-1]

— deposits placed with other financial institutions and withdrawals of deposits;
— time deposits accepted and repayments of deposits; and
— loans made to customers and principal collections.

This presentation option is not available to finance companies, insurance companies, other financial intermediaries, or to subsidiaries of financial institutions unless the subsidiary is itself a bank, savings institution or credit union. [942-230-45-2]

For additional guidance over the presentation of cash receipts and payments on a net basis in financial institutions statements of cash flows, see chapter 11.

4. Classification principles

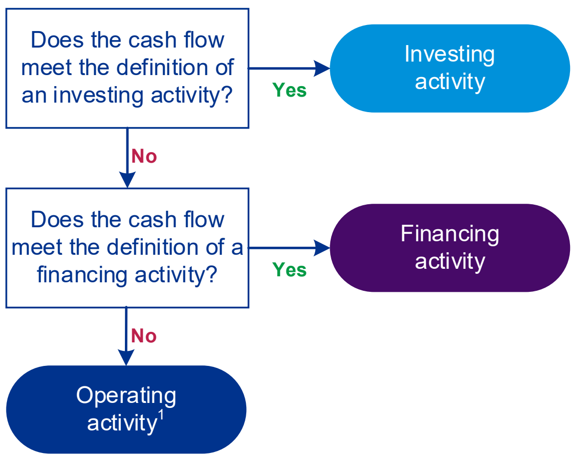
Detailed contents

Item significantly updated in this edition: #

4.1 How the standard works

Topic 230 requires entities to classify cash receipts and payments as cash flows from **operating**, **investing** or **financing** activities based on the nature of the cash flows. It also requires **noncash** investing and financing activities to be disclosed.

The following chart highlights the process when determining the appropriate classification of cash receipts and payments in the statement of cash flows.



Note:

1. Cash flows from **operating** activities are generally the cash effects of transactions and other events that enter into the determination of net income.

The classification of cash receipts and payments may require judgment, especially when some transactions generate more than one class of cash flows and the predominance principle is applied. Therefore, entities are encouraged to adequately disclose their policies and related judgments with respect to classification.

Additionally, some arrangements may create difficulties in determining whether the entity should report constructive receipts and disbursements in its statement of cash flows although no apparent cash flow has occurred – e.g. arrangements in which other parties exchange cash on behalf of the entity.

Recent ASUs reflected in this chapter

This chapter reflects the amendments of ASU 2016-02, Leases (Topic 842).

See chapter 1 for an overview of this ASU and its transition requirements. Excerpts from the Codification included in this chapter reflect these amendments – i.e. the Codification is reproduced as if the pending content were currently effective for all entities.

4.2 Investing activities

Excerpt from ASC 230-10

20 Glossary

Investing Activities – Investing activities include making and collecting loans and acquiring and disposing of debt or equity instruments and property, plant, and equipment and other productive assets, that is, assets held for or used in the production of goods or services by the entity (other than materials that are part of the entity’s inventory). Investing activities exclude acquiring and disposing of certain loans or other debt or equity instruments that are acquired specifically for resale, as discussed in paragraphs 230-10-45-12 and 230-10-45-21.

Topic 230 provides a list of cash inflows and outflows that are **investing** activities (reproduced below). Information about items on this list can be found in this publication throughout the subsequent chapters addressing the specific types of transactions.

Excerpt from ASC 230-10

> Classification

>> Cash Flows from Investing Activities

45-11 Cash flows from purchases, sales, and maturities of available-for-sale debt securities shall be classified as cash flows from **investing activities** and reported gross in the statement of cash flows.

45-12 All of the following are cash inflows from investing activities:

a. Receipts from collections or sales of loans made by the entity and of other entities' debt instruments (other than cash equivalents, certain debt instruments that are acquired specifically for resale as discussed in paragraph 230-10-45-21, and certain donated debt instruments received by not-for-profit entities (NFPs) as discussed in paragraph 230-10-45-21A) and collections on a transferor’s beneficial interests in a securitization of the transferor’s trade receivables
b. Receipts from sales of equity instruments of other entities (other than certain equity instruments carried in a trading account as described in paragraph 230-10-45-18 and certain donated equity instruments received by NFPs as discussed in paragraph 230-10-45-21A) and from returns of investment in those instruments
c. Receipts from sales of property, plant, and equipment and other productive assets
d. Subparagraph not used
e. Receipts from sales of loans that were not specifically acquired for resale. That is, if loans were acquired as investments, cash receipts from sales of

those loans shall be classified as investing cash inflows regardless of a change in the purpose for holding those loans.

For purposes of this paragraph, receipts from disposing of loans, debt or equity instruments, or property, plant, and equipment include directly related proceeds of insurance settlements, such as the proceeds of insurance on a building that is damaged or destroyed.

45-13 All of the following are cash outflows for investing activities:

a. Disbursements for loans made by the entity and payments to acquire debt instruments of other entities (other than cash equivalents and certain debt instruments that are acquired specifically for resale as discussed in paragraph 230-10-45-21)
b. Payments to acquire equity instruments of other entities (other than certain equity instruments carried in a trading account as described in paragraph 230-10-45-18)
c. Payments at the time of purchase or soon before or after purchase to acquire property, plant, and equipment and other productive assets, including interest capitalized as part of the cost of those assets. Generally, only advance payments, the down payment, or other amounts paid at the time of purchase or soon before or after purchase of property, plant, and equipment and other productive assets are investing cash outflows. However, incurring directly related debt to the seller is a financing transaction (see paragraphs 230-10-45-14 through 45-15), and subsequent payments of principal on that debt thus are financing cash outflows.
d. Payments made soon after the acquisition date of a business combination by an acquirer to settle a contingent consideration liability.

4.3 Financing activities

Excerpt from ASC 230-10

20 Glossary

Financing Activities – Financing activities include obtaining resources from owners and providing them with a return on, and a return of, their investment; receiving restricted resources that by donor stipulation must be used for long-term purposes; borrowing money and repaying amounts borrowed, or otherwise settling the obligation; and obtaining and paying for other resources obtained from creditors on long-term credit.

Topic 230 provides a list of cash inflows and outflows that are **financing** activities (reproduced below). Information about items on this list can be found in this publication throughout the subsequent chapters addressing the specific types of transactions.

Excerpt from ASC 230-10

> Classification

>> Cash Flows from Financing Activities

45-14 All of the following are cash inflows from financing activities:

a. Proceeds from issuing equity instruments
b. Proceeds from issuing bonds, mortgages, notes, and from other short- or long-term borrowing
c. 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**
d. Proceeds received from derivative instruments that include financing elements at inception, whether the proceeds were received at inception or over the term of the derivative instrument, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments
e. Subparagraph superseded by Accounting Standards Update No. 2016-09.

45-15 All of the following are cash outflows for financing activities:

a. Payments of dividends or other distributions to owners, including outlays to reacquire the entity's equity instruments. Cash paid to a tax authority by a grantor when withholding shares from a grantee’s award for tax-withholding purposes shall be considered an outlay to reacquire the entity’s equity instruments.
b. Repayments of amounts borrowed, including the portion of the repayments made to settle zero-coupon debt instruments that is attributable to the principal or the portion of the repayments made to settle 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.
c. Other principal payments to creditors who have extended long-term credit. See paragraph 230-10-45-13(c), which indicates that most principal payments on seller-financed debt directly related to a purchase of property, plant, and equipment or other productive assets are financing cash outflows.
d. Distributions to counterparties of derivative instruments that include financing elements at inception, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments. The distributions may be either at inception or over the term of the derivative instrument.
e. Payments for debt issue costs.
f. Payments, or the portion of the payments, not made soon after the acquisition date of a business combination by an acquirer to settle a contingent consideration liability up to the amount of the contingent consideration liability recognized at the acquisition date, including measurement-period adjustments, less any amounts paid soon after the acquisition date to settle the contingent consideration liability. See also paragraph 230-10-45-17(ee).

g. Payments for debt prepayment or debt extinguishment costs, including third-party costs, premiums paid, and other fees paid to lenders that are directly related to the debt prepayment or debt extinguishment, excluding accrued interest.

4.4 Operating activities

Excerpt from ASC 230-10

20 Glossary

Operating Activities – Operating activities include all transactions and other events that are not defined as investing or financing activities (see paragraphs 230-10-45-12 through 45-15). Operating activities generally involve producing and delivering goods and providing services. Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income.

Cash flows that are neither investing nor financing activities are classified as cash flows from **operating** activities. Topic 230 provides a list of cash inflows and outflows that are **operating** activities (reproduced below). Information about items on this list can be found in this publication throughout the subsequent chapters addressing the specific types of transactions.

Excerpt from ASC 230-10

> Classification

>> Cash Flows from Operating Activities

45-16 All of the following are cash inflows from operating activities:

a. Cash receipts from sales of goods or services, including receipts from collection or sale of accounts and both short- and long-term notes receivable from customers arising from those sales. The term *goods* includes certain loans and other debt and equity instruments of other entities that are acquired specifically for resale, as discussed in paragraph 230-10-45-21.
b. Cash receipts from returns on loans, other debt instruments of other entities, and equity securities—interest and dividends.
c. All other cash receipts that do not stem from transactions defined as investing or financing activities, such as amounts received to settle lawsuits and refunds from suppliers.

45-17 All of the following are cash outflows for operating activities:

a. Cash payments to acquire materials for manufacture or goods for resale, including principal payments on accounts and both short- and long-term notes payable to suppliers for those materials or goods. The term *goods*

includes certain loans and other debt and equity instruments of other entities that are acquired specifically for resale, as discussed in paragraph 230-10-45-21.
b. Cash payments to other suppliers and employees for other goods or services.
c. Cash payments to governments for taxes, duties, fines, and other fees or penalties.
d. Cash payments to lenders and other creditors for interest, including the portion of the payments made to settle zero-coupon debt instruments that is attributable to accreted interest related to the debt discount or the portion of the payments made to settle other debt instruments with coupon interest rates that are insignificant in relation to the **effective interest rate** of the borrowing that is attributable to accreted interest related to the debt discount. For all other debt instruments, an issuer shall not bifurcate cash payments to lenders and other creditors at settlement for amounts attributable to accreted interest related to the debt discount, nor classify such amounts as cash outflows for operating activities.
e. Cash payment made to settle an asset retirement obligation.
ee. Cash payments, or the portion of the payments, not made soon after the acquisition date of a business combination by an acquirer to settle a contingent consideration liability that exceed the amount of the contingent consideration liability recognized at the acquisition date, including measurement-period adjustments, less any amounts paid soon after the acquisition date to settle the contingent consideration liability. See also paragraph 230-10-45-15(f).
f. All other cash payments that do not stem from transactions defined as investing or financing activities, such as payments to settle lawsuits, cash **contributions** to charities, and cash refunds to customers.

4.5 More than one class of cash flows

Excerpt from ASC 230-10

> Classification

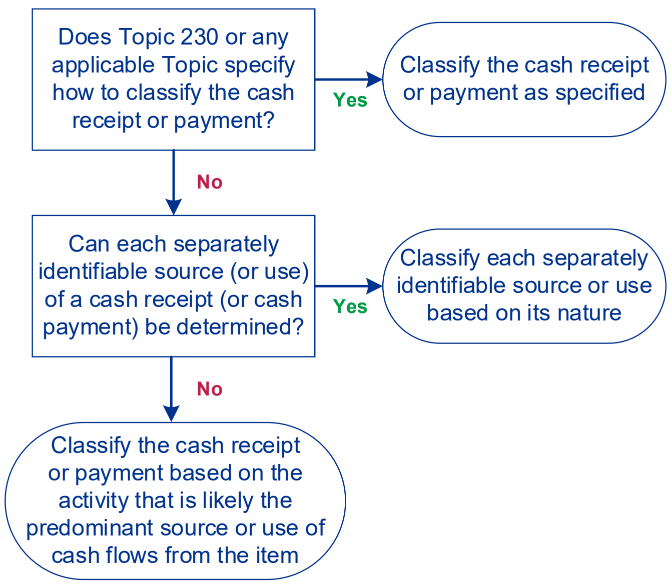
>> More than One Class of Cash Flows

45-22 Certain cash receipts and payments may have aspects of more than one class of cash flows. The classification of those cash receipts and payments shall be determined first by applying specific guidance in this Topic and other applicable Topics. In 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, including when judgment is necessary to estimate the amount of each separately identifiable source or use. A reporting entity shall then classify each separately identifiable source or use within the cash receipts and payments on the basis of their nature in financing, investing, or operating activities.

45-22A In 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 (for example, when a piece of equipment is acquired or produced by an entity to be rented to others for a period of time and then sold), the appropriate classification shall depend on the activity that is likely to be the predominant source or use of cash flows for the item.

When a cash receipt or payment has characteristics of more than one class of cash flows, an entity applies the predominance principle to determine the appropriate classification.

Topic 230 provides guidance on how to apply the predominance principle. This guidance is summarized in the following chart. [230-10-45-22 – 45-22A]



Section 8.5.10 illustrates the application of the predominance principle to PP&E and other productive assets.

Question 4.5.10

What are the disclosure requirements when an entity applies the predominance principle?

Interpretive response: Although additional guidance has been provided on how the predominance principle should be applied and specific disclosures are not required, we believe entities should continue to provide sufficient disclosures to inform users of the basis for the classification selected. [ASU 2016-15.BC41]

4.6 Change in classification vs change in accounting principle#

Topic 230 is silent on whether a change in classification (i.e. as **operating**, **investing** or **financing**) of a cash flow item is a change in accounting principle, subject to the requirements in Topic 250 (accounting changes and error corrections). Further, the statement of cash flows may be affected by changes in accounting principle, whether voluntary or not.

Assessing if a change in accounting principle is preferable (voluntary changes only)

Topic 250 presumes that once an entity adopts an accounting principle for initial events and transactions, it should not change the accounting for similar events and transactions in subsequent periods. However, an entity may make a change in accounting principle when (1) the change is required by a newly issued accounting standard, or (2) adopting the alternative accounting principle is preferable to the current one. A change in accounting principle is therefore subject to a preferability assessment under Topic 250. [250-10-45-1 – 45-2]

In addition, SEC registrants are required to include a preferability letter from their independent auditors as an exhibit to the first Form 10-Q filed subsequent to the date of the accounting change. [250-10-S99-4, SAB Topic 6G.2.b]

Accounting for a change in accounting principle

Topic 250 requires changes in accounting principles to be recorded retrospectively unless the change arises from a Codification update that provides specific transition requirements. [250-10-45-3]

Retrospectively applying a change in accounting principle typically requires adjusting all comparative periods presented as if the new accounting principle had always been applied. The effect of the change is recorded through the opening balance of retained earnings of the earliest period presented, meaning that the amounts for prior periods, including those in working capital captions, are consistently presented. [250-10-45-5]

Certain Codification updates permit an entity to make a change in accounting principle without recasting comparative periods. In this case, the effect of the change is generally recorded through the opening balance of retained earnings in the period of adoption.

See section 3.3 in KPMG Handbook, Accounting changes and error corrections.

Question 4.6.10#

Is a change in the classification of a cash flow item a change in accounting principle?

Interpretive response: No. We do not believe that a change in classification (i.e. as **operating**, **investing** or **financing**) of a cash flow item is a change in accounting principle if the entity is able to conclude that both the previous and the new classifications are acceptable under US GAAP. Instead, we believe the change represents a reclassification from one acceptable classification to another acceptable classification in accordance with Topic 230. A preferability assessment under Topic 250 is therefore not required.

In addition, we believe an SEC registrant does not need a preferability letter to change its classification of a cash flow item from one acceptable classification to another acceptable classification. [250-10-S99-4]

If an entity changes the classification of a cash flow item, we believe it should recast its prior-period statement of cash flows (if presented), and use the new classification for the comparative periods. The notes to the financial statements should also disclose the classification change. See section 3.5 in KPMG Handbook, Accounting changes and error corrections.

Question 4.6.20#

How does a change in accounting principle affect the statement of cash flows?

Interpretive response: Regardless of how a change in accounting principle is accounted for, it is a noncash event. Therefore, we believe total cash flows should be unchanged, unless the change in accounting principle affects the determination of the total cash and cash equivalents (see Question 6.3.30 and Question 6.4.20 for examples).

However, the change may have line-by-line effects, such as if the change in accounting principle:

— affects balance sheet working capital captions: reconciling items in the reconciliation of net income to net cash flows from operating activities (see section 3.2) may be affected.

— modifies how cash flows should be classified: total cash flows by category may be affected.

4.7 Noncash activities

4.7.10 Constructive receipt and disbursement

An entity may enter into an arrangement where cash is exchanged between two or more third parties on behalf of the entity. For example, in lieu of paying a trade payable and receiving cash for a trade receivable, the entity directs its customer to pay cash to its vendor on its behalf. Although such an arrangement may not result in a direct exchange of cash to or from the entity, the same economic result is achieved – i.e. a constructive receipt and disbursement.

Question 4.7.10

How does an entity determine whether receipts and disbursements are constructive?

Interpretive response: Judgment should be applied to determine whether an entity should report cash flows in its statement of cash flows, when the arrangement does not result in a direct exchange of cash for the entity. While all facts and circumstances must be considered, we believe that if an entity is not directly involved in the cash exchange based on convenience, it may still need to report corresponding constructive receipts and disbursements as cash flows.

Conversely, if an entity is precluded from participating in the cash exchange by the other parties, then we believe there may be no constructive receipt and disbursement to consider.

4.7.20 Noncash investing and financing activities

Excerpt from ASC 230-10

> Noncash Investing and Financing Activities

50-3 Information about all **investing** and **financing activities** of an entity during a period that affect recognized assets or liabilities but that do not result in **cash** receipts or cash payments in the period shall be disclosed. Those disclosures may be either narrative or summarized in a schedule, and they shall clearly relate the cash and noncash aspects of transactions involving similar items.

50-4 Examples of noncash investing and financing transactions are converting debt to equity; acquiring assets by assuming directly related liabilities, such as purchasing a building by incurring a mortgage to the seller; obtaining a right-of-use asset in exchange for a lease liability; obtaining a beneficial interest as consideration for transferring financial assets (excluding cash), including the transferor's trade receivables, in a securitization transaction; obtaining a building or investment asset by receiving a gift; and exchanging noncash assets or liabilities for other noncash assets or liabilities.

50-5 Some transactions are part cash and part noncash; only the cash portion shall be reported in the statement of cash flows.

50-6 If there are only a few such noncash transactions, it may be convenient to include them on the same page as the statement of cash flows. Otherwise, the transactions may be reported elsewhere in the financial statements, clearly referencing to the statement of cash flows.

Investing and financing activities that affect recognized assets or liabilities but that do not result in actual cash receipts or payments are disclosed as **noncash** investing and financing activities. Such disclosures are summarized in a schedule or in narrative form on the face of the statement of cash flows, or in the notes to the financial statements by reference to the statement of cash flows. [230-10-50-3, 50-6]

Examples of **noncash** investing and financing activities include: [230-10-50-4, 946-230-55-1]

- transfers between held-to-maturity or available-for-sale and trading portfolios that result in a noncash transfer between investing and operating activities;
- noncash effects of a business combination, including any noncash consideration included in the purchase consideration and the total effects on the assets and liabilities of the acquirer;
- purchases of PP&E with unpaid costs accrued within accounts payable;
- acquisition of assets by assuming liabilities (including capital lease obligations under Topic 840 or obtaining a ROU asset in exchange for a lease liability on adoption of Topic 842) or by issuing equity securities;
- exchanges of nonmonetary assets;
- conversion of debt or preferred stock to common stock;
- issuance of equity securities to retire debt;
- issuance of stock in connection with a stock compensation plan where no cash payment is required;
- reinvestment of dividends and distributions for investment companies.

To the extent that a transaction includes both cash and noncash components, an entity should disclose the noncash component of the transaction and present the cash component in the statement of cash flows. [230-10-50-5]

5. Interim reporting

Detailed contents

5.1 How the standard works

Interim reporting is the reporting of financial results of any period that is shorter than a fiscal year. The Securities Exchange Act of 1934 requires most SEC registrants to file a quarterly report with the SEC on Form 10-Q. The Form 10-Q includes condensed financial information, such as statements of cash flows, and other data prepared by an entity's accounting personnel and reviewed by its independent auditors. The format and contents of the Form 10-Q are defined by the SEC.

This chapter focuses on interim reporting requirements for SEC registrants. However, other entities may also prepare interim reports.

5.2 General interim reporting requirements

Excerpt from Reg S-X Rule 10-1

a. *Condensed statements*. Interim financial statements shall follow the general form and content of presentation prescribed by the other sections of this Regulation with the following exceptions: …

4. The statement of cash flows may be abbreviated starting with a single figure of net cash flows from operating activities and showing cash changes from investing and financing activities individually only when they exceed 10% of the average of net cash flows from operating activities for the most recent three years. Notwithstanding this test, § 210.4-02 applies and *de minimis* amounts therefore need not be shown separately.

c. *Periods to be covered*. The periods for which interim financial statements are to be provided in registration statements are prescribed elsewhere in this Regulation (see §§ 210.3-01 and 3-02). For filings on Form 10-Q, financial statements shall be provided as set forth in this paragraph (c): …

3. Interim statements of cash flows shall be provided for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding period of the preceding fiscal year. Such statements may also be presented for the cumulative twelve month period ended during the most recent fiscal quarter and for the corresponding preceding period.

4. Registrants engaged in seasonal production and sale of a single-crop agricultural commodity may provide interim statements of comprehensive income and cash flows for the twelve month period ended during the most recent fiscal quarter and for the corresponding preceding period in lieu of the year-to-date statements specified in paragraphs c(2) and (3) of this section.

Excerpt from ASC 270-10

>>> SAB Topic 6.G.2, Amendments to Form 10Q

S99-2 The following is the text of SAB Topic 6.G.2, Amendments to Form 10Q.

a. Form of condensed financial statements.

Facts: Rules 10-01(a)(2) and (3) of Regulation S-X provide that interim balance sheets and statements of income shall include only major captions (i. e., numbered captions) set forth in Regulation S-X, with the exception of inventories where data as to raw materials, work in process and finished goods shall be included, if applicable, either on the face of the balance sheet or in notes thereto. Where any major balance sheet caption is less than 10% of total assets and the amount in the caption has not increased or decreased by more than 25% since the end of the preceding fiscal year, the caption may be combined with others. When any major income statement caption is less than 15% of average net income attributable to the registrant for the most recent three fiscal years and the amount in the caption has not increased or decreased by more than 20% as compared to the corresponding interim period of the preceding fiscal year, the caption may be combined with others. Similarly, the statement of cash flows may be abbreviated, starting with a single figure of cash flows provided by operations and showing other changes individually only when they exceed 10% of the average of cash flows provided by operations for the most recent three years.

Question 1: If a company previously combined captions in a Form 10-Q but is required to present such captions separately in the Form 10-Q for the current quarter, must it retroactively reclassify amounts included in the prior-year financial statements presented for comparative purposes to conform with the captions presented for the current-year quarter?

Interpretive Response: Yes.

Question 2: If a company uses the gross profit method or some other method to determine cost of goods sold for interim periods, will it be acceptable to state only that it is not practicable to determine components of inventory at interim periods?

Interpretive Response: The staff believes disclosure of inventory components is important to investors. In reaching this decision the staff recognizes that registrants may not take inventories during interim periods and that managements, therefore, will have to estimate the inventory components. However, the staff believes that management will be able to make reasonable estimates of inventory components based upon their knowledge of the company's production cycle, the costs (labor and overhead) associated with this cycle as well as the relative sales and purchasing volume of the company.

Question 3: If a company has years during which operations resulted in a net outflow of cash and cash equivalents, should it exclude such years from the computation of cash and cash equivalents provided by operations for the three most recent years in determining what sources and applications must be shown separately?

Interpretive Response: Yes. Similar to the determination of average net income, if operations resulted in a net outflow of cash and cash equivalents during any year, such amount should be excluded in making the computation of cash flow provided by operations for the three most recent years unless operations resulted in a net outflow of cash and cash equivalents in all three years, in which case the average of the net outflow of cash and cash equivalents should be used for the test.

Question 5.2.10

What periods does an SEC registrant present in its interim statement of cash flows?

Interpretive response: In an interim reporting period, an SEC registrant is required to present a statement of cash flows for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding period of the preceding fiscal year (i.e. a year-to-date statement of cash flows). The statement of cash flows may also be presented for the cumulative 12-month period ended during the most recent fiscal quarter and for the corresponding preceding period. [S-X Rule 10-01(c)(3)]

SEC registrants engaged in the seasonal production and sale of a single-crop agricultural commodity may provide an interim statement of cash flows for the 12-month period ended during the most recent fiscal quarter, and for the corresponding preceding period, instead of year-to-date statements of cash flows. [S-X Rule 10-01(c)(4)]

SEC registrants engaged primarily in either of the following may at their option include cash flows for the 12-month period ending on the date of the most recent balance sheet being filed in lieu of the statement of cash flows for the interim periods specified: [S-X Rule 3-03(b)(1)(2)]

— the generation, transmission or distribution of electricity, the manufacture, mixing, transmission or distribution of gas, the supplying or distribution of water, or the furnishing of telephone or telegraph service, or

— holding securities of companies engaged in such businesses.

Example 5.2.10
Interim statements of cash flows

ABC Corp. is a calendar year-end SEC registrant and its third fiscal quarter ends on September 30. In preparing its September 30, Year 2, interim results reported on Form 10-Q, ABC presents its interim statements of cash flows for the nine-month periods ended September 30, Year 2, and September 30, Year 1 (i.e. cash flow activity from January 1 through September 30, or year-to-date statements of cash flows).

ABC may also present interim statements of cash flows for the 12-month period ended September 30, Year 2, and September 30, Year 1 (i.e. cash flow activity from October 1 through September 30).

Question 5.2.20
May a public entity present quarterly statements of cash flows in a registration statement?

Background: As discussed in Question 5.2.10, a year-to-date statement of cash flows is required by the SEC for interim reporting periods. A quarter-to-date statement of cash flows is not required even though a quarter-to-date income statement is required for interim reporting periods. [S-X Rule 10-01(c)(2) – (3)]

Interpretive response: Yes. There is no indication in the relevant technical literature that a quarterly presentation of the statement of cash flows is prohibited under US GAAP.

Question 5.2.30

May an SEC registrant abbreviate its interim statement of cash flows?

Interpretive response: Yes. In an interim period, an entity may abbreviate its statement of cash flows. An entity's interim statement of cash flows may start with a single amount of net cash flows from operating activities and show cash changes from investing and financing activities individually only when they exceed 10% of the average net cash flows from operating activities for the most recent three years. Otherwise, the caption may be combined with other captions in Form 10-Q. [S-X Rule 10-01(a)(4)]

The computation of the average net cash flows from operating activities excludes years with negative net operating cash flows unless all three years were negative. If all three years were negative, the average negative operating cash flows should be used for the test. [270-10-S99-2]

If an SEC registrant previously combined captions on Form 10-Q but is required to present these captions separately on Form 10-Q for the current quarter (or vice versa), it is required to retroactively reclassify amounts included in the prior year financial statements presented for comparative purposes to conform with the captions presented for the current year quarter. [270-10-S99-2]

Question 5.2.40

Is an entity required to disclose changes in noncash items or the cash interest and income taxes paid during an interim period?

Interpretive response: No. The disclosure of the change in noncash items or the amount of cash interest and income taxes paid is not required in interim financial statements. However, we believe an entity may elect to provide this information in an interim period. For example, entities often provide interim disclosures when a noncash investing or financing activity exceeds 10% of the three-year average of net cash flows from operating activities.

6. Cash, cash equivalents and restricted cash

Detailed contents

New item added in this edition: **
Item significantly updated in this edition: #

6.1 How the standard works

The statement of cash flows explains the changes in the aggregate of cash, cash equivalents and amounts generally described as restricted cash or restricted cash equivalents ('restricted cash balances') during the period.

The following chart summarizes cash, cash equivalents and restricted cash balances, which are each explained in more detail in this chapter.

Cash	Cash equivalents	Restricted cash balances
Funds that may be deposited or withdrawn at any time without prior notice or penalty for withdrawal. Examples include: — currency on hand — demand deposits — negotiable instruments on hand, such as – money orders – certified checks – cashier's checks – personal checks – bank checks.	Short-term, highly liquid investments that are (1) readily convertible to cash and (2) so near maturity that they present insignificant risk of changes in value because of changes in interest rates. Examples include: — US Treasury bills — certificates of deposit — commercial paper — money market funds — federal funds sold (for an entity with banking operations).	Cash and cash equivalents that are restricted for withdrawal or use. Restrictions include: — legally restricted deposits held as compensating balances against short-term borrowing arrangements — contracts entered into with others — statements of intention regarding particular deposits.

6.2 Cash

6.2.10 Overview

Excerpt from ASC 230-10

20 Glossary

Cash – Consistent with common usage, cash includes not only currency on hand but demand deposits with banks or other financial institutions. Cash also includes other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty. All charges and credits to those accounts are cash receipts or payments to both the entity owning the account and the bank holding it. For example, a bank's granting of a loan by crediting the proceeds to a customer's demand deposit account is a cash payment by the bank and a cash receipt of the customer when the entry is made.

Cash includes currency on hand and demand deposits with banks or other financial institutions. Demand deposits comprise all accounts in which the entity may deposit or withdraw funds at any time without prior notice or penalty for withdrawal. [230-10 Glossary]

Cash also includes negotiable instruments on hand such as money orders, certified checks, cashier's checks, personal checks and bank checks.

Question 6.2.10
Are savings accounts classified as cash?

Interpretive response: Generally, yes. Even though banks have the legal right to demand notice before withdrawal from a savings account, savings accounts are usually classified as cash because prior notice is rarely required or demanded.

Question 6.2.20
Are checks issued and out of an entity's control, but not yet cleared by the bank, presented as a reduction of cash?

Background: A check is out of an entity's control after it has been mailed or delivered to the payee, even if it has not yet been cleared by the bank (i.e. an outstanding check). Book overdrafts are created when the sum of the outstanding checks related to a specific bank account is in excess of funds on deposit for that bank account (see section 6.2.20).

Interpretive response: It depends on whether the outstanding checks create a book overdraft. The balance sheet caption 'cash' should represent an amount within an entity's control – i.e. the amount of cash in banks plus the amount of cash and checks on hand (see Question 6.2.30) and deposits in transit minus the amount of outstanding checks until the specific bank account deposit balance is reduced to zero. [TQA 1100.08]

Outstanding checks in excess of a specific bank account deposit balance create a book overdraft that is presented as a liability and excluded from cash as presented on the balance sheet and in the statement of cash flows (see Question 6.2.40). The right of offset between account balances should also be considered (see Question 6.2.60). [TQA 1300.15]

Question 6.2.30

Are written checks still within the entity's control presented as a reduction of cash?

Interpretive response: No. On the balance sheet date, an entity should add back to cash and accounts payable the aggregate dollar amount of written checks it still holds (i.e. that are within its control). Checks that have not left an entity's custody should not reduce the recorded cash or accounts payable balances because the entity has not surrendered control over them by tendering them to the vendor to satisfy the debt. [TQA 2110.02]

Question 6.2.35

How do investment companies report amounts 'due from broker' and other cash balances?

Background: Certain investment companies, but not all, are exempt from providing a statement of cash flows (see Question 2.3.40). Many investment companies have funds held in brokerage or collateral accounts with broker-dealers.

Interpretive response: Investment companies include cash on hand and demand deposits under the general caption 'cash' on the statement of assets and liabilities. Amounts held in foreign currencies are presented separately at value, with acquisition cost shown parenthetically. [946-210-45-20 – 45-21]

However, there is diversity regarding the presentation of funds held in brokerage or collateral accounts with broker-dealers. These amounts are commonly included by nonregistered investment companies in the 'due from broker' caption on the statement of assets and liabilities.

Regardless of the presentation on the statement of assets and liabilities, investment companies that provide a statement of cash flows should report cash balances included in the 'due from broker' caption on the statement of assets and liabilities as cash and cash equivalents in the statement of cash flows. This also applies to cash balances that an investment company considers to be restricted cash (see section 6.4). This is because cash includes demand deposits with banks or other financial institutions. Broker-dealers are considered 'other financial institutions'. [230-10 Glossary]

Question 6.2.36
Are funds held for others reported as cash?

Background: Certain entities like payroll or tax compliance service providers and mortgage servicers receive funds from their customers and disburse those funds in accordance with the service agreement. Usually, such funds are received in advance of the payment due dates, which results in large amounts of funds held for others by these entities.

Interpretive response: It depends on whether the entity has *control* over the funds because cash should represent an amount that is within the entity's control. [TQA 1100.08]

Although control is not defined in Topic 230, we believe it is established if:

— the entity has the ability to direct the payments of the funds, including the ability to invest the funds before their disbursement; and
— the funds are held in an account that is in the name of the entity.

Entity has control over the funds

If the entity has control over the funds, we believe they should be reported as cash on the balance sheet and in the statement of cash flows. Funds held for others but considered restricted in use (see section 6.4) are typically segregated from nonrestricted cash balances on the balance sheet; however, they should be reported as cash and cash equivalents in the statement of cash flows.

Further, we believe that changes in funds held for others should be classified as cash flows from **financing** activities, which is consistent with the views of the SEC staff. This is because the contractual obligation to spend the funds on behalf of the customers represents a borrowing that is settled as the funds are disbursed.

Entity does not have control over the funds

If the entity does not have control over the funds, they should not be recognized as an asset of the entity. Therefore, there is no corresponding liability or cash flows to report.

6.2.20 Cash overdrafts

Cash overdrafts include bank and book overdrafts.

— Bank overdrafts occur when a bank honors disbursements in excess of funds on deposit in an entity's account. This is commonly referred to as overdraft protection.
— Book overdrafts are created when the sum of outstanding checks related to a specific account are in excess of funds on deposit (including deposits in transit) for that bank account.

Question 6.2.40

Are cash overdrafts presented as a reduction of cash?

Interpretive response: No. Cash overdrafts are excluded from cash as presented on the balance sheet and in the statement of cash flows. Bank overdrafts are a form of short-term financing from the bank. As such, they are classified as debt. [210-20-55-18A, TQA 1300.15]

In contrast, there is no specific presentation guidance on *book* overdrafts. We believe book overdrafts are analogous to accounts payable and should be reported as a liability (not debt) on the balance sheet. This is because, unlike a bank overdraft, at the time of the book overdraft, the bank has not extended credit.

Question 6.2.50

How are changes in cash overdrafts classified?

Interpretive response: We believe changes in bank overdrafts should be classified as cash flows from **financing** activities. [TQA 1300.15]

In contrast, we believe an entity may elect to include changes in a *book* overdraft position as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2) instead of as cash flows from financing activities. This is consistent with the view that book overdrafts are analogous to accounts payable (see Question 6.2.40). An entity should consistently apply and disclose its policy.

Question 6.2.60

Is the right of offset with other deposit accounts considered in determining whether a book overdraft exists?

Interpretive response: Yes. If an entity has other accounts with positive balances with the same bank, the right of offset among the accounts should be considered in determining whether a book overdraft exists.

However, a book overdraft at one financial institution cannot be netted against a positive balance at another financial institution because the balances represent a distinct liability and asset with separate counterparties. [210-20-05-1, TQA 1300.15]

6.2.30 Centralized cash management arrangements (cash pools)

Entities often maintain centralized cash management arrangements whereby excess cash generated by a subsidiary is swept daily into a centralized cash pool and the subsidiary's cash requirements are met through withdrawals or borrowings from that pool.

Similarly, funds in excess of current needs borrowed by the subsidiary from third parties may be transferred to the parent. The consolidated entity's cash is invested in bank depository accounts in the parent entity's name to lower borrowing costs and provide higher rates of return on investments for the consolidated entity or to help fund other operations of the parent.

Question 6.2.70

Is the balance resulting from a centralized cash management arrangement presented as cash or cash equivalents in a subsidiary's stand-alone financial statements?

Interpretive response: We believe that whether the balance resulting from a centralized cash management arrangement constitutes cash or cash equivalents in the stand-alone financial statements of a subsidiary depends on the legal and operating structure of the cash management arrangement.

Factors to consider include:

- whether the subsidiary has legal title to the balance;
- whether the subsidiary earns interest on the balance; and
- the degree of autonomy the subsidiary has in making deposits to and withdrawals from the centralized cash pool.

Cash management arrangements that require intervention, notification or permission from the parent entity for a subsidiary to make deposits and withdrawals generally do not meet the definition of cash or cash equivalents. Instead, these types of arrangements are considered short-term loans or borrowings from the parent.

If a subsidiary determines that it has legal title to the balance and has autonomy to access funds in a centralized cash management arrangement, we believe it would be acceptable to present the balance as cash or cash equivalents.

Question 6.2.71

Is the right of offset on balances from a centralized cash management arrangement considered when preparing a subsidiary's stand-alone financial statements?

Interpretive response: Yes. When management has determined that the balances resulting from a centralized cash management arrangement constitute cash or cash equivalents in the stand-alone financial statements of a subsidiary, it should consider the legal right of offset and whether it should net overdrafts against positive cash balances resulting from the arrangement.

If one or more of the subsidiaries' cash balances, after considering the legal right of offset, is overdrawn, the subsidiary should present the overdraft position as a liability on its balance sheet. The classification in the statement of cash flows should follow Question 6.2.50.

Question 6.2.80

How are the related cash flows in a centralized cash management arrangement classified in a subsidiary's stand-alone financial statements?

Interpretive response: As discussed in Question 6.2.70, a subsidiary may conclude that the balance that results from a centralized cash management arrangement should not be presented as cash or cash equivalents. Rather, it may be a loan of excess funds to the parent (i.e. a receivable from the parent) or a borrowing from the parent (i.e. a note payable to the parent).

In those cases, it generally is not appropriate for the subsidiary to present the cash flows related to the intra-entity balances as operating cash flows, even if items settled through intercompany accounts are costs or revenues reflected in the subsidiary's income statement. Instead, in general: [230-10-45-12(a), 45-13(a), 45-14(b), 45-15(b)]

— the change in a net receivable from the parent related to excess subsidiary cash loaned to the parent is an **investing** activity; and
— the change in a net payable to the parent related to funds borrowed from the parent is a **financing** activity.

A subsidiary should also consider whether the activities within the cash management arrangement have characteristics of other forms of cash flows. For example, if a decrease in a net receivable from the parent results from a declared dividend, the subsidiary should segregate the cash flow for the dividend payment from the activity that relates solely to the cash management arrangement and present it separately as a **financing** activity. [230-10-45-14(b)]

Example 6.2.10

Centralized cash management arrangement

Parent maintains a centralized cash management arrangement, or cash pool, with certain of its operating subsidiaries. Subsidiary participates in this cash pool and issues stand-alone financial statements that reflect a $1 million receivable from Parent as of December 31, Year 1, in connection with cash deposited by Subsidiary into the cash pool.

During Year 2, Subsidiary withdraws $3 million from the cash pool, resulting in a $2 million payable to Parent as of December 31, Year 2.

The table illustrates the effect of this transaction on Subsidiary's Year 2 statement of cash flows.

$'000s	
Cash flows from investing activities	
Cash received from centralized cash management arrangement with Parent[1]	$1,000
Net cash provided by (used in) investing activities	**1,000**
Cash flows from financing activities	
Cash received from centralized cash management arrangement with Parent[2]	2,000
Net cash provided by (used in) financing activities	**$2,000**

Notes:

1. Represents change in net receivable balance ($1,000 to nil).
2. Represents change in net payable balance (nil to $2,000).

Question 6.2.90

Are payments and receipts in a centralized cash management arrangement reported on a gross or net basis?

Interpretive response: As discussed in section 3.5, cash receipts and payments should generally be reported on a gross basis in the statement of cash flows. However, there are certain exceptions in which cash receipts and payments can be reported on a net basis (e.g. when the entity is substantively holding or disbursing cash on behalf of its customers).

Most centralized cash management arrangements require that funds are due on demand. Therefore, the parent acts like a bank to the subsidiary – holding and disbursing cash on the subsidiary's behalf. Therefore, centralized cash management arrangements are generally presented net in the statement of cash flows. [230-10-45-8]

6.3 Cash equivalents

6.3.10 Overview

Excerpt from ASC 230-10

20 Glossary

Cash Equivalents – Cash equivalents are short-term, highly liquid investments that have both of the following characteristics:

a. Readily convertible to known amounts of cash
b. So near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

Generally, only investments with original maturities of three months or less qualify under that definition. Original maturity means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year U.S. Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an entity with banking operations).

> Form and Content

>> Cash and Cash Equivalents

45-5 Cash purchases and sales of items commonly considered to be cash equivalents generally are part of the entity's cash management activities rather than part of its operating, investing, and **financing activities**, and details of those transactions need not be reported in a statement of cash flows. In addition, transfers between cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents are not part of the entity's operating, investing, and financing activities, and details of those transfers are not reported as cash flow activities in the statement of cash flows.

45-6 Not all investments that qualify are required to be treated as cash equivalents. An entity shall establish a policy concerning which short-term, highly liquid investments that satisfy the definition of cash equivalents are treated as cash equivalents. For example, an entity having banking operations might decide that all investments that qualify except for those purchased for its trading account will be treated as cash equivalents, while an entity whose operations consist largely of investing in short-term, highly liquid investments might decide that all those items will be treated as investments rather than cash equivalents.

> Cash Equivalents Policy

50-1 An entity shall disclose its policy for determining which items are treated as **cash equivalents**. Any change to that policy is a change in accounting principle that shall be effected by restating financial statements for earlier years presented for comparative purposes.

Excerpt from ASC 815-10

20 Glossary

Readily Convertible to Cash – Assets that are readily convertible to cash have both of the following:

a. Interchangeable (fungible) units

b. Quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.

(Based on paragraph 83(a) of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.)

A cash equivalent is a short-term, highly liquid investment that is (1) readily convertible to known amounts of cash and (2) so near maturity that a change in interest rates would present an insignificant risk of a change in value. The FASB decided to specify an original maturity limit of three months or less to treat only those items that are so near cash that it is appropriate to refer to them as the 'equivalent' of cash. [230-10 Glossary]

Common types of cash equivalents are US Treasury bills, commercial paper, money market funds (see section 6.3.40), certificates of deposit (see section 6.3.70), and federal funds sold (for an entity with banking operations).

Question 6.3.05
How is the maturity of an investment assessed?

Interpretive response: Maturity for the purpose of Topic 230 (also referred as 'original maturity') is determined based on the remaining time to maturity when an entity first acquired the investment. [230-10 Glossary]

For example, a three-year US Treasury note that an entity purchases at issuance does not become a cash equivalent to that entity when the note has fewer than three months remaining until maturity – i.e. original maturity is more than three months. However, if that entity sells the note to another entity two months before the note matures, the note is a cash equivalent to the buyer.

Further, we believe that maturity is assessed based on the investment itself, and not the underlying securities that collateralize the investment.

Question 6.3.130 discusses the maturity of certificate deposits.

Question 6.3.10
Is a security a cash equivalent if an entity intends to hold it for fewer than three months but its maturity is greater than three months?

Interpretive response: No. Because the security is subject to more than an insignificant risk in the change in value due to changes in interest rates, the security is not a cash equivalent. [230-10 Glossary]

Question 6.3.20
Should all investments that meet the definition of a cash equivalent be characterized as such?

Interpretive response: No. An entity should establish an accounting policy about which short-term, highly liquid investments that meet the definition of cash equivalents are treated as cash equivalents. [230-10-45-6]

For example, a bank might decide that all investments that meet the definition of cash equivalents, except those purchased for trading, are treated as cash equivalents. Conversely, an entity whose operations consist largely of investing in short-term, highly liquid investments might decide that all those items will be treated as investments rather than cash equivalents. See chapter 9 for classification guidance over investments. [230-10-45-6]

An entity should consistently apply and disclose its accounting policy for determining which items are treated as cash equivalents. Question 6.3.30 discusses changes to that policy. [230-10-50-1]

Question 6.3.30
May an entity change the types of items it treats as cash equivalents?

Interpretive response: Yes. However, a change to an accounting policy for determining which items are treated as cash equivalents is a change in accounting principle. Therefore, it is subject to a preferability assessment under Topic 250 and requires retrospective adjustment of prior-period financial statements, as well as a preferability letter for SEC registrants (see section 4.6). [230-10-50-1]

A change to the composition of cash equivalents as a result of a money market fund no longer meeting the definition of cash equivalents (see Question 6.3.60) is not a change in accounting principle.

6.3.20 Credit card receivables

Question 6.3.40
Do receivables from credit and debit card service providers meet the definition of a cash equivalent?

Interpretive response: Yes. Credit and debit card receivables can be viewed as being synonymous with deposits in transit (i.e. as if the customer had paid by check), which are also subject to a clearance process. A retailer typically receives daily funding from the service providers and amounts typically settle within at most five business days (most often within two days). The receivables are so near their maturity that they present insignificant risk of changes in value due to changes in interest rates. Additionally, the receivables are readily convertible to known amounts of cash as the process of reconciling the amounts submitted to the service providers to the point-of-sale system does not yield differences on a day-to-day basis. [230-10 Glossary]

Example 6.3.10

Classification of credit card receivables

ABC Corp. is a retailer whose sales are recognized at the point of sale at its retail stores or on delivery for products purchased from its website. Customers pay by cash, debit cards or credit cards.

ABC receives daily settlement funding from debit and credit card service providers. Credit card transactions are funded to ABC on a daily basis net of settlement fees. Debit transactions are funded to ABC usually within two days.

ABC determines that its credit and debit card receivables meet the definition of a cash equivalent. This is because the receivables are readily convertible to known amounts of cash and the receivables are so near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

6.3.30 Equity securities

Question 6.3.50#

Do equity securities meet the definition of a cash equivalent?

Interpretive response: Generally, no. A cash equivalent is defined in part as an investment that is near its maturity, meaning to be a cash equivalent an investment must have a stated maturity. Because equity securities do not have stated maturities, they do not qualify as cash equivalents. However, Topic 230's definition of cash equivalent notes that money market funds are commonly considered cash equivalents. Therefore, even if a money market fund is considered an equity security, it likely will also be a cash equivalent. [230-10 Glossary]

See section 6.3.40 for guidance on money market funds and see chapter 9 for classification guidance on investments.

6.3.40 Money market funds

A money market fund is a type of mutual fund that has relatively low risks compared to other mutual funds and most other investments, and historically has had lower returns. Money market funds invest in high quality, short-term debt securities and pay dividends that generally reflect short-term interest rates.

Many investors use money market funds to store cash or as an alternative to investing in the stock market.

Money market funds maintain a constant per-share net asset value (NAV) by adjusting the periodic interest rates paid to investors. The NAV is usually set at $1 per share. Generally, investors can make withdrawals from money market funds on short notice without incurring a penalty.

In July 2014, the SEC amended the rules governing money market funds under the Investment Company Act of 1940. The amendments require certain money market funds to "sell and redeem shares based on the current market-based value of the securities in their underlying portfolios rounded to the fourth decimal place (e.g. $1.0000), i.e. transact at a 'floating' NAV." Additionally, the amendments give the boards of directors of money market funds the discretion to impose a liquidity fee or suspend redemptions temporarily (i.e. gate) if a fund's weekly liquidity falls below the required regulatory threshold. Further, the rules require non-governmental money market funds to impose a liquidity fee or gate if a fund's weekly liquidity falls below a designated threshold.

Question 6.3.60

Do money market funds meet the definition of a cash equivalent?

Interpretive response: Generally, yes. The definition of cash equivalents indicates that money market funds are often included within its scope. However, if there are increased credit and liquidity concerns associated with the fund, especially if there is a significant decline in net asset value, a money market fund may no longer have the attributes to be considered a cash equivalent, in which case it is reclassified as an investment. [230-10 Glossary, 230-10-45-6, FRR 220]

In addition, as indicated in Question 6.3.20, not all money market funds that meet the definition of a cash equivalent are treated as such under an entity's accounting policy.

Question 6.3.70

Is a money market fund a cash equivalent when the fund restricts or suspends redemptions?

Interpretive response: No. If a money market fund restricts or suspends redemptions, it is no longer highly liquid and therefore does not meet the definition of a cash equivalent.

However, the SEC has stated that under normal circumstances a money market fund would still qualify as a cash equivalent if the fund has the ability to impose redemption restrictions or liquidity fees. Entities need to monitor events that may indicate that a money market fund no longer meets the definition of a cash equivalent as a result of significant restrictions on redemption. [FRR 220]

Question 6.3.80

Is the classification of a money market fund adjusted in the financial statements if a redemption restriction is imposed after the balance sheet date but before financial statements are issued?

Interpretive response: It depends on whether credit and liquidity issues existed as of the balance sheet date. As discussed in Question 6.3.70, if a money market fund restricts or suspends redemptions, it is no longer highly liquid and therefore does not meet the definition of a cash equivalent.

The entity must reconsider the classification of the money market fund and evaluate whether credit and liquidity issues existed as of the balance sheet date. Even if the redemption restriction was not imposed until after the balance sheet date, it may be appropriate to reclassify the money market fund in the financial statements depending on whether those conditions existed as of the balance sheet date. [855-10-25-1]

Question 6.3.90

How is the change in the classification of a money market fund classified if it no longer meets the definition of a cash equivalent?

Background: When a security no longer meets the definition of a cash equivalent and a change in classification occurs, we believe an entity should reduce its investment balance to fair value and record the decrease in the income statement.

This conclusion is based on the requirement in Topic 320 (debt securities) that the transfer of a security between categories of investments be accounted for at fair value and liquidity adjustments be included in the measurement. Because the investment was previously classified as a cash equivalent and provided an interest-like return with no fluctuation in NAV, usually there was no determination about classification of the investment as available-for-sale or trading. [320-10-35-10]

Interpretive response: Because the security represents an investment, the classification change is typically a cash outflow for **investing** activities. However, if the investment is entered into in connection with an entity's principal activities (e.g. broker/dealers or other entities with similar operations), the classification change is a cash outflow for **operating** activities. [230-10-45-13(b), 45-20]

Question 6.3.100

Can non-registered money market funds and other non-registered cash management investment products be considered cash equivalents?

Interpretive response: It depends on whether they are designed to operate like registered money market funds.

A money market fund generally refers to a registered money market fund regulated under Rule 2a-7 of the Investment Company Act of 1940. We believe that in certain circumstances non-registered money market funds and other non-registered cash management investment products may qualify as cash equivalents.

To conclude that these non-registered investment vehicles are cash equivalents, it is necessary to understand the investment policies, restrictions and redemption procedures and then conclude that the investment vehicle is designed to operate like a registered money market fund under Rule 2a-7. To classify a non-registered fund as a cash equivalent, the fund should be structured to maintain a constant NAV and follow investment policies and procedures that are no less restrictive than the rules for registered money market funds.

The SEC website and Rule 2a-7 provide useful information in understanding the characteristics of registered money market funds and other unregistered cash management products.

6.3.50 Auction rate securities

Auction rate securities may be issued as debt or preferred stock. Auction rate securities are long-term variable-rate bonds tied to short-term interest rates that are reset through a 'Dutch auction' process that occurs every 7 to 35 days. When issued as debt, they commonly have an original maturity of 10, 15 or 20 years; and when issued as preferred stock, they commonly are perpetual. An investor can maintain a standing hold order at each auction date or issue a sell order on the instrument at an auction. Without a credit, liquidity or other factor, these securities typically sell at par because of the frequent repricing at auction. The holder does not have the right to put the security back to the issuer.

Question 6.3.110

Do auction rate securities meet the definition of a cash equivalent?

Interpretive response: No. While auction rate securities may be considered highly liquid by market participants because of the auction process, we believe these securities do not meet the definition of cash equivalents.

Auction rate securities have stated maturities of more than three months and, in some cases, there is no maturity. Further, because these securities may have exposure to risks that affect valuation (such as liquidity and credit risk), they are not by their nature readily convertible to known amounts of cash. These securities are typically offered at auction, and frequently sellers and buyers are not matched. Therefore, they may not be highly liquid because they do not trade on an established market.

6.3.60 Variable-rate demand notes

Variable-rate demand notes (VRDNs) – also known as variable-rate demand obligations or municipal floaters – have many of the same features as auction rate securities but are puttable periodically at par.

Question 6.3.120

Do variable-rate demand notes meet the definition of a cash equivalent?

Interpretive response: It depends on whether a VRDN has an effective maturity of three months or less – and therefore may be considered a cash equivalent. This determination depends on whether the put option is to the issuer of the debt instrument. Generally, most put options associated with VRDNs are to a financial institution (e.g. through a stand-by letter of credit) rather than the debt issuer. To qualify as a cash equivalent, the instrument must include a put option to the issuer within three months throughout the term of the instrument.

A put or call option added to a debt instrument by a third party contemporaneously with or after the issuance of the debt instrument should be separately accounted for by the investor as a derivative under Topic 815 (derivatives and hedging). Under Topic 815, it is reported at fair value with changes recognized currently in earnings unless designated in a qualifying hedging relationship. Because a put option issued by a party other than the issuer of the debt is a freestanding derivative that is accounted for separately, an entity should not combine the debt instrument with the associated put option when applying Topic 230. [815-10-15-6]

A financial institution that issues a put option on the debt of another entity may purport to be acting as an agent on behalf of the debt issuer. Agency relationships require careful evaluation to conclude whether the issuer is, in fact, the principal/counterparty to the put or call option.

6.3.70 Certificates of deposit

A CD is a time deposit usually issued by a financial institution. Unlike savings accounts, each CD has specified terms, ranging from days to several months or years, and funds are expected to be held to maturity. Some CDs offer early redemption features for a fee or reduced interest rate. The interest rate is otherwise fixed; the longer the time to maturity, the higher the interest income typically will be.

Question 6.3.130

Do CDs meet the definition of a cash equivalent?

Interpretive response: It depends on the CD's early withdrawal features and maturity (see Question 6.3.05).

Maturity	Early withdrawal possible at no cost to holder	Early withdrawal possible at a cost to holder	No early withdrawal possible
Less than three months	Cash equivalent	Generally, a cash equivalent; see further analysis below	
More than three months	Cash equivalent	Additional analysis required	Not a cash equivalent

Early withdrawal is possible

If early withdrawal is possible at no cost to the holder, the CD functions like a demand deposit, regardless of its stated maturity. The CD therefore meets the definition of a cash equivalent.

When early withdrawal comes at a cost to the holder (e.g. penalty or accrued interest recalculated at a reduced rate), we believe further analysis is required to determine how the feature affects determination of the CD's effective maturity.

A significant penalty usually indicates that the stated maturity is substantive, and that early withdrawal could expose the holder to a loss in value that is other than insignificant. Alternatively, the holder may still be entitled to accrued interest through the date of withdrawal at a reduced rate compared to what it would have received if the CD was held to maturity. If the reduced interest rate is still in line with market rates for similar maturity deposits, this may indicate that the CD's effective maturity is shorter than its stated maturity.

CD's maturity is three months or less

We believe a CD with a stated or effective maturity of three months or less can generally be classified as a cash equivalent.

Despite not being immediately convertible to cash, the CD may be considered readily convertible to a known amount of cash considering the horizon of the entity's liquidity needs and management's intent in using the CD. Additionally, given its short-term maturity, the CD presents an insignificant risk of changes in value because of changes in interest rates to maturity. This is consistent with the FASB's three-month US Treasury bill example in the Codification. [230-10 Glossary]

Further, in developing the definition of a cash equivalent, the FASB noted that the objective of enterprises' cash management programs generally is to earn interest on temporarily idle funds – not to put capital at risk in the hope of benefiting from favorable price changes that may result from changes in interest rates or other factors. [FAS 95.BC53]

CD's maturity is more than three months

We believe a CD with a stated maturity of more than three months and no early redemption feature, or a CD with an effective maturity of more than three months, is not a cash equivalent. Typically, the longer the term of the investment (greater than three months), the greater the risk that the effect of a change in market conditions (such as interest rates) on its value will be other than insignificant.

6.4 Restricted cash balances

6.4.10 Overview

Excerpt from ASC 230-10

> Form and Content

>> Cash and Cash Equivalents

45-4 A statement of cash flows shall explain the change during the period in the total of cash, **cash equivalents**, and amounts generally described as restricted cash or restricted cash equivalents. The statement shall use descriptive terms such as cash or cash and cash equivalents rather than ambiguous terms such as funds. When cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents are presented in more than one line item within the statement of financial position, an entity shall provide the disclosures required in paragraph 230-10-50-8.

> Restrictions on Cash and Cash Equivalents

50-7 An entity shall disclose information about the nature of restrictions on its cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. An entity within the scope of Topic 958 on not-for-profit entities also shall provide the disclosures required in paragraph 958-210-50-3 (see paragraphs 230-10-55-12A and 230-10-55-18A).

50-8 When cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents are presented in more than one line item within the statement of financial position, an entity shall, for each period that a statement of financial position is presented, present on the face of the statement of cash flows or disclose in the notes to the financial statements, the line items and amounts of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents reported within the statement of financial position. The amounts, disaggregated by the line item in which they appear within the statement of financial position, shall sum to the total amount of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents at the end of the corresponding period shown in the statement of cash flows. This disclosure may be provided in either a narrative or tabular format (see paragraphs 230-10-55-12A and 230-10-55-18A).

Excerpt from Reg S-X Rule 5-02, Balance Sheets

Current Assets, When Appropriate

1. *Cash and cash items.* Separate disclosure shall be made of the cash and cash items which are restricted as to withdrawal or usage. The provisions of any restrictions shall be described in a note to the financial statements. Restrictions may include legally restricted deposits held as compensating balances against short-term borrowing arrangements, contracts entered into with others, or company statements of intention with regard to particular deposits; however, time deposits and short-term certificates of deposit are not generally included in legally restricted deposits. In cases where compensating balance arrangements exist but are not agreements which legally restrict the use of cash amounts shown on the balance sheet, describe in the notes to the financial statements these arrangements and the amount involved, if determinable, for the most recent audited balance sheet required and for any subsequent unaudited balance sheet required in the notes to the financial statements. Compensating balances that are maintained under an agreement to assure future credit availability shall be disclosed in the notes to the financial statements along with the amount and terms of such agreement.

Restricted cash or restricted cash equivalents (restricted cash balances) are generally presented separately from unrestricted cash and cash equivalents on the balance sheet. However, Topic 230 requires restricted cash balances to be included in the total cash and cash equivalents in the statement of cash flows. [230-10-45-4]

As a result, the total cash and cash equivalents in the statement of cash flows may differ from similarly titled line items or subtotals shown on the balance sheet. If those amounts differ, they should be reconciled (see section 6.4.30). [230-10-50-8]

The amount of restricted cash balances and the nature of the restrictions should be disclosed. For specific disclosure requirement for financial institutions, see Question 6.2.35. [230-10-50-7]

6.4.20 Definition of restricted cash balances

Topic 230 does not define what restricted cash balances are. In its deliberations of ASU 2016-18, the EITF noted that its "intent is not to change practice for what an entity reports as restricted cash or restricted cash equivalents." This reliance on practice for the definition of restricted cash balances is the reason Topic 230 uses the phrase 'amounts generally described as restricted cash or restricted cash equivalents'. [ASU 2016-18.BC9]

Question 6.4.10

When are cash balances considered 'restricted'?

Interpretive response: Topic 230 does not define what restricted cash balances are. However, S-X Rule 5-02(1) provides some guidance. The regulation requires cash and cash items that are 'restricted as to withdrawal or usage' to be disclosed separately, which is typically done on the balance sheet.

The regulation gives examples of those restrictions: [S-X Rule 5-02(1)]

- legally restricted deposits held as compensating balances against short-term borrowing arrangements;
- contracts entered into with others; and
- statements of intention regarding particular deposits.

Because the total cash and cash equivalents in the statement of cash flows has to reconcile to the same amounts on the balance sheet (see Question 6.4.50), SEC registrants have to use this regulation when characterizing amounts for the statement of cash flows. However, we believe this regulation is also helpful to non-SEC registrants in characterizing restricted cash amounts for the statement of cash flows. [230-10-50-8]

Question 6.4.15

How does an entity identify restricted cash equivalents?

Interpretative response: We believe entities should review the composition of assets outside of the 'cash and cash equivalents' caption on the balance sheet to determine whether any of those assets are generally described as restricted cash equivalents and need to be included in the total cash and cash equivalents in the statement of cash flows.

We also believe that this determination should first consider which short-term highly liquid investments are treated as cash equivalents under the entity's accounting policy (see Question 6.3.20). Only those assets treated as cash equivalents, may be *restricted* cash equivalents. In other words, if certain short-term highly liquid investments are treated as investments, then they would not be included in the total cash and cash equivalents in the statement of cash flows. Alternatively, if the short-term highly liquid investment meets the definition of a cash equivalent, is treated as such and has restrictions on use (e.g. contractual), then it is a restricted cash equivalent. This means it is included in the total cash and cash equivalents in the statement of cash flows, and the nature of the restrictions must be disclosed. [230-10-45-6, 50-7]

The following table summarizes this approach.

Does the asset meet the definition of a cash equivalent?	Is the asset treated as a cash equivalent under the entity's accounting policy? (see Question 6.3.20)	Include in the total cash and cash equivalents in the statement of cash flows?
Yes	Yes	Yes
Yes	No	No
No	N/A	No

See Question 22.3.20 when an NFP has short-term highly liquid investments with long-term donor-imposed restrictions.

Question 6.4.20

May an entity change the nature of the items that are considered restricted cash balances?

Interpretive response: Yes. However, a change to an accounting policy for determining which items are treated as restricted cash balances is a change in accounting principle. Therefore, it is subject to a preferability assessment under Topic 250 and requires retrospective adjustment of prior-period financial statements, as well as a preferability letter for SEC registrants (see section 4.6). [ASU 2016-18.BC19]

Question 6.4.30

Is cash subject to a compensating balance arrangement considered restricted?

Interpretive response: It depends on the nature of the compensating arrangement. Topic 230 does not define restricted cash. However, S-X Rule 5-02(1) provides some relevant guidance.

Under that regulation, restricted cash includes legally restricted deposits held as compensating balances for certain borrowing arrangements. In contrast, deposits are not restricted cash if they are subject to a compensating balance arrangement that does not legally restrict their use; in this case however, the arrangement and the amounts involved should be disclosed. [S-X Rule 5-02(1)]

We believe that non-SEC registrants should follow this guidance when classifying deposits subject to compensating balance agreements as either cash or restricted cash.

Question 6.4.40

How are cash flows from interest earned on restricted cash balances classified?

Interpretive response: The statement of cash flows should explain the changes during the period in the total cash and cash equivalents, i.e. including restricted cash balances. As a result, regardless of whether the interest on the initial deposit is restricted, interest income should be classified as a cash flow from **operating** activities. [230-10-45-4, 45-16(b)]

Question 6.4.45**

Are cash balances considered restricted during bankruptcy?

Interpretive response: It depends on the nature of the restrictions. In our experience, an entity operating while in bankruptcy generally does not show cash and cash equivalents related to normal business operations as restricted, even though the bankruptcy court is required to approve expenditures. However, we believe the entity should consider disclosing the court's authority on the operations of the business and the implications to liquidity and uses of cash.

Question 4.10.120 in KPMG Handbook, Accounting for bankruptcies, further explores situations in which cash balances may be restricted. For guidance on the format of the statement of cash flows during bankruptcy, see Question 3.3.05.

6.4.30 Balance sheet reconciliation of total cash and cash equivalents

When cash, cash equivalents and restricted cash balances are presented in more than one line item on the balance sheet, an entity is required to provide a reconciliation of the total cash and cash equivalents in the statement of cash flows to the related captions on the balance sheet. [230-10-50-8]

Question 6.4.50

How is the balance sheet reconciliation of total cash and cash equivalents presented?

Interpretive response: This reconciliation may be provided in either a narrative or tabular format, either on the face of the statement of cash flows or in the notes to the financial statements. [230-10-50-8]

The table provides a reconciliation of all captions of cash, cash equivalents and restricted cash reported on the balance sheet that sum to the total of those same amounts shown in the statement of cash flows. [230-10-55-12A]

	December 31, Year 1
Cash and cash equivalents	$1,465
Restricted cash	125
Restricted cash included in other long-term assets	75
Total cash, cash equivalents and restricted cash shown in the statement of cash flows	**$1,665**

Question 6.4.60

How is the balance sheet reconciliation of cash, cash equivalents and restricted cash presented when certain amounts are classified as 'held-for-sale'?

Background: Cash, cash equivalents and restricted cash may be included in a disposal group or component that is classified as held-for-sale under Subtopics 360-10 or 205-20. Therefore, the cash and cash equivalents caption on the balance sheet may not include all of an entity's cash and cash equivalents.

Interpretive response: We believe there are two acceptable presentation approaches to adjust the statement of cash flows for cash and cash equivalents that are included in assets held-for-sale on the balance sheet.

Approach 1: Reconciling item in the statement of cash flows

Under Approach 1, the entity includes a reconciling line item after Net cash provided by (used in) financing activities and before beginning cash balances in the statement of cash flows to reflect the change in cash balances included in the assets held-for-sale caption.

Net cash provided by (used in) operating activities	$ XXX
Net cash provided by (used in) investing activities	(XXX)
Net cash provided by (used in) financing activities	XXX
Net change in cash, cash equivalents and restricted cash, including cash balances classified as assets held-for-sale	XXX
Less: Net change in cash balances classified as assets held-for-sale	(XXX)
Net change in cash, cash equivalents and restricted cash	XXX
Cash, cash equivalents and restricted cash at beginning of period	XXX
Cash, cash equivalents and restricted cash at end of period	**$XXX**

Approach 2: Reconciliation in a note

Under Approach 2, the entity adds cash balances included in assets held-for-sale at the beginning of the period to beginning cash balances in the statement of cash flows, and adds the corresponding amount at the end of the period to ending cash balances as presented in the statement of cash flows.

The entity then includes a reconciliation of these adjusted amounts as presented in the statement of cash flows to the amounts reported on the balance sheet in the notes to the financial statements.

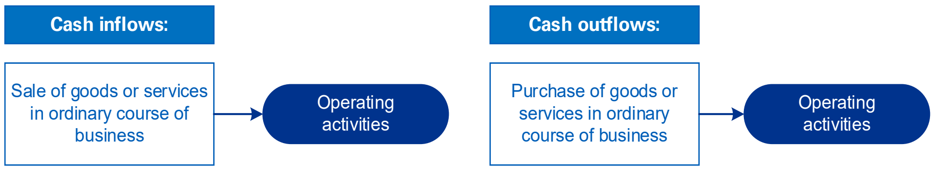
7. Working capital accounts

Detailed contents

Example

7.1 How the standard works

Changes in working capital accounts generally represent cash flows from **operating** activities. This includes changes in trade accounts receivable, inventories, prepaid expenses, accounts payable and accrued expenses. The following chart summarizes some of the classification issues encountered, which are explained in more detail in this chapter.



However, cash flow classification depends on the facts and circumstances specific to each transaction. For example, purchases of inventory through financing arrangements or advance payments made by a customer may result in cash flows from **financing** activities.

Recent ASUs reflected in this chapter

This chapter reflects the amendments of ASU 2018-15, Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract, and ASU 2019-02, Improvements to Accounting for Costs of Films and License Agreements for Program Materials. See chapter 1 for an overview of these ASUs and their transition requirements.

In addition, Question 7.4.30 discusses cash flows classification post ASU 2018-15; and Question 7.4.40 discusses cash flows classification post ASU 2019-02.

7.2 Trade accounts receivable

Trade accounts receivable include receivables for sales of goods or services to customers.

Question 7.2.10

How are cash flows from the sale of goods and services classified?

Interpretive response: An entity should classify cash receipts from the sale of goods or services, including receipts from the collection or sale of accounts receivables, as cash flows from **operating** activities. [230-10-45-16(a)]

This classification is required regardless of whether the cash flows represent: [230-10-45-16(a), 2004 AICPA Conf]

— immediate cash collections from customers;
— collections of cash from receivables obtained in exchange for goods or services (short-term or long-term); or
— the proceeds from the sale of customer receivables (originated in exchange for goods or services) to third parties (e.g. in a securitization accounted for under Topic 860 (transfers and servicing), excluding any beneficial interests retained in the customer receivables). See chapter 10.

Example 7.2.10

Trade accounts receivable

ABC Corp. is a calendar year-end entity. On December 15, Year 1, ABC enters into a contract to sell Product P to Customer for $300,000. Product P is delivered to Customer at the time of sale; however, Customer will pay ABC for Product P in 30 days (i.e. on January 15, Year 2). The cost of Product P to ABC is $200,000.

Year 1

The following illustrates the effect of this transaction on ABC's Year 1 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)[1]	$100
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities	
Change in assets and liabilities:	
Increase in accounts receivable	(300)
Decrease in inventory	200
Net cash provided by (used in) operating activities	**$ -**

Note:
1. Revenue of $300 less cost of goods sold of $200.

Year 2

On January 15, Year 2, ABC receives cash from Customer for Product P. The following illustrates the effect of this transaction on ABC's Year 2 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$ -
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities	
Change in assets and liabilities:	
Decrease in accounts receivable	300
Net cash provided by (used in) operating activities	**$ 300**

Question 7.2.20

When an entity accepts government-backed bonds to settle a customer note receivable, how is this transaction classified?

Interpretive response: The exchange of government-backed bonds to settle a customer note receivable should be separately disclosed as a **noncash** investing activity (see section 4.7.20). [230-10-50-3 – 50-4]

We believe the classification of the subsequent cash receipts on the bonds is based on the entity's intent and ability to liquidate the bonds for cash:

— The subsequent cash principal received from the government as payment on the bonds may be considered collections of loans and classified as cash flows from **investing** activities to the extent the securities are not defined or designated as trading securities (see section 9.2.10). [230-10-45-12(a), 45-19]

— Alternatively, because the customer (i.e. the government) is the issuer of the bonds, the subsequent cash receipts may be considered a form of long-term financing for the collection on the sale of goods or services and classified as cash flows from **operating** activities. [230-10-45-16(a)]

Example 7.2.20

Exchange of government-backed bonds to settle a note receivable

ABC Corp. sells goods to a foreign government-controlled entity and allows the foreign government to finance its purchase of the goods through a note payable to ABC, which ABC presents as a long-term note receivable on its balance sheet.

ABC agrees to accept government-backed bonds to settle the note receivable. The fair value of the government bonds received equals the note receivable balance at the time of transfer. The government bonds are not considered cash equivalents and ABC determines that the bonds are available-for-sale securities under Topic 320 (debt securities). The bonds mature at various times in the future and, although ABC could redeem them before their maturity dates, it currently expects to hold these bonds longer than one year to maximize its return on the investment. The bonds are not actively traded and only trade in a secondary market of the foreign country.

ABC discloses the receipt of the government bonds as a **noncash** investing activity.

ABC determines that the subsequent cash receipts from repayment of the principal on the government bonds will be classified as cash flows from **investing** activities. This classification is determined to be appropriate because ABC intends to hold the securities to maximize its return on the investment. Furthermore, ABC's ability to liquidate the bonds for cash, if it so chooses, is limited because the bonds are only traded in a secondary market of the foreign country.

Question 7.2.30

How are cash flows from the changes in time-sharing notes receivable classified?

Background: Time-sharing is an arrangement in which a seller sells or conveys the right to occupy a dwelling unit for specified periods in the future.

Interpretive response: Changes in time-sharing notes receivable, including sales of the notes, are classified as cash flows from **operating** activities. [978-230-45-1]

7.3 Inventory and trade accounts payable

Excerpt from ASC 330-10

20 Glossary

Inventory – The aggregate of those items of tangible personal property that have any of the following characteristics:

a. Held for sale in the ordinary course of business
b. In process of production for such sale
c. To be currently consumed in the production of goods or services to be available for sale.

The term inventory embraces goods awaiting sale (the merchandise of a trading concern and the finished goods of a manufacturer), goods in the course of production (work in process), and goods to be consumed directly or indirectly in production (raw materials and supplies). This definition of inventories excludes long-term assets subject to depreciation accounting, or goods which, when put into use, will be so classified. The fact that a depreciable asset is retired from regular use and held for sale does not indicate that the item should be classified as part of the inventory. Raw materials and supplies purchased for production may be used or consumed for the construction of long-term assets or other purposes not related to production, but the fact that inventory items representing a small portion of the total may not be absorbed ultimately in the production process does not require separate classification. By trade practice, operating materials and supplies of certain types of entities such as oil producers are usually treated as inventory.

Trade accounts payable include payables to vendors for goods delivered to or services consumed by an entity in the ordinary course of business.

Question 7.3.10

How are cash flows for purchases of goods and services used in the ordinary course of business classified?

Interpretive response: Cash payments for the purchase of goods (e.g. inventory) or services used in the ordinary course of business are cash outflows for **operating** activities. These **operating** cash outflows can be either up-front cash payments or payments of accounts or notes payable to vendors. [230-10-45-17(a) – 45-17(b)]

Example 7.3.10

Inventory and trade accounts payable

Assume the same facts as Example 7.2.10, except that this example illustrates Customer's accounting.

Year 1

The following illustrates the effect of this transaction on Customer's Year 1 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$ -
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities	
Change in assets and liabilities:	
Increase in inventory	(300)
Increase in accounts payable	300

Net cash provided by (used in) operating activities	**$ -**

Year 2

On January 15, Year 2, Customer pays cash for Product P. The following illustrates the effect of this transaction on Customer's Year 2 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$ -
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities	
Change in assets and liabilities:	
Decrease in accounts payable	(300)
Net cash provided by (used in) operating activities	**$(300)**

Question 7.3.20

How are cash flows for purchases of inventory through a direct financing arrangement with a finance subsidiary of the vendor (floor plan financing transaction) classified?

Background: In certain industries (e.g. the automotive industry), it is common practice for an entity to finance its purchases of inventory through a vendor or, in many cases, a finance subsidiary of the vendor. These latter arrangements are referred to as 'floor plan' financing transactions.

In these types of arrangements, the finance subsidiary typically makes a direct payment to the vendor (its parent) on behalf of the entity that purchased the inventory. The finance subsidiary then holds a lien on the inventory purchased by the entity and is repaid by the entity at a future date, generally when the underlying inventory is sold.

Interpretive response: If the entity presents its statement of cash flows under the indirect method, the increase to inventory and the increase to trade loans as a result of the purchase from the vendor are classified as cash flows from **operating** activities – i.e. there is no effect to net cash flows from **operating** activities. In contrast, if the entity presents its statement of cash flows under the direct method, there is nothing to report as no cash flows occurred. This presentation is appropriate because the finance subsidiary is affiliated with the vendor, and from the entity's perspective, the transaction is akin to entering into a note payable with the vendor. See Question 7.3.40 for situations where the financing is obtained through a third party not affiliated with the vendor. [230-10-45-17(a), 2005 AICPA Conf, TQA 1300.16]

Regardless of the method used, any repayment on a future date is a cash outflow for **operating** activities. As such, the net effect to the entity's statement of cash flows is a net cash inflow from **operating** activities that is equal to the gross profit on the sale of the inventory to the end customer. [2005 AICPA Conf, TQA 1300.16]

Question 7.3.30
How is a floor plan financing transaction classified by the vendor?

Interpretive response: From a consolidated entity perspective, the substance of the transaction to the vendor is the sale of inventory in exchange for a note receivable (see section 7.2). The stand-alone financial statements of a financing subsidiary may classify cash flows for loans made to customers to permit them to purchase the parent entity's (i.e. vendor's) product as cash flows from **investing** activities. However, in the parent's consolidated financial statements, it is inappropriate to reflect the cash flows between the parent and the consolidated finance subsidiary as a cash outflow from investing activities (from finance subsidiary) and a cash inflow from operating activities (to the parent) when there is no cash inflow to the consolidated entity. [2004 AICPA Conf]

Example 7.3.20
Floor plan financing transaction

On December 15, Year 1, Car Dealer purchases inventory (100 cars) under a floor plan financing arrangement with Finance Subsidiary, which is wholly owned by Car Manufacturer.

Under the terms of the arrangement, Finance Subsidiary pays Car Manufacturer directly (no cash is transferred to Car Dealer). Additionally, Finance Subsidiary holds a lien on the inventory, and is to be repaid by Car Dealer when the inventory is sold to the end customer.

The financing for the inventory is $1.5 million in total, or $15,000 per car (interest is not considered for simplicity). None of the inventory purchased on December 15, Year 1, was sold by the end of Year 1 (December 31).

Year 1

The following illustrates the effect of this transaction on Car Dealer's Year 1 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$ -
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities	
Change in assets and liabilities:	
Increase in inventory	(1,500)
Increase in trade loan	1,500
Net cash provided by (used in) operating activities	**$ -**

Year 2

During Year 2, Car Dealer sells all of the inventory to customers for cash of $20,000 each, or $2 million in total. Car Dealer also repays Finance Subsidiary for the floor plan financing. The following illustrates the effect of these transactions on Car Dealer's Year 2 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)[1]	$ 500
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities	
Change in assets and liabilities:	
Decrease in inventory	1,500
Decrease in trade loan	(1,500)
Net cash provided by (used in) operating activities	**$ 500**

Note:

1. Revenue of $2,000 less cost of goods sold of $1,500.

Question 7.3.40

How are cash flows for purchases of inventory classified when the source of financing is unaffiliated with the vendor?

Interpretive response: When a loan is obtained from an unaffiliated financing source (i.e. not affiliated with the vendor) for purposes of purchasing inventory, the entity classifies: [2005 AICPA Conf]

- the loan as a cash flow from **financing** activities;
- the purchase of inventory from the vendor as a cash flow from **operating** activities; and
- any subsequent repayments of the loan to the unaffiliated financing source as cash flows from **financing** activities.

This classification of cash flows would be the same regardless of whether the unaffiliated financing source paid the loan proceeds directly to the entity or to the vendor on behalf of the entity (i.e. constructive receipt and disbursement – see section 4.7.10).

See Question 12.4.10 for structured payable arrangements.

Example 7.3.30
Financing from unaffiliated source

On December 15, Year 1, Retailer obtains a loan from Bank and purchases inventory (50 washing machines) from Vendor that will be sold in Retailer's stores. Bank is not affiliated with Vendor.

The loan is for $15,000 in total and equal to the cost of the inventory ($300 per washing machine). Under the terms of the loan, Retailer must repay Bank for the full amount in one year (interest is not considered for simplicity).

None of the inventory purchased on December 15, Year 1, was sold by the end of Year 1 (December 31).

Year 1

The following illustrates the effect of these transactions on Retailer's Year 1 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$ -
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities	
Change in assets and liabilities:	
Increase in inventory	(15)
Net cash provided by (used in) operating activities	**(15)**
Cash flows from financing activities	
Proceeds from loan	15
Net cash provided by (used in) financing activities	**$15**

Year 2

During Year 2, Retailer sells all of the inventory purchased for $400 each, or $20,000 in total. Retailer also repays Bank for the loan. The following illustrates the effect of these transactions on Retailer's Year 2 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)[1]	$ 5
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities	
Change in assets and liabilities:	
Decrease in inventory	15
Net cash provided by (used in) operating activities	**20**
Cash flows from financing activities	
Repayment of loan	(15)
Net cash provided by (used in) financing activities	**$(15)**

Note:

1. Revenue of $20 less cost of goods sold of $15.

Note: The same classification illustrated would occur if Bank paid Vendor directly on Retailer's behalf. See section 4.7.10 for discussion of constructive receipt and disbursement.

7.4 Advance payments, deposits and capitalized costs

Question 7.4.10

How are cash flows from receipt of an up-front payment classified?

Interpretive response: It depends on whether the entity expects to refund the up-front (i.e. advance) payment.

An advance payment received from a customer is recognized as a liability on the balance sheet. If the advance payment represents a deposit that is expected to be refunded to the customer in cash at a future date (i.e. refund liability), we believe the initial cash inflow and subsequent cash outflow are classified as cash flows from **financing** activities. This is because the entity has use of the customer's cash, which reduces its need for debt or other borrowings. However, we believe this classification does not apply to refundable deposits paid by a lessee to a lessor at or before the lease commencement date (see Questions 14.3.30 and 14A.3.20).

In contrast, the cash receipt may be an advance payment for goods and services (i.e. contract liability) and it is expected that the advance payment will be applied against future receivables. In that case, the cash inflow is an **operating** activity. Any subsequent refund would be a cash outflow from **operating** activities. [230-10-45-16(a), 45-17(f)]

Example 7.4.10

Arrangement with up-front payment

On December 15, Year 1, ABC Corp. enters into a contract to sell Product P to Customer for an up-front cash payment of $300,000.

At contract inception, ABC expects to deliver Product P to Customer in six months. The cost of Product P to ABC is $200,000. For purposes of this example, assume that ABC determines that the contract does not have a significant financing component.

Based on the terms of the arrangement, there are no provisions requiring cash repayment of the up-front payment. Furthermore, under the terms of the arrangement, when Product P is delivered, ABC will reduce the contract liability (rather than recognizing a receivable) and recognize revenue.

Year 1

The following illustrates the effect of this transaction on ABC's Year 1 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$ -
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities	
Change in assets and liabilities:	
Increase in contract liability	300
Net cash provided by (used in) operating activities	**$300**

Year 2

On June 15, Year 2, ABC delivers Product P to Customer and recognizes revenue on the sale. The following illustrates the effect of this transaction on ABC's Year 2 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)[1]	$100
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities	
Change in assets and liabilities:	
Decrease in inventory	200
Decrease in contract liability	(300)
Net cash provided by (used in) operating activities	**$ -**

Note:

1. Revenue of $300 less cost of goods sold of $200.

Question 7.4.20

How are cash flows for costs to obtain and to fulfill a customer contract classified?

Background: If the criteria in Subtopic 340-40 are met, the following costs are recognized as a contract cost asset:

- incremental costs incurred to obtain a contract with a customer. As a practical expedient, an entity can expense these costs if the asset would otherwise be amortized over less than one year. [340-40-25-1 – 25-4]
- costs incurred to fulfill a contract with a customer unless those costs are in the scope of other guidance. [340-40-25-5 – 25-6]

Interpretive response: We believe that payments for costs to obtain a customer contract should be classified as cash flows from **operating** activities, as these costs are typically commissions paid to employees or selling agents. The fact that Subtopic 340-40 requires capitalization of certain selling costs does not change the nature of the cash flow; it remains a selling cost rather than a payment to acquire a productive asset. [230-10-45-17(b)]

Similarly, we believe that payments for costs to fulfill a customer contract should be classified as cash flows from **operating** activities.

In addition, the amortization of the capitalized costs is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities.

Question 7.4.30

How are cash flows for costs of implementing cloud computing arrangements classified by the customer, after adopting ASU 2018-15?

Background: ASU 2018-15 (see chapter 1) aligns the accounting for implementation costs incurred by a customer in a hosting arrangement that does not include a license to internal-use software (i.e. a cloud computing arrangement) with one that does. The customer determines whether to defer cloud computing implementation costs or expense them as incurred using the internal-use software guidance in Subtopic 350-40. Deferred implementation costs are recognized to expense over the 'term of the hosting arrangement', which includes the non-cancellable period of the arrangement plus any optional renewal periods that are either reasonably certain to be exercised by the customer or controlled by the cloud service provider.

See KPMG Hot Topic, Customers' accounting for cloud computing arrangements after adopting ASU 2018-15, and Defining Issues, FASB issues ASU on accounting for implementation costs of cloud computing arrangements, for additional details on customers' accounting for cloud computing arrangements after adopting ASU 2018-15.

Interpretive response: The customer is required to classify cash outflows for cloud computing implementation costs consistent with how it classifies the cash outflows for the hosting service (or subscription) fees, irrespective of whether the costs are deferred or expensed as incurred under Subtopic 350-40. [350-40-45-3]

This means that these payments are generally classified as cash flows from **operating** activities. In addition, amortization of deferred costs is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities.

Question 7.4.40

How are cash flows for costs incurred by film producers classified?

Interpretive response: A film producer classifies cash payments for film costs, participation costs, exploitation costs, and manufacturing costs as cash flows from **operating** activities. In addition, the amortization of the capitalized costs is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities. [926-230-45-1]

Question 7.4.50

How are cash flows for costs incurred by broadcasters for license rights to program materials classified, after adopting ASU 2019-02?

Background: ASU 2019-02 (see chapter 1) conforms the cash flow statement guidance for broadcasters with that of film producers (see Question 7.4.40).

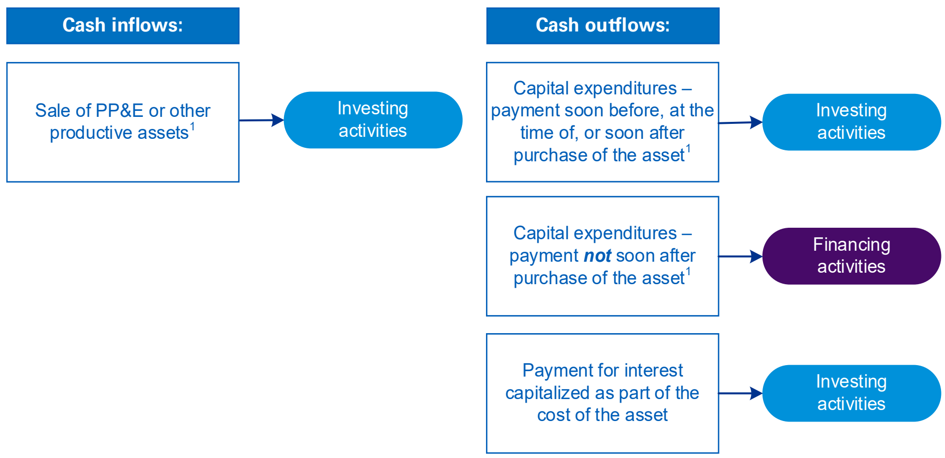
Interpretive response: A broadcaster licensee classifies cash payments to purchase the rights acquired under a license agreement for program materials as cash flows from **operating** activities. In addition, the amortization of the capitalized costs is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities. [920-230-45-1]

8. PP&E and other productive assets

Detailed contents

8.1 How the standard works

This chapter addresses how to classify cash flows from/for PP&E and other productive assets (i.e. assets held for or used in producing goods or services that are not part of an entity's inventory). The following chart summarizes some of the classification issues encountered, which are explained in more detail in this chapter.



Note:

1. An entity may need to apply the predominance principle to determine the classification of cash payments (see section 8.5.10).

Complications arise when an asset is purchased with third-party lender financing. The classification of the related cash flows by the buyer is dependent on whether the lender remits payment directly to the vendor, or whether the lender remits payment to the buyer, who then pays the vendor (see section 8.3).

See chapter 7 for guidance over classification matters relating to inventory.

8.2 Capital expenditures without third-party financing (unaffiliated with vendor)

8.2.10 Overview

Payments for capital expenditures are classified as cash flows from **investing** activities when made at the time of purchase or soon before or afterward. [230-10-45-13(c)]

Question 8.2.05
What are capital expenditures?

Interpretive response: Capital expenditures are payments to acquire PP&E and other productive assets. [230-10-45-13(c)]

PP&E

PP&E typically comprises long-lived tangible assets used to create and distribute an entity's products and services. PP&E includes: [360-10-05-3]

— land and land improvements
— buildings
— machinery and equipment
— furniture and fixtures.

However, if held for sale in the normal course of business, none of the above are PP&E (see Example 8.5.10).

Other productive assets

Other productive assets, as described in the definition of **investing** activities, are assets held for or used in producing goods or services by the entity – other than materials that are part of an entity's inventory. Other productive assets include, for example, purchased licenses and internal used software. [230-10 Glossary]

The following assets are not productive assets even though their related costs may be capitalized: customer contract costs (see Question 7.4.20), costs of implementing cloud computing arrangements (see Question 7.4.30), film costs incurred by film producers (see Question 7.4.40) and license rights of broadcasters (see Question 7.4.50).

For a discussion of R&D assets, see Question 8.2.15.

Payments to self-develop or construct PP&E and other productive assets

We believe that capital expenditures also are funds used to self-develop or construct PP&E and other productive assets. See further discussion in Question 8.5.20 (interest), Question 8.5.25 (salaries) and Question 14.2.40 (lease payments capitalized to the cost of PP&E and other productive assets).

Question 8.2.10

How are cash flows for capital expenditures classified?

Interpretive response: Cash outflows for capital expenditures are generally classified based on the timing of payment.

Timing of payment	Classification
Payment at the time of purchase	**investing** activities [230-10-45-13(c)]
Payment soon before or after purchase (see Question 8.2.20)	**investing** activities [230-10-45-13(c)]
Advance payments and deposits *not* soon before purchase	**investing** activities [230-10-45-13(c)]
Payments after, but *not* soon after, purchase (see Question 8.2.20)	**financing** activities [230-10-45-13(c)] See section 8.2.30 for disclosure requirements.

In certain transactions, an entity may need to apply the predominance principle to determine the classification of cash payments. For a discussion of applying the predominance principle for capital expenditures, see section 8.5.10.

Question 8.2.15

How are cash flows for acquired R&D assets classified?

Background: R&D costs are generally expensed as incurred unless they represent costs of materials, equipment or facilities that have alternative future uses. [730-10-25-1, 25-2(a)]

Similarly, if in-process R&D is acquired in an asset acquisition, the amount allocated to the IPR&D is expensed immediately unless it has an alternative future use. Questions 4.2.20 and 4.8.20 in KPMG Handbook, Asset acquisitions, discuss the accounting for IPR&D assets acquired in an asset acquisition. [350-30-35-6, 35-7]

Question 18.2.30 discusses IPR&D acquired in a business combination.

Interpretive response:

Alternative future use

Payments made to acquire an R&D asset or IPR&D with an alternative future use are classified as cash flows from **investing** activities. This is because recognized assets are examples of productive assets (see Question 8.2.10). [230-10-45-13(c)]

No alternative future use

Topic 230 does not address how payments made to acquire an R&D asset or IPR&D with no alternative future use should be classified. Given the absence of guidance and the diversity in practice, we would not object to such payments being classified as cash flows from either **operating** or **investing** activities. The approach selected should be disclosed and consistently applied.

Classification in **operating** activities is consistent with Topic 730, which requires such assets to be expensed immediately, and the definition of operating activities – i.e. cash effects of transactions and other events that enter into the determination of net income. [230-10 Glossary, 730-10-25-1]

Alternatively, classification in **investing** activities captures the view that an asset still has been acquired even though the cost or allocated amount (for IPR&D) is expensed immediately. Under this approach, the cost or allocated amount should be presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see chapter 3). This is because such amounts are recorded through net income; however, the statement of cash flows presents the cash payment as **investing** activities. [AAVG-AARD.5.12]

8.2.20 Applying the 'soon before or after' test

Question 8.2.20

How should 'soon before or after' be interpreted when classifying cash flows for capital expenditures?

Interpretive response: We believe three months or less is an appropriate interpretation for 'soon before or after' because this interpretation is consistent with other provisions in Topic 230 (and related guidance). For example, a period of three months or less is used to define cash equivalents (see section 6.3), determine net or gross presentation (see section 3.5), and classify cash outflows for liability-classified contingent consideration in a business combination (see Question 18.4.50). [230-10 Glossary, 230-10-45-9, ASU 2016-15.BC16]

Therefore, an entity should generally consider payments made within three months of the capital expenditure to be cash outflows for **investing** activities. Conversely, payments made after the capital expenditure that are outside of this three-month period are generally cash outflows for **financing** activities.

Question 8.2.30

May payments made after three months of a capital expenditure be classified as investing activities?

Interpretive response: Generally no. However, there are limited circumstances in which payments made after three months of a capital expenditure may be appropriately classified as cash flows from **investing** activities.

If payment terms extend beyond three months, but those terms are consistent with standard industry practice as well as with terms that are customary for the vendor, we believe classification as a cash flow from **investing** activities may still be appropriate.

However, we believe that payments made after one year are cash outflows for **financing** activities, even if the terms are consistent with industry practice and are considered customary for the vendor.

Example 8.2.10

Capital expenditures – payment at time of purchase

On December 15, Year 1, ABC Corp. purchases equipment for $500,000. On the date of purchase, ABC pays cash for the equipment.

The table illustrates the effect of this transaction on ABC's Year 1 statement of cash flows.

$'000s	
Cash flows from investing activities	
Capital expenditures	$ (500)
Net cash provided by (used in) investing activities	**$(500)**

Example 8.2.20

Capital expenditures – payment after purchase

ABC purchases two pieces of equipment, Machine X and Machine Z. ABC pays the vendor for Machine X on day 95, but delays payment on Machine Z until day 150 because of working capital needs. ABC obtains approval from the vendor for the delay in payment.

Payment is due within 100 days under standard industry practice and the vendor's normal terms.

ABC evaluates whether the payments occur 'soon before or after' the purchase date, and concludes that it will classify the payments in these ways:

— The payment for Machine X is classified as a cash flow from **investing** activities. Although payment is made outside the three-month period, it falls within the period of normal payment terms for the industry and the vendor.

— The payment for Machine Z falls outside of the normal payment terms for the industry and the vendor. Therefore, the transaction represents a financing to ABC, even though the vendor approved the delay in payment. As such, ABC discloses a **noncash** investing and financing activity for the purchase of Machine Z and issuance of financing, respectively. Once the payment to the vendor is made, it is a cash outflow for **financing** activities.

Example 8.2.30
Capital expenditures – vendor financed

On December 15, Year 1, ABC Corp. purchases equipment from Vendor for $500,000. On the date of purchase, ABC pays $100,000 in cash to Vendor and obtains financing from Vendor for the remaining $400,000.

Under the terms of the financing, ABC must repay Vendor for the full amount in one year (interest is not considered in this example for simplicity). ABC has not made any payments on the financing by the end of Year 1 (December 31).

Year 1

The table illustrates the effect of these transactions on ABC's Year 1 statement of cash flows.

$'000s	
Cash flows from investing activities	
Capital expenditures	$ (100)
Net cash provided by (used in) investing activities	**$ (100)**
Supplemental schedule of noncash investing and financing activities	
Purchase of PP&E through vendor financing	$ 400

Year 2

During Year 2, ABC pays off the financing from Vendor. The table illustrates the effect of this transaction on ABC's Year 2 statement of cash flows.

$'000s	
Cash flows from financing activities	
Repayment of loan	$ (400)
Net cash provided by (used in) financing activities	**$ (400)**

8.2.30 Disclosing noncash capital expenditures

Question 8.2.40
Are accrued unpaid amounts for capital expenditures excluded from the statement of cash flows?

Interpretive response: Yes. Activity in the statement of cash flows is based on the cash method of accounting rather than the accrual method used for other financial statements.

Investing and financing activities that affect recognized assets or liabilities but that do not result in actual cash receipts or payments during the period are disclosed as **noncash** investing and financing activities. As such, cash flows for capital expenditures as reported in cash flows from **investing** activities are adjusted to exclude unpaid amounts accrued for at period-end. Furthermore, the change in accounts payable (or accrued expenses) line item as reported in cash flows from **operating** activities under the indirect method must also exclude these unpaid amounts. This amount should be separately disclosed as a **noncash** investing activity (see section 4.7.20). [230-10-50-3]

Example 8.2.40
Unpaid amounts accrued – equipment purchase

On December 15, Year 1, ABC Corp. purchases equipment on account from Vendor for $500,000. Payment terms with Vendor are 90 days from the date of purchase. At the end of Year 1 (December 31), ABC has not paid for the equipment and the unpaid amount is accrued in accounts payable.

Year 1

The table illustrates the effect of this transaction on ABC's Year 1 statement of cash flows.

$'000s	
Net cash provided by (used in) operating activities	$ -
Net cash provided by (used in) investing activities	-
Net cash provided by (used in) financing activities	$ -
Supplemental schedule of noncash investing and financing activities	
Purchases of PP&E in accounts payable	$ 500

Year 2

On January 15, Year 2, ABC pays Vendor the $500,000 for the equipment. The table illustrates the effect of this transaction on ABC's Year 2 statement of cash flows.

$'000s	
Cash flows from investing activities	
Capital expenditures	$ (500)
Net cash provided by (used in) investing activities	**$(500)**

Example 8.2.50
Unpaid amounts accrued – PP&E construction

ABC Corp. is constructing a manufacturing plant. The table illustrates the change in ABC's accounts payable during Year 2 related to this construction project.

$'000s	
Accounts payable at December 31, Year 1	$1,000
Purchases per PP&E roll-forward	3,000
Payments for PP&E in Year 2	(2,800)
Accounts payable at December 31, Year 2	**$1,200**

All capital expenditures are on standard payment terms that do not exceed three months.

The table illustrates the effect of these transactions on ABC's Year 2 statement of cash flows.

$'000s	
Cash flows from investing activities	
Capital expenditures	$ (2,800)
Net cash provided by (used in) investing activities	**$(2,800)**
Supplemental schedule of noncash investing and financing activities	
Purchases of PP&E in accounts payable[1]	$ 1,200

Note:

1. Payment of $2,800 less amounts accrued in accounts payable as of Year 1 of $1,000 less PP&E purchases in Year 2 of $3,000.

8.3 Capital expenditures with third-party financing (unaffiliated with vendor)

The classification of cash outflows for capital expenditures with third-party financing unaffiliated with the vendor depends on the facts and circumstances of the arrangement. It is different from the classification of cash outflows for the purchase of inventory through financing arrangements (see section 7.3).

Question 8.3.10

How are cash flows for capital expenditures financed by a third-party lender classified?

Interpretive response: When a buyer's capital expenditures are financed by a third-party lender unaffiliated with the vendor, these classifications apply when financing is obtained:

If the lender remits payment to the buyer and the buyer pays the vendor	Present: — Cash inflow from **financing** activities (issuance of debt) [230-10-45-14(b)] — Cash outflow for **investing** activities (purchase of PP&E or other productive asset) [230-10-45-13(c)]
If the lender remits payment directly to the vendor	Topic 230 does not directly address this situation. Given the absence of guidance and the diversity in practice, we would not object to either of the following approaches. Disclose: [TQA 1300.19, 230-10-50-3] — **Noncash** investing activity (purchase of PP&E or other productive asset) — **Noncash** financing activity (issuance of debt) Present constructive receipt and disbursement as (see section 4.7.10): — Cash inflow from **financing** activities (issuance of debt) [230-10-45-14(b)] — Cash outflow for **investing** activities (purchase of PP&E or other productive asset) [230-10-45-13(c)]

Subsequent repayments of the debt to the lender are cash outflows for **financing** activities. [230-10-45-15(b), TQA 1300.19]

Question 8.3.20

How does a buyer classify cash flows from/for a loan check it receives and endorses to a vendor in return for PP&E or other productive assets?

Interpretive response: The buyer reports this transaction as a cash inflow from **financing** activities; this is because the buyer is the payee named on the loan check. In addition, purchasing PP&E and other productive assets by endorsing the loan check over to the vendor is a cash outflow for **investing** activities and subsequent repayments to the lender are cash outflows for **financing** activities. [230-10-45-15(b), TQA 1300.21]

This approach is the same as if the lender had remitted payment to the buyer, and the buyer had then paid the vendor (see Question 8.3.10).

Example 8.3.10

Capital expenditures – bank financed and funds remitted by lender to buyer

On December 15, Year 1, ABC Corp. takes out a loan from Bank for $400,000 and uses the funds, plus $100,000 of its own cash, to purchase equipment from Vendor for $500,000.

Under the terms of the loan, ABC must repay the full amount borrowed in one year (interest is not considered in this example for simplicity). ABC has not made any payments on the loan by the end of Year 1 (December 31).

Year 1

The table illustrates the effect of these transactions on ABC's Year 1 statement of cash flows.

$'000s	
Cash flows from investing activities	
Capital expenditures	$(500)
Net cash provided by (used in) investing activities	**(500)**
Cash flows from financing activities	
Proceeds from loan	400
Net cash provided by (used in) financing activities	**$ 400**

Year 2

During Year 2, ABC repays the loan. The table illustrates the effect of this transaction on ABC's Year 2 statement of cash flows.

$'000s	
Cash flows from financing activities	
Repayment of loan	$ (400)
Net cash provided by (used in) financing activities	**$(400)**

Example 8.3.20

Capital expenditures – bank financed and funds remitted by lender to vendor

Assume the same facts as Example 8.3.10, except that Bank remits the payment directly to Vendor.

Year 1

The table illustrates the effect of these transactions on ABC's Year 1 statement of cash flows.

$'000s	
Cash flows from investing activities	
Capital expenditures	$ (100)
Net cash provided by (used in) investing activities	**$ (100)**
Supplemental schedule of noncash investing and financing activities	
Purchase of PP&E through debt financing	$ 400

Year 2

During Year 2, ABC repays the loan. The table illustrates the effect of this transaction on ABC's Year 2 statement of cash flows.

$'000s	
Cash flows from financing activities	
Repayment of loan	$ (400)
Net cash provided by (used in) financing activities	**$ (400)**

8.4 Sale of PP&E and other productive assets

8.4.10 Overview

Question 8.4.10

How are cash flows from the sale of PP&E and other productive assets classified?

Interpretive response: Cash inflows from the sale of PP&E and other productive assets are generally **investing** activities. [230-10-45-12(c)]

In certain transactions, an entity may need to apply the predominance principle to determine the classification of cash receipts. For a discussion of applying the predominance principle in the sale of PP&E and other productive assets, see section 8.5.10.

8.4.20 Gain or loss on sale of PP&E and other productive assets

Question 8.4.20
How are gains or losses on the sale of PP&E and other productive assets presented?

Interpretive response: Gains or losses on the sale of PP&E and other productive assets are presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2). [230-10-45-28(b)]

Example 8.4.10
Gain on sale of PP&E

On December 15, Year 1, ABC Corp. sells equipment that is classified as PP&E for $600,000. The carrying amount of the equipment on the date of sale is $400,000, resulting in a gain on sale of $200,000 for ABC.

The table illustrates the effect of this transaction on ABC's Year 1 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$200
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities	
Gain on sale of equipment	(200)
Net cash provided by (used in) operating activities	**-**
Cash flows from investing activities	
Proceeds from sale of equipment	600
Net cash provided by (used in) investing activities	**$600**

8.4.30 Gross vs net presentation

Question 8.4.30

Can cash flows from the sale of PP&E and other productive assets be netted against cash flows for capital expenditures?

Interpretive response: No. As noted in section 3.5, items that qualify for net reporting must have quick turnover, occur in large amounts and have short maturities (i.e. less than 90 days).

Therefore, cash receipts from the sale of PP&E and other productive assets cannot be netted against cash outflows for capital expenditures, even if the receipts are used to replace the asset sold. Those cash receipts and cash payments must be reported separately (i.e. gross). [230-10-45-7 – 45-8]

8.5 Other considerations

8.5.10 Applying the predominance principle

In transactions involving PP&E and other productive assets, an entity will sometimes have to apply the predominance principle (see section 4.5) to determine the appropriate classification of the cash payment/receipt. The predominance principle is a mechanism for classifying cash flows when there is no specific guidance in US GAAP and the cash flows could be classified in more than one category based on their nature. Under this principle, cash flows are classified based on the activity that is likely to be the predominant source or use of the cash flows. [230-10-45-22 – 45-22A]

Example 8.5.10

Purchase of land in a real estate business

ABC Corp. is a real estate company that purchases land to resell as part of its core business.

Although cash payments for land are generally cash outflows for **investing** activities, ABC will resell land as part of its core business. Therefore, the land is similar to inventory. Therefore, ABC classifies payments made for land purchased for resale as cash flows from **operating** activities. [230-10-45-13(c), 45-17(a)]

Example 8.5.20

Purchase of equipment to be leased for a short period and then sold

ABC Corp. purchases farming equipment that it then rents to customers under a short-term operating lease that is structured to be six months or less. At the end of the operating lease, ABC sells the farming equipment.

Purchasing equipment to be used to rent to customers generally is a cash outflow for **investing** activities (see sections 14.3.20 and 14A.3.20). In contrast, purchasing equipment to be sold to customers generally is a cash outflow for **operating** activities (see section 7.3). [230-10-45-13(c), 45-17(a)]

Because ABC plans to both rent and sell the farming equipment, the cash flows to purchase the equipment have aspects of both **operating** and **investing** activities. Therefore, ABC will need to determine the nature of the activity that is likely the predominant source of cash flows to determine how the cash flows from/for the purchase and sale of the equipment should be classified. [230-10-45-22A]

ABC will rent the farming equipment for only a short period before selling it, and the amount of cash flows that ABC expects to receive from rental income as compared to the proceeds from sale of the equipment is relatively small.

As such, the farming equipment is more like an inventory item than a leased asset (although the equipment is presented and depreciated as PP&E on ABC's balance sheet). Therefore, the cash flows related to the purchase and sale of the farming equipment are **operating** activities. [230-10-45-16(a), 45-17(a)]

Example 8.5.30

Purchase of equipment to be leased for a significant period and then sold

Assume the same facts as Example 8.5.20, except that ABC intends to rent the farming equipment under operating leases to multiple customers for a significant portion of the asset's economic life before selling it to realize the equipment's residual value.

Based on its intent, ABC concludes that the farming equipment has the nature of PP&E. Therefore, cash payments related to the purchase and sale of the farming equipment are cash outflows for **investing** activities. [230-10-45-12(c), 45-13(c)]

Question 8.5.10

How are cash flows for the purchase of software to be sold, leased or marketed classified?

Background: Software to be sold, leased or otherwise marketed that is acquired in an asset purchase (i.e. not a business combination) is capitalized and amortized under Subtopic 985-20. [985-20-25-8 – 25-9]

Interpretive response: The cash outflows for the purchase of software in the scope of Subtopic 985-20 have characteristics of:

— **operating** activities, because the purchased software, like inventory, is marketed and sold to others for the purpose of generating revenue; and

— **investing** activities, because the software also has characteristics similar to a productive asset – it may continue to be available for download and provide future economic benefits for an extended period, even after being fully amortized or sold.

An entity should support the classification selected by analyzing the facts and circumstances of the specific purchase, including an analysis of the estimated economic life of the assets, to determine whether the predominant source of cash outflows is for **operating** or **investing** activities (i.e. the purchased software is more like inventory or a productive asset, respectively). [230-10-45-22]

8.5.20 Capitalized interest and other costs

Question 8.5.20

How are cash flows for interest capitalized to the cost of PP&E and other productive assets classified?

Background: If an asset requires a period of time to carry out the activities necessary to bring it to the condition and location necessary for its intended use, Subtopic 835-20 requires that the interest cost be capitalized and included in the cost of the asset. The amount of interest capitalized is the portion of the interest cost that could have been theoretically avoided by not constructing the asset. However, this amount is capped at the actual interest cost incurred. [835-20-05-1]

Interpretive response: Cash flows for interest capitalized as part of the cost of PP&E and other productive assets are cash outflows for **investing** activities. This is an exception to the general rule that interest payments are cash outflows for **operating** activities. [230-10-45-13(c), 45-17(d)]

However, cash flows for interest capitalized as part of the cost of PP&E and other productive assets only represent interest paid during the period (see section 8.2.30).

Interest paid but capitalized is not included in the interest paid disclosure (see section 3.3.30). [230-10-50-12]

Question 8.5.25

How are cash flows for salaries capitalized to the cost of PP&E and other productive assets classified?

Interpretive response: We believe that cash flows for salaries capitalized as part of the cost of PP&E and other productive assets are cash flows for **investing** activities. This is consistent with our view that capital expenditures include funds used to self-develop or construct PP&E and other productive assets (see Question 8.2.05).

This position is also supported by analogy to the guidance on capitalized interest (see Question 8.5.20) and lease payments (see Question 14.2.40).

8.5.30 Depreciation, amortization and impairment of PP&E and other productive assets

Question 8.5.30

How is depreciation, amortization and impairment of PP&E and other productive assets presented?

Interpretive response: Depreciation of PP&E and amortization of other productive assets, as well as impairment losses, are presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2). This is because those costs are noncash items in the current period. [230-10-45-28(b)]

9. Investments

Detailed contents

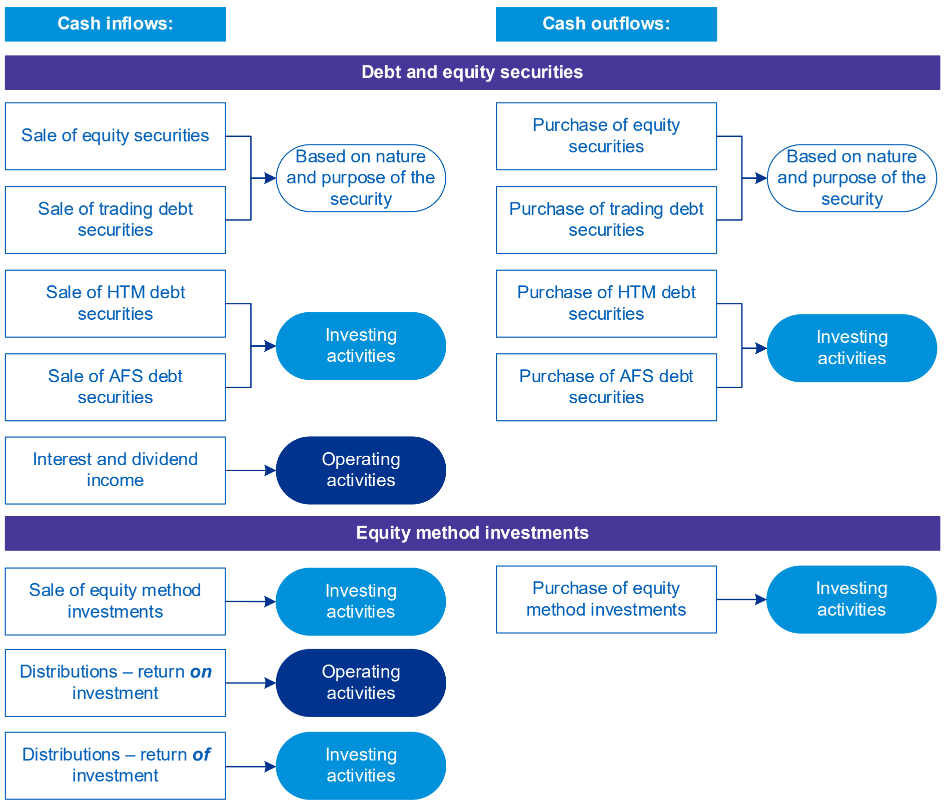
Example

9.1 How the standard works

This chapter addresses how to classify the cash flows from/for investments in debt and equity securities, when those securities are not cash equivalents. For securities that are cash equivalents, see section 6.3.

Typical cash flows include payments to purchase investments and proceeds from their sale, as well as income derived from holding the investment – i.e. interest, dividends and distributions.

The accounting for the investment usually drives classification of the related cash flows. The following chart summarizes some of the classification issues encountered, which are explained in more detail in this chapter.



See chapter 11 for investments in loans and chapter 10 for transfers of financial assets (including investments) and securitizations. The classification guidance discussed in this chapter for debt securities does not apply to NFPs that are not business-oriented healthcare entities. See chapter 22 for guidance specific to these NFPs.

9.2 Debt and equity securities

9.2.10 Debt securities

Excerpt from ASC 230-10

> Classification

>> Acquisitions and Sales of Certain Securities and Loans

45-19 Cash receipts and cash payments resulting from purchases and sales of securities classified as trading debt securities accounted for in accordance with Topic 320 … shall be classified pursuant to this Topic based on the nature and purpose for which the securities were acquired.

Excerpt from ASC 320-10

> Cash Flow Presentation

45-11 Cash flows from purchases, sales, and maturities of available-for-sale securities and held-to-maturity securities shall be classified as cash flows from **investing activities** and reported gross for each security classification in the statement of cash flows. Cash flows from purchases, sales, and maturities of trading securities shall be classified based on the nature and purpose for which the securities were acquired.

Excerpt from ASC 825-10

> Statement of Cash Flows

45-3 Entities shall classify cash receipts and cash payments related to items measured at fair value according to their nature and purpose as required by Topic 230.

Debt securities are any securities representing a creditor relationship with an entity. They include, for example, US Treasury securities, US government agency securities, corporate bonds, convertible debt and other securities. [320-10 Glossary]

An entity investing in debt securities is required to determine the appropriate category for those debt securities under Topic 320 (debt securities), which also affects the appropriate classification of cash flows under Subtopic 825-10 (financial instruments) and Topic 230. For an in-depth understanding of the requirements of Topic 320, see KPMG Handbook, Investments.

Investment categories	Measurement	Classification of cash flows from/for purchases, sales and maturities
Debt security defined or designated as trading – Debt security acquired with the intent of selling it within hours or days. However, at acquisition an entity can designate a security as trading even if it plans to hold the security for a longer period. Therefore, designating a security as trading is not precluded simply because the entity does not intend to sell in the near term. [320-10-25-1(a)]	Fair value through earnings [320-10-45-1(a)]	Based on nature and purpose for which the security was acquired (see Question 9.2.10) [230-10-45-19, 320-10-45-11]
Held-to-maturity debt security – Debt security that the entity has the positive intent and ability to hold to maturity. [320-10-25-1(c)]	Amortized cost [320-10-45-1(c)]	**investing** activities [320-10-45-11]
Available-for-sale debt security – Debt security not designated as trading security or as held-to-maturity security. [320-10-25-1(b)]	Fair value through OCI [320-10-45-1(b)]	**investing** activities [230-10-45-11, 320-10-45-11]

Question 9.2.10

How are cash flows from/for trading securities classified?

Interpretative response: An entity classifies cash flows from/for a debt security designated as trading based on the nature and purpose for which the security was acquired. Therefore, if an entity that actively buys and sells debt securities with the intended purpose of generating trading profits in the short term, cash flows from those transactions are **operating** activities.

In contrast, if the reporting entity's investment objective and strategy is not to engage in such trading activities (i.e. the securities are designated, rather than defined, as trading), cash flows from purchases and sales of trading debt securities are **investing** activities. [230-10-45-19, 320-10-45-11]

9.2.20 Equity securities

Excerpt from ASC 230-10

> Acquisitions and Sales of Certain Securities and Loans

45-19 Cash receipts and cash payments resulting from purchases and sales of securities classified as … equity securities accounted for in accordance with

Topic 321 shall be classified pursuant to this Topic based on the nature and purpose for which the securities were acquired.

Excerpt from ASC 321-10

> Cash Flow Presentation

45-1 An entity shall classify cash flows from purchases and sales of **equity securities** on the basis of the nature and purpose for which it acquired the securities.

Equity securities are securities representing an ownership interest in an entity or the right to acquire or dispose of an ownership interest in an entity at fixed or determinable prices. Equity securities exclude written equity options, cash-settled options on equity securities or options on equity-based indexes, and convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor. [321-10 Glossary]

Under Topic 321 (equity securities), equity securities with a readily determinable fair value are generally measured at fair value with changes in fair value recorded in earnings. Equity securities without a readily determinable fair value are generally measured at cost, adjusted for impairment and certain changes in prices – referred to as the measurement alternative.

The guidance in Topic 321 does not apply to investments accounted for under the equity method. See section 9.3 for guidance on classifying cash flows from/for equity method investments.

Question 9.2.20

How are cash flows from/for purchases and sales of equity securities classified?

Interpretative response: Topic 321 requires cash flows for purchases of or from sales of equity securities to be classified based on the nature and purpose for which they were acquired similar to the guidance for debt securities described in Question 9.2.10 – i.e. as cash flows from **operating** or **investing** activities. [321-10-45-1]

Therefore, even though a security is measured at fair value through earnings (if the measurement alternative is not elected) under Topic 321, the cash flows are not necessarily an operating activity.

For the presentation of changes in the fair value of equity securities, see Question 9.2.90.

9.2.30 Other presentation considerations

Gross vs net cash flows presentation

Generally, cash flows from purchases and sales of investments should be presented gross in the statement of cash flows (i.e. as separate line items). [230-10-45-7]

The gross amounts of purchases and sales of investments generally provide more meaningful information than the net amounts do. They are necessary to understand the entity's investing activities and provide more transparency and visibility into how an entity operates. For example, it is more informative to the users of the financial statements to present cash outflows of $3 million for purchases of investments and cash inflows of $5 million from sales of investments, than it would be to show net cash inflows of $2 million on these transactions.

Question 9.2.40

Can purchases and sales of investments be presented on a net basis?

Interpretive response: It depends on where the cash flows are classified and whether the netting criteria in Topic 230 are satisfied.

Purchases and sales of investments classified in cash flows from investing activities

Purchases and sales of investments classified in cash flows from **investing** activities can be presented on a net basis only if the netting criteria in Topic 230 are satisfied. The netting criteria are satisfied if the investments have a quick turnover, occur in large amounts, and have short maturities (see section 3.5). To have a short maturity an investment needs to have an original maturity of three months or less (see Question 6.3.05). [230-10-45-8 – 45-9]

The following are examples of cash flows that do not qualify for net reporting:

— cash payments for purchases and cash receipts from sales of equity securities because there are no maturities;
— cash payments for purchases and cash receipts from sales of debt securities with an original maturity of more than three months.

Other purchases and sales of investments

The following are examples of cash flows that typically qualify for net reporting:

— cash payments for purchases and cash receipts from sales of trading investments classified in cash flows from **operating** activities;
— cash flows from purchases and sales of Treasury bills, commercial paper, money market funds and federal funds (for an entity with banking operations), if these transactions are part of the entity's cash management activities.

Question 9.2.50

Can purchases and sales of alternative investments be presented on a net basis?

Background: Investors may purchase alternative investments (e.g. hedge funds, real estate ventures and private equity funds) to diversify their portfolios. Alternative investments are often structured as limited partnerships, but may be structured in other legal forms, including limited liability corporations, limited liability partnerships and trust arrangements.

Hedge funds are a common example of alternative investments. They typically require investors to make a large, fixed investment and can have provisions that reduce liquidity, such as only permitting withdrawals at certain times of the year or requiring 60-90 days' notice of withdrawals.

Interpretive response: Cash flows from/for purchases and sales of alternative investments should be presented gross in the statement of cash flows (i.e. as separate line items). This is because purchases and sales are generally classified as cash flows from **investing** activities and the netting criteria in Topic 230 (i.e. turnover is quick, they occur in large amounts, and the maturities are short) are generally not satisfied. Although the amounts traded may be large, the turnover of the purchases and sales (or redemptions) of alternative investments is generally not quick. [230-10-45-8]

In any event, the gross amounts of purchases and sales of alternative investments provide more meaningful information than the net amounts do. They are necessary to understand the entity's investing activities and provide more transparency and visibility into how an entity operates. [230-10-45-7]

Separate presentation by each security category

Cash flows from/for debt securities are presented gross and amounts for each security category are presented separately. This means that there could be up to three line items for each category. For example: [230-10-45-11]

— purchases of held-to-maturity debt securities
— proceeds from sale of held-to-maturity debt securities
— proceeds from maturity of held-to-maturity debt securities.

Question 9.2.60

Can cash flows from the sale of debt securities that occur within 90 days of maturity be presented as proceeds received on maturity?

Interpretive response: Yes. We believe debt securities sold within 90 days of maturity may be presented as proceeds received on maturity. This means that the cash received is a cash inflow from either **operating** or **investing** activities depending on the debt security category (see section 9.2.10).

Question 9.2.70

How are transfers between investment categories presented?

Interpretive response: Transfers between investment categories do not result in actual cash receipts or cash payments; therefore, these transactions are not included in the statement of cash flows. Instead, they represent **noncash** investing activities (see section 4.7.20). [230-10-50-3]

Investment income

Question 9.2.80

How are interest and dividend income earned on investments classified?

Interpretative response: Interest and dividend income received on all debt and equity securities represent cash inflows from **operating** activities. [230-10-45-16(b)]

Question 9.2.90

How are unrealized gains (losses) on investments presented?

Interpretative response: Unrealized gains (losses) do not represent cash flows. The change in fair value of investments that is recorded in OCI is not reported in the statement of cash flows. The change in fair value of investments measured at fair value through earnings is reported as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2). For example, this applies to debt securities designated as trading (see section 9.2.10) or equity securities for which the measurement alternative is not elected (see section 9.2.20). [230-10-45-28(b)]

Similarly, any changes to the carrying amount of equity securities measured at cost (i.e. impairments and certain changes in prices) are reported as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2).

Question 9.2.95

How are realized gains (losses) on investments classified when an entity classifies cash flows from investments as investing activities?

Interpretative response: The realized gain (loss) resulting from the sale of an investment is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see chapter 3). This is because the realized gain (loss) is recorded through net income; however, the statement of cash flows presents proceeds from the sale of the investments, inclusive of any realized gains (losses) as **investing** activities. [230-10-45-12]

Question 9.2.100

How are periodic cash receipts in excess of interest income from a debt security purchased at a premium classified?

Background: An entity may purchase debt securities at a premium. In that case, the cash receipts for interest will exceed the amount recognized as interest income because amortization of the premium reduces the amount of interest income.

For example, an investor purchases a $1 million bond at a premium for $1.2 million with 10% interest and maturing in 10 years. The annual cash receipt for interest is $100,000 ($1 million × 10%). However, the net interest income earned is $80,000 ($100,000 - $20,000 annual premium amortization). The investor should generally amortize the premium over the stated term of the bond using the interest method under Subtopic 835-30. This example uses the straight-line method for illustrative purposes only.

Interpretive response: Generally, we believe that cash flows from periodic cash receipts that are greater than the amount the entity recognizes as interest income are cash inflows from **investing** activities. This is because the excess is viewed as a return of principal.

9.3 Equity method investments

Excerpt from ASC 230-10

> Classification

>> Distributions Received from Equity Method Investees

45-21D When a reporting entity applies the equity method, it shall make an accounting policy election to classify distributions received from equity method investees using either of the following approaches:

a. Cumulative earnings approach: Distributions received are considered returns on investment and shall be classified as cash inflows from operating activities unless the investor's cumulative distributions received less distributions received in prior periods that were determined to be returns of investment exceed cumulative equity in earnings recognized by the investor (as adjusted for amortization of basis differences). When such an excess occurs, the current-period distribution up to this excess is considered a return of investment and shall be classified as cash inflows from investing activities.
b. Nature of the distribution approach: Distributions received shall be classified on the basis of the nature of the activity or activities of the

investee that generated the distribution as either a return on investment (classified as a cash inflow from operating activities) or a return of investment (classified as a cash inflow from investing activities) when such information is available.

If an entity elects to apply the nature of the distribution approach and the information to apply that approach to distributions received from an individual equity method investee is not available to the investor, the entity shall report a change in accounting principle on a retrospective basis by applying the cumulative earnings approach described in (a) above for that investee. In such situations, an entity shall disclose that a change in accounting principle has occurred with respect to the affected investee(s) due to the lack of available information and shall provide the disclosures required in paragraphs 250-10-50-1(b) and 250-10-50-2, as applicable. With either approach described in (a) or (b) above, an entity also shall comply with the applicable accounting policy disclosure requirements in paragraphs 235-10-50-1 through 50-6.

An investment in another entity is accounted for under the equity method in Topic 323 (equity method and joint ventures) if the investor has significant influence over the investee's operating and financial policies but does not have control over the investee. Equity method investments are recognized initially at cost and are subsequently adjusted through net income for the investor's share of the investee's earnings or losses for each reporting period. [323-10-30-1 – 30-2, 35-4]

An investor classifies its cash flows from/for equity method investments in accordance with Topic 230. Topic 230 requires cash flows from/for purchases and sales of such investments to be classified as cash flows from **investing** activities. However, the classification of cash distributions from the investee presents some further complexities. For an in-depth understanding of the accounting requirements for equity method investments, see KPMG Handbook, Equity method of accounting.

Question 9.3.10

How are cash flows from distributions by an equity method investee classified?

Interpretive response: An investor is required to determine whether distributions from an equity method investee represent a return *on* or a return *of* the investment. [230-10-45-21D]

- Distributions that are returns *on* an investment are cash flows from **operating** activities.
- Distributions that are returns *of* an investment are cash flows from **investing** activities.

Question 9.3.20

How does an investor determine whether distributions are a return *on* or a return *of* the investment?

Interpretative response: Topic 230 allows for two approaches for determining whether distributions are a return *on* or a return *of* the investment: the cumulative earnings approach and the nature of the distribution approach.

The chosen approach is an accounting policy election, to be disclosed as such under Subtopic 235-10. It should be applied consistently by the investor to all its equity method investments. An exception applies when an investor elects the nature of the distribution approach but fails to obtain the necessary information to apply it to an individual investment (see Question 9.3.50). [230-10-45-21D]

Cumulative earnings approach

Under this approach, the investor compares the cumulative distributions it receives to its cumulative equity in US GAAP earnings from the investee, as adjusted for the investor's amortization of basis differences. [230-10-45-21D]

- Cumulative distributions received up to the amount of cumulative equity in US GAAP earnings represent returns on investment classified as cash flows from **operating** activities.
- Cumulative distributions received exceeding cumulative equity in US GAAP earnings represent returns of investment classified as cash flows from **investing** activities.

Nature of the distribution approach

Under this approach, the investor classifies distributions from an investee by evaluating the facts, circumstances and nature of each distribution. We believe the investor should consider the nature of the activity that led to the distribution, including whether the distribution was generated through the investee's normal course of business, or through activities outside of its normal course of business – e.g. a liquidating dividend, or distributions funded from the sale of PP&E at the end of its useful life.

For example, if the investee has real estate operations, the investor classifies distributions received from property sales or debt refinancing as cash flows from **investing** activities, and it classifies distributions from cash generated by property operations as cash flows from **operating** activities. [230-10-45-21D]

Example 9.3.10

Cumulative earnings approach

In Year 1, ABC Corp. makes a 20% equity investment in joint venture XYZ. The investment is accounted for as an equity method investment and there is no basis difference between ABC's equity investment and its share of the underlying equity of XYZ.

The following table indicates how ABC should classify cash distributions received from XYZ, using the cumulative earnings approach.

Year	ABC's share of XYZ's ...			Operating activities	Investing activities
	... annual net income/ (loss)	... cumulative earnings (losses) since investment inception	... cash distributions		
Year 1	$ (4,000)	$(4,000)	$2,000	$ -	$2,000
Year 2	$ (2,000)	$(6,000)[1]	$2,000	$ -	$2,000
Year 3	$10,000	$ 4,000[2]	$6,000	$4,000	$2,000
Year 4	$ 5,000	$ 9,000[3]	$6,000	$5,000	$1,000

Notes:

1. $(4,000) + $(2,000).
2. $(6,000) + $10,000.
3. $4,000 + $5,000.

ABC's share of XYZ's annual net income/ (loss) and distributions are assumed numbers.

In Years 1 and 2, XYZ has accumulated losses. Therefore, the distributions are considered a return *of* investment and classified as a cash flow from **investing** activities.

In Year 3, the distributions of $6,000 received by ABC are allocated between a return *on* investment and a return *of* investment. The portion of the distribution that is considered a return *on* investment and classified as a cash flow from **operating** activities is limited to $4,000 (i.e. the cumulative earnings to date). The remaining $2,000 of the current period distribution is considered a return *of* investment and classified as a cash flow from **investing** activities.

In Year 4, the distributions of $6,000 received by ABC are also allocated between a return *on* investment and a return *of* investment. The cumulative distributions received since investment inception ($16,000), adjusted for those that were previously determined to be returns *of* investment ($6,000), exceed cumulative earnings to date ($9,000) by $1,000 ($16,000 - $6,000 - $9,000). Therefore, $1,000 of the current period distribution is considered a return *of* investment and classified as a cash flow from **investing** activities. The remaining $5,000 is classified as a cash flow from **operating** activities. In other words, the portion of the Year 4 distribution classified as a cash flow from **operating** activities is limited to $5,000, because out of the cumulative earnings to date of $9,000, $4,000 have already been classified in cash flows from **operating** activities since investment inception.

Question 9.3.40

How is the cumulative earnings approach applied in the interim statement of cash flows?

Interpretive response: We believe an investor can choose either to consider the projected annual earnings of the investee or to analyze the distributions received each quarter without considering the investee's projected earnings. The approach followed should be disclosed and consistently applied to all periods.

Regardless of the approach taken, the investor should ensure that its annual statement of cash flows reflects the appropriate classification of the distribution received.

Question 9.3.50

May an investor switch from the nature of distribution approach to the cumulative earnings approach or vice versa?

Interpretive response: Yes. However, switching approaches is a change in accounting principle. Therefore, it is subject to a preferability assessment under Topic 250 and requires retrospective adjustment of prior-period financial statements, as well as a preferability letter for SEC registrants (see section 4.6). [230-10-45-21D]

An investor should consider all facts and circumstances when determining if using the new approach is preferable, as well as the basis for conclusions to ASU 2016-15. The basis for conclusions indicates that for investors that currently apply the nature of distribution approach, applying the cumulative earnings approach might not provide financial statement users with the most useful information or the most accurate reflection of the nature of the distributions received. [ASU 2016-15.BC28]

However, an investor that applies the nature of the distribution approach but does not have the information necessary to apply that approach to an individual investment should: [230-10-45-21D]

- change to applying the cumulative earnings approach for that investment;
- account for the change as a change in accounting principle on a retrospective basis; and
- disclose the change under Topic 250 as a change in accounting principle.

The investor would not need to establish preferability under these circumstances.

10. Securitizations and other transfers of financial assets

Detailed contents

Item significantly updated in this edition: #

Example

10.3.10 Repurchase agreement with the intent to increase return on investment

10.4 Securities-lending transactions

Question

10.4.10 How does a transferor present secured borrowing cash collateral receipts?

10.1 How the standard works

Transfers of financial assets encompass a wide variety of structured sales and repurchase programs such as factoring, securitizations, securities repurchases, reverse repurchases and securities-lending transactions. Financial assets transferred commonly include trade and other receivables, loans, debt and equity securities.

Understanding the facts and circumstances, and the accounting for the transaction, is key to determining the appropriate classification in the statement of cash flows as **operating**, **investing** or **financing** activities.

Classification generally depends on the following.

— **Accounting.** Is the transfer of the assets accounted for as a sale or a secured borrowing under Topic 860 (transfers and servicing)?

— **Nature of the assets.** Are the transferred assets trade receivables or other financial assets? This is because cash receipts from the sale of goods or services are cash inflows from **operating** activities, even if the corresponding trade receivables are factored or securitized. However, collections from beneficial interests in trade receivables securitizations are cash inflows from **investing** activities.

— **Intent.** What is the intent of the parties in entering into the transaction? These transactions are often designed to accelerate cash flow collection for the transferor but may have other purposes from both transferor and transferee perspectives that may affect their respective classification.

Transfers of financial assets may also result in the disclosure of a **noncash** investing or financing activity. This typically occurs when the financial assets are exchanged for other financial assets, including beneficial interests in securitization vehicles.

10.2 Factoring and securitizations for transferors

10.2.10 Overview

Many entities choose to sell various types of financial assets to meet liquidity needs or accelerate cash flows through factoring or securitization arrangements. Financial assets sold typically include trade receivables and other long-term receivables (e.g. mortgage loans, automobile loans). Other entities purchase debt or equity securities specifically for resale through securitization arrangements.

Factoring arrangement

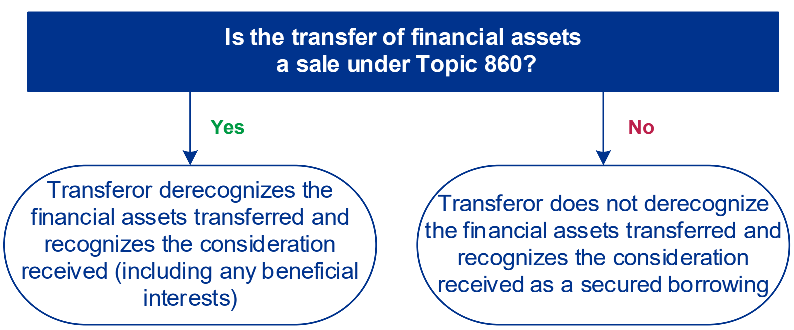
In a factoring arrangement, an entity sells its invoices, or trade receivables in their entirety, to a third-party financial company – the factor. The factor then collects payment on those invoices from the entity's customers. Factoring is sometimes referred to as trade receivable financing.

Securitization arrangement

A securitization arrangement typically involves an entity (the transferor) transferring a group of financial assets to a securitization entity (the transferee) in return for cash. The securitization entity is commonly a trust.

In certain arrangements, the transferor may not receive full cash consideration for the transferred financial assets, but rather receives a beneficial interest in the securitization in addition to cash. This beneficial interest provides the transferor with the right to receive cash in the future as the securitization entity subsequently collects on the financial assets transferred.

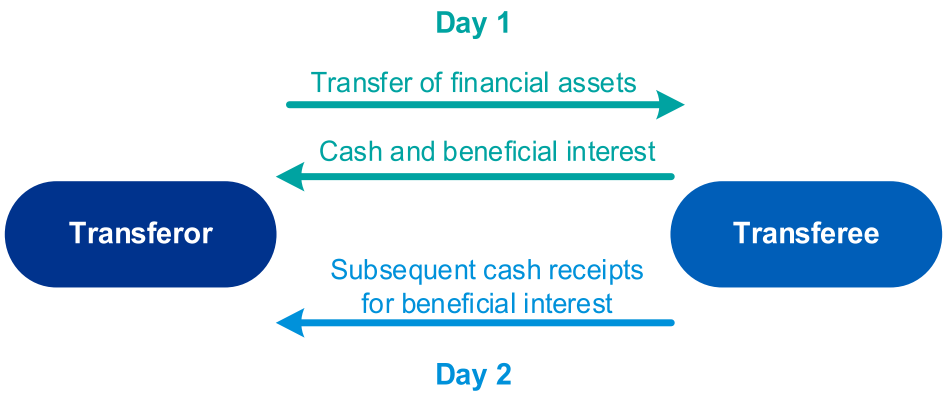
If the transferor does not consolidate the transferee under Topic 810 (consolidation), the transfer of financial assets is then evaluated under Topic 860 to determine if sale accounting has been achieved.



This section illustrates the statement of cash flows implications of such transactions from the transferor's perspective.

10.2.20 Securitizations

In this section, it is assumed that the transferor does not consolidate the transferee and that the securitization arrangement meets the criteria in Topic 860 to account for the transfer of the financial assets as a sale.



Day 1: financial assets transferred in exchange for cash and beneficial interest

Question 10.2.10

How are cash flows from the transfer of financial assets in a securitization arrangement classified?

Interpretive response: Cash receipts from the sale of trade receivables in a securitization arrangement, received at the time of the sale (Day 1 in the above chart), are classified as cash flows from **operating** activities. This is because cash receipts from the sale of goods or services, including receipts from the collection or sale of accounts receivable, are cash inflows from **operating** activities (see Question 7.2.10). [230-10-45-16(a)]

For securitizations of assets other than trade receivables, the classification of the cash received at the time of sale depends on whether the transferor originated or acquired the financial assets: [230-10-45-12, 45-16(a)]

- specifically for resale: cash flows from **operating** activities;
- for investment purposes, but subsequently sold them in a securitization arrangement: cash flows from **investing** activities.

Question 10.2.20

How is the receipt of a beneficial interest in a securitization arrangement presented?

Interpretive response: In a securitization transaction accounted for as a sale, the transferor should disclose the receipt of beneficial interests as a **noncash** investing activity (see section 4.7.20). [230-10-50-3]

Question 10.2.40

How are cash flows from/for loans classified when the loans are originated or purchased with the intent to securitize them?

Background: Banking and lending institutions (lenders) often have programs to originate or acquire loans, transfer them in securitization transactions, and retain and record a beneficial interest in the securitization when the securitization qualifies for sale accounting under Topic 860. However, the proportion of the beneficial interest to the securitized loans may vary.

Interpretive response: The classification of cash flows from/for loans when they are originated or purchased with the intent to securitize them depends on whether the lender retains a majority or a minority of the cash flows.

Lender retains majority of the cash flows

If a lender intends to securitize loans but still retain a *majority* of the cash flows through its beneficial interest, the facts and circumstances may support a conclusion that the lender is not holding those loans for sale and therefore should not classify the cash payments to purchase or originate the loans as cash outflows for operating activities.

Rather, those payments are cash outflows for **investing** activities because the lender will recharacterize its asset from a loan to a beneficial interest once it securitizes the loan and the underlying purpose of the asset pre- and post-securitization is essentially the same – the asset is meant to be held as an investment. Therefore, even before securitizing these loans, the cash receipts from borrowers after the loans are originated are classified as cash flows from **investing** activities, consistent with the guidance in chapter 11.

Once the securitization transaction has occurred, the related cash inflows upon securitization (cash receipts for loans sold) and separately the subsequent cash collections on the beneficial interest from the securitization entity continue to be classified as cash flows from **investing** activities. As discussed in Question 10.2.20, the receipt of the beneficial interest is a **noncash** investing activity; however, the receipt of cash as the beneficial interest pays down is an **investing** activity.

Lender retains minority of the cash flows

A lender may intend to retain a *minor* portion of the cash flows through a beneficial interest. In this case, the cash payments to originate or acquire the loans are cash outflows for **operating** activities (see chapter 11). Then, upon securitization, the cash receipts are classified as cash flows from **operating** activities (when the securitization entity buys the loans from the lender). However, the cash flows from the beneficial interest that are received subsequent to the securitization transaction are classified as cash flows from **investing** activities (see Question 10.2.50).

Day 2: Cash received on a beneficial interest

Question 10.2.50

How are cash flows from payments on a transferor's beneficial interest in a securitization classified?

Interpretive response: Topic 230 requires a transferor to classify cash receipts on the beneficial interests in a securitization of trade receivables as cash flows from **investing** activities. [230-10-45-12(a)]

We believe this classification generally applies to cash received on beneficial interests in other types of securitizations in addition to securitizations of trade receivables. This is consistent with the notion that the transferor's decision to hold beneficial interests is a separate investing decision, analogous to holding investment securities, because the transferor no longer controls the financial assets transferred.

Question 10.2.70

What is the unit of account to determine cash flows from a transferor's beneficial interest in a revolving securitization?

Background: In revolving securitizations, transfers of trade receivables to the securitization entity as well as cash settlements can occur with varying frequency (daily, weekly, monthly), as agreed by the parties. The cash settlement can relate to the beneficial interest asset or payment for additional trade receivables.

The amount of cash the transferor receives for trade receivables compared to the amount of beneficial interest received will depend on the amount of cash the securitization vehicle holds versus the amount of trade receivables transferred. Separately tracking cash received for trade receivables versus beneficial interests can be complicated if, for example, the transfers and payments occur daily.

Interpretive response: Topic 230 does not address the unit of account (day, week, month's cash activity) for purposes of classifying cash flows from the beneficial interests in revolving securitizations.

It is our understanding that the SEC staff believes that the unit of account should follow the frequency of transfers and settlements – i.e. daily, weekly, monthly, etc. For example, it would not be appropriate to use a monthly convention when the revolving securitization involves daily transactional activity.

10.2.30 Factoring

Question 10.2.80#

How are cash flows from factored trade receivables classified?

Interpretive response: If an entity factors trade receivables and achieves sale accounting under Topic 860, it classifies the cash proceeds from the factor as cash flows from **operating** activities. This is because cash receipts from the sale of goods or services, including receipts from the collection or sale of accounts receivable, are cash inflows from **operating** activities (see Question 7.2.10). [230-10-45-16(a)]

In some instances, a factoring arrangement may provide for a contractual delay in cash payments to the transferor. If such features result in the arrangement having characteristics of a securitization, the guidance in section 10.2.20 applies. For example, a contractual delay in cash payments to the transferor (e.g. 5% of the trade receivables balance) to mitigate the factor's credit risk related to the receivables may create an asset akin to a beneficial interest in a securitization. The timing and/or amount of expected cash flows have substantially changed, resulting in a security or receivable of a different nature than the original trade receivables. If such features do not result in the arrangement having characteristics of a securitization, the transferor classifies all proceeds from the factor as cash flows from **operating** activities, consistent with the preceding paragraph.

Recourse provisions in factoring arrangements should be analyzed carefully. In some cases, those provisions can cause the entity to fail sale accounting under Topic 860. If that occurs, see section 10.2.40 for transfers of financial assets accounted for as secured borrowings.

10.2.40 Transfer of financial assets accounted for as a secured borrowing

In this section, it is assumed that the transferor does not consolidate the transferee and that the transfer does not meet the criteria in Topic 860 to be accounted for as a sale, but rather is characterized as a secured borrowing under Topic 860.

Question 10.2.90

How are cash flows from a transfer of financial assets accounted for as a secured borrowing classified?

Interpretive response: A transfer of financial assets that fails sale accounting under Topic 860 and is accounted for as a secured borrowing is a financing transaction. Therefore, the proceeds received by the transferor are cash inflows from **financing** activities. [230-10-45-14(b)]

The transferor does not derecognize the financial assets transferred. Therefore, further cash receipts related to the assets themselves are classified consistent with those assets. For example, cash receipts from trade receivables are cash inflows from **operating** activities (see Question 7.2.10); cash receipts related to loans are classified by a lender as explained in Questions 11.2.10 to 11.2.50.

10.3 Repurchase and reverse repurchase agreements

Repurchase agreements occur when a seller-borrower (transferor) transfers financial assets to a buyer-lender (transferee) in exchange for cash and agrees to reacquire the financial assets in the future. The reacquisition price is a fixed or determinable price – generally the original sales price plus accrued interest.

A reverse repurchase agreement is when a buyer-lender buys financial assets with the agreement to resell them to the seller-borrower for a fixed or determinable price in the future.

Most repurchase and reverse repurchase agreements are accounted for as secured borrowings and lending arrangements, respectively, under Topic 860. This is because the transferor has usually retained effective control over the transferred financial assets.

Question 10.3.10

How are cash flows related to repurchase agreements and reverse repurchase agreements classified?

Interpretive response: A repurchase agreement is a collateralized borrowing (for the transferor) and a reverse repurchase agreement is a collateralized lending (for the transferee of the security). Therefore, generally any cash flows from/for the transfer and subsequent repurchase of the financial assets should be classified as:

— cash flows from **financing** activities by the transferor, in a repurchase agreement; and

— cash flows from **investing** activities by the transferee, in a reverse repurchase agreement. [860-10-40-4, 230-10-45-13(a), 230-10-45-14(b)]

However, there may be situations where this classification is not appropriate depending on the nature of the activity and the entity's core business. As such, the classification of cash flows related to repurchase and reverse repurchase agreements requires an evaluation of the specific facts and circumstances, such as the reasons for entering into the agreement. [AAG-BRD Ex 6-7]

For example, we believe an entity may classify cash flows related to both repurchase and reverse repurchase agreements as follows.

- Cash flows from **operating** activities, if the transactions are entered into in connection with the entity's principal activities – i.e. broker/dealers or other entities with similar operations.
- Cash flows from **investing** activities, if the primary purpose for which the entity entered into the transaction is to increase the return on an investment portfolio.
- Cash flows from **financing** activities, if the primary purpose of the arrangement is to provide funds to finance operations or raise working capital.

Example 10.3.10
Repurchase agreement with the intent to increase return on investment

ABC Corp. (transferor) enters into a repurchase agreement under which it transfers certain financial assets for the purpose of reinvesting the cash proceeds in another investment portfolio. ABC believes it can earn a higher return on that portfolio compared to the spread on the repurchase side of the repurchase agreement.

The funds received from the transfer of the financial assets are essentially a secured borrowing, which suggests that the cash inflows are a financing activity. However, the business purpose and substance of the transaction is to generate a higher yield on the investment portfolio. Therefore, ABC concludes that the initial cash inflow from the transfer of financial assets and the subsequent cash outflow for the repurchase of financial assets are cash flows from/for **investing** activities.

10.4 Securities-lending transactions

Securities-lending transactions occur when an investor (securities lender or transferor) lends marketable securities to a third party (securities borrower or transferee) – generally a financial institution or broker-dealer. The securities borrower typically provides cash or other securities to the lender as collateral for borrowing the securities.

Securities-lending transactions are first evaluated to determine whether they are accounted for as sales or secured borrowings under Topic 860. Many securities-lending transactions contain an agreement that the transferor repurchase or redeem the transferred securities before their maturity, which generally requires accounting for the secured lending transaction as a secured borrowing under Topic 860.

Question 10.4.10

How does a transferor present secured borrowing cash collateral receipts?

Interpretive response: Many securities-lending transactions are noncash transactions because the transferor is transferring a security for another security. Such transactions are presented as a **noncash** financing activity.

However, a transferor may receive some cash in exchange for the transferred securities. In this instance, we believe the transferor should classify the cash received as a cash flow from **financing** activities, similar to a borrowing arrangement. If the transferor subsequently repurchases the transferred securities, the cash payment is a cash outflow for **financing** activities (similar to the repayment of a borrowing).

Nevertheless, if securities-lending arrangements are part of an entity's core operations, we believe classifying the cash flows from such transactions as cash flows from **operating** activities, rather than as cash flows from financing activities, may be appropriate. This may be the case for many financial institutions and broker-dealers. [940-320-45-7]

11. Lending activities

Detailed contents

11.1 How the standard works

This chapter addresses how to classify cash flows from loans originated or purchased by financial institutions as part of their lending activities – i.e. loans that do not arise from the sale of an entity's goods or services. In this chapter, we refer to these financial institutions simply as 'lenders'.

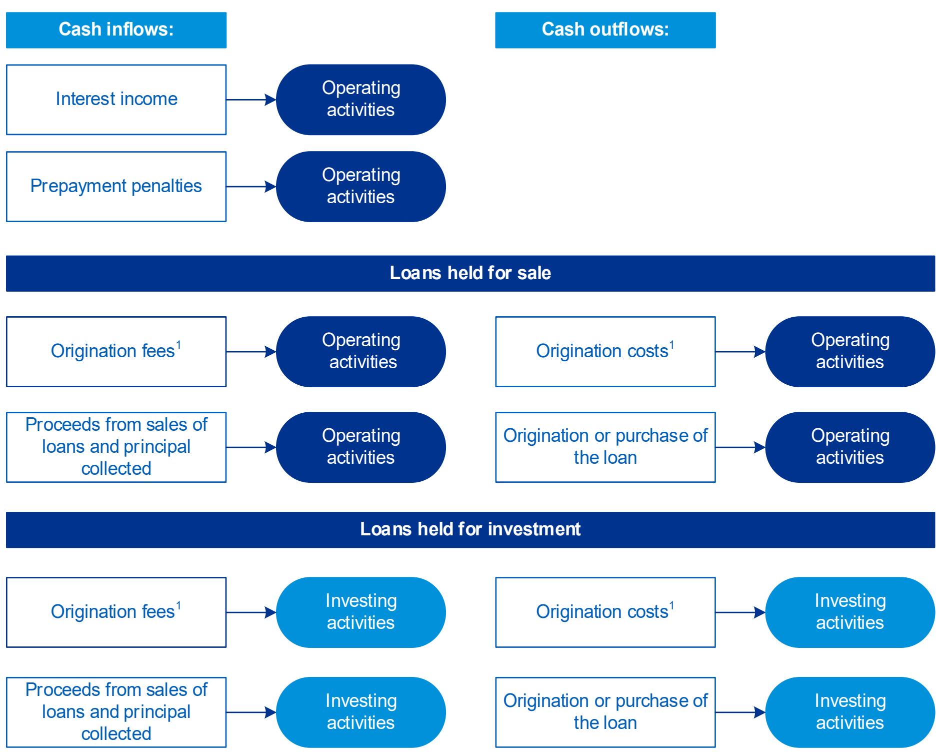
Cash flows from/for lending activities relate to the origination, purchase and sale of loans and the collection of principal on those loans. In addition to the loan itself, related cash receipts and payments usually occur for interest and prepayment penalties, and origination fees and costs.

Cash receipts from interest earned on loans are classified as cash flows from **operating** activities. Other cash flows from lending activities are typically classified based on whether the lender intends to hold the loan for sale or for investment purposes.

Chapter 7 discusses cash receipts from loans to customers that arise from the sale of an entity's goods or services, such as short- and long-term trade accounts receivable.

Chapter 10 discusses the transfer of assets (including loans) and securitizations.

The following chart summarizes some of the classification issues encountered, which are explained in more detail in this chapter.



Note:

1. Payment of origination fees and costs may be a net cash inflow or outflow.

11.2 Lending activities

Excerpt from ASC 230-10

> Classification

>> Acquisitions and Sales of Certain Securities and Loans

45-21 Some loans are similar to debt securities in a trading account in that they are originated or purchased specifically for resale and are held for short periods of time. Cash receipts and cash payments resulting from acquisitions and sales of loans also shall be classified as operating cash flows if those loans are acquired specifically for resale and are carried at fair value or at the lower of cost or fair value. For example, mortgage loans held for sale are required to be reported at the lower of cost or fair value in accordance with Topic 948.

Pending Content

Transition Date: *(P) December 16, 2019; (N) December 16, 2022* ¦ Transition Guidance: 326-10-65-1

45-21 … Cash receipts and cash payments resulting from acquisitions and sales of loans also shall be classified as operating cash flows if those loans are acquired specifically for resale and are carried at fair value or at the lower of amortized cost or fair value. For example, mortgage loans held for sale are required to be reported at the lower of amortized cost basis or fair value in accordance with Topic 948.

Excerpt from ASC 942-230

45-1 Banks, savings institutions, and credit unions are not required to report gross amounts of cash receipts and cash payments for any of the following:

a. Deposits placed with other financial institutions and withdrawals of deposits
b. Time deposits accepted and repayments of deposits
c. Loans made to customers and principal collections of loans.

45-2 When those entities constitute part of a consolidated entity, net amounts of cash receipts and cash payments for deposit or lending activities of those entities shall be reported separate from gross amounts of cash receipts and cash payments for other investing and financing activities of the consolidated entity, including those of a subsidiary of a bank, savings institution, or credit union that is not itself a bank, savings institution, or credit union.

A loan represents a contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset on the lender's balance sheet. [310-10 Glossary]

Loans that a lender has the intent and ability to hold for the foreseeable future or until maturity or payoff are not presented as held for sale, but rather are held for investment purposes. [310-10-35-47, 948-310-25-1]

Statement of cash flows classification and presentation issues for lenders are generally addressed by Topic 230. However, specific guidance exists for banks, savings institutions and credit unions in Topic 942 (depository and lending), which allows net reporting for certain loan transactions in the statement of cash flows (see Question 11.2.30). For financial institution lessors, see Question 14.3.30. [942-230-45-1(c) – 45-2]

Question 11.2.10
How does a lender classify cash flows from lending activities?

Background: A lender may either originate or purchase a loan in the normal course of business. Cash flows from/for lending activities result from:

— originating loans
— purchasing loans
— sales of loans
— collection of principal and interest on the loans.

Interpretive response: The classification of cash payments to originate or purchase loans and cash receipts from selling loans or collecting principal is generally based on whether the lender intends to hold the loan for sale or for investment purposes.

Transaction	Classification
Loan originated or purchased for **resale**	**operating** activities [230-10-45-16(a), 45-17(a), 45-21]
Loan originated or purchased for **investment**	**investing** activities [230-10-45-12(a), 45-12(e), 45-13(a)]

Cash flows from loans originated or purchased specifically for resale are classified as cash flows from **operating** activities irrespective of how the loan is measured. For example, nonmortgage and mortgage loans held for sale under Subtopic 310-10 (receivables) and Subtopic 948-310 (mortgage banking) respectively, can be measured at the lower of cost (amortized cost) or fair value, or at fair value under the fair value option in Subtopic 825-10 (financial instruments).

Cash flows from receiving interest on loans are classified as cash flows from **operating** activities regardless of whether the loans were originated or purchased for resale or investment. [230-10-45-16(b)]

Question 11.2.20
How are loan origination fees and costs classified?

Background: Lenders may receive loan origination fees and incur direct loan origination costs that are deferred and amortized over the life of the loan. The cash activity related to these amounts occurs at loan origination but affects the income statement as an adjustment of yield (interest income). Loan origination fees and related direct loan origination costs for a given loan are offset and included in the cost basis of the loan. The net amount is amortized over the life of the related loan. [310-20-35-2]

Interpretive response: We believe the cash flows from loan origination fees and for direct loan origination costs should be classified consistently with other cash activity from/for originating loans – i.e.:

- loans held for investment are cash flows from **investing** activities
- loans held for sale are cash flows from **operating** activities.

The subsequent amortization of those amounts is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2).

Question 11.2.30
Can loan originations and principal collections be presented on a net basis?

Interpretive response: Yes. Banks, savings institutions and credit unions are not required to report gross amounts of cash receipts and cash payments for loans made to customers and the related principal collections of loans (see section 3.5). [942-230-45-1(c)]

It is common practice for lenders to report only the net amount of cash payments for loans made to customers with the related principal collections for loans held for investment, but lenders may also report these amounts gross.

In a consolidated group, net amounts of cash receipts and cash payments for lending activities of banks, savings institutions and credit unions are reported separately from other investing activities of the consolidated group. [942-230-45-2]

Question 11.2.40
How does a lender classify cash flows from the sale of a loan it either originated or purchased for investment that it subsequently decides to sell?

Interpretive response: Because the lender initially classified the loan as held for investment, it should classify the cash receipts from the sale of the loan as cash flows from **investing** activities, even though it subsequently decided to sell the loan. [230-10-45-12(e)]

For loans originated or purchased with the intent to securitize the loans and retain a beneficial interest, see Question 10.2.40.

Question 11.2.50
How does a lender classify cash flows from prepayment penalties received?

Background: Lenders may receive prepayment penalties when a loan is settled before its stated maturity at the borrower's election. Prepayment penalties received are recognized in interest income by the lender. [310-20-35-9]

Interpretive response: We believe lenders should classify prepayment penalties received as cash flows from **operating** activities, as such fees represent the prepayment of interest.

We do not expect lenders to analogize to the guidance for borrowers on debt prepayment or debt extinguishment costs classification. Borrowers classify cash payments for debt prepayment or debt extinguishment costs as cash flows from **financing** activities, rather than as cash flows from operating activities (see Question 12.3.50).

Question 11.2.60
What types of noncash investing and financing activities can occur with lending activities?

Interpretive response: Various **noncash** investing and financing activities related to lending activities must be disclosed. Some common examples (not exhaustive) include: [AAG-DEP.6]

- acquiring real estate property through, or in lieu of, foreclosure of the related loan
- transferring loans to held-for-sale classification from held-for-investment, or vice versa
- originating a mortgage loan to finance the sale of real estate.

11.3 Other considerations

Question 11.3.10
How are cash flows from the FDIC as part of a loss-sharing agreement classified?

Background: An acquirer agrees to purchase certain assets, insured deposits, and other liabilities of a troubled financial institution from the FDIC, as receiver. This transaction may take the form of an asset acquisition or business combination under Topic 805 (business combinations). In connection with the acquisition, the FDIC agrees to share in future losses on certain assets (typically loans but may also include debt securities and real estate owned (REO)), including the reimbursement of certain fees and expenses for loans being foreclosed. The loss-sharing agreement (LSA) is typically accounted for as an indemnification asset under Topic 805.

Interpretive response: Topic 230 does not address how loss-sharing reimbursements received from the FDIC should be classified. As a result, there is diversity in practice. The economics of the LSA and the indemnified items are closely linked – i.e. there is a direct relationship between the cash flows from the indemnified items and the cash flows from the LSA. Therefore, we believe that the classification of the FDIC LSA reimbursements should be consistent with the cash flows for the related indemnified items.

Given the absence of guidance and the diversity in practice, we would not object to FDIC LSA reimbursements being classified as cash flows from either **operating** or **investing** activities. The approach selected should be disclosed and consistently applied.

— Topic 805 states that the accounting for the indemnification asset should mirror the accounting of the indemnified item (in this case, the loans, debt securities, or REO). For example, collections or sales of loans held for investment are **investing** activities (see Question 11.2.10). Therefore, an acquirer may classify FDIC LSA reimbursements as cash flows from **investing** activities. [230-10-45-12(a), 805-20-25-27]

— Alternatively, an acquirer may classify FDIC LSA reimbursements as cash flows from **operating** activities because changes to the FDIC indemnification asset are included in net income. This classification is consistent with the definition of **operating** activities, which 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." [230-10 Glossary, 805-20-35-4B]

Question 11.3.20

How does a bank classify cash flows from customer deposits?

Background: Deposits are a bank's largest borrowing source and include many different product types including demand deposits, savings deposits, time deposits and brokered deposits. These different product types may or may not have a duration associated with them (i.e. demand deposit vs time deposit).

Interpretive response: As a borrowing, cash receipts and cash payments for customer deposits are classified as cash flows from **financing** activities. [230-10-45-14 – 45-15]

Customer deposits of a bank are typically presented on a net basis within financing activities. This is because the bank is substantively holding cash on behalf of its customers, and knowledge of the gross receipts and payments for that account activity may not be necessary to understand the entity's financing activities. [230-10-45-8, 942-230-45-1(b)]

Banks, savings institutions, and credit unions can elect to present cash receipts and cash payments for time deposits net or gross, irrespective of their maturity. Subtopic 942-230 provides an example where the gross presentation has been elected for all time deposits. [942-230-55-2]

In a consolidated group, net amounts of cash receipts and cash payments for deposit activities of banks, savings institutions and credit unions are reported separately from other investing activities of the consolidated group. [942-230-45-2]

Question 11.3.30

How does a bank disclose restrictions on cash balances?

Interpretive response: In addition to the general requirements for restricted cash balances (see section 6.4), banks must disclose restrictions on the use or availability of certain cash balances. Examples include deposits with a Federal Reserve Bank, Federal Home Loan Bank, or correspondent financial institutions to meet reserve requirements or deposits under formal compensating balance agreements. [942-210-50-1]

12. Debt financing transactions for debtors

Detailed contents

New item added in this edition **
Item significantly updated in this edition #

Questions

12.4.10 How are cash flows for structured payable arrangements classified by the debtor?

12.4.20 Can draws and repayments on a revolving credit arrangement be presented on a net basis?

12.4.30 How are cash flows for creditor fees and third-party costs related to a revolver classified? **

Example

12.4.10 Revolver – original maturity of three years.

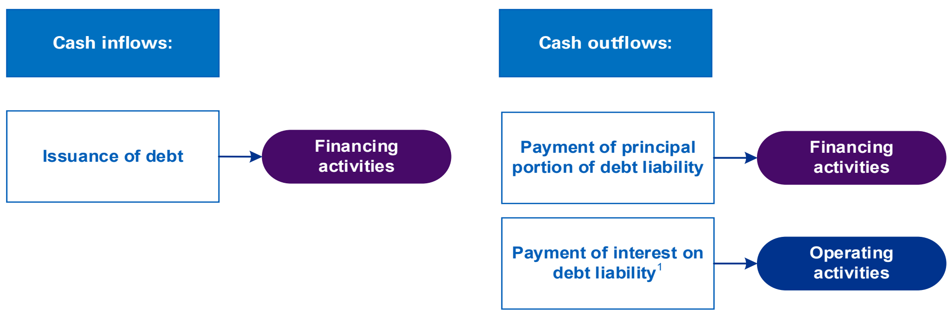
12.1 How the standard works

Debt financing results from the issuance of debt securities representing a credit relationship between the borrower (debtor) and another party (creditor). Debt financing can occur through various means and structures, such as collateralized mortgages, corporate bonds and convertible debt.

This chapter focuses on general classification issues encountered by debtors. The creditor's perspective is presented in chapter 9 (investors) and chapter 11 (lenders).

Financing can also be obtained through transactions other than debt (e.g. vendors, asset securitizations). Other financing transactions are discussed in chapter 7 (purchase of inventory), chapter 8 (purchase of PP&E and other productive assets) and chapter 10 (transfer of assets and securitizations).

The following chart summarizes some of the classification issues encountered, which are explained in more detail in this chapter.



Note:

1. Included in cash flows from **investing** activities to the extent the payments represent costs to bring another asset to the condition and location necessary for its intended use (see section 8.5.20).

Complexities arise when a debt instrument is:

- issued with conversion features or options (see Question 12.2.20);
- either a zero-coupon or deeply discounted bond (see section 12.2.40); or
- restructured (see section 12.3).

Costs and fees are often incurred in connection with the issuance, restructuring or prepayment of debt. Their classification is summarized in the following table.

Costs and fees paid for:	Paid to creditor	Paid to third party	See Question
Debt issuance	**financing** activities	**financing** activities	12.2.30
Debt modification	**financing** activities	**operating** activities	12.3.40
Debt prepayment or extinguishment	**financing** activities	**financing** activities	12.3.50
Troubled debt restructuring	**operating** activities	**operating** activities	12.3.100

Debt financing transactions can also involve the issuance of equity interests. Related classification issues are addressed in chapter 19.

12.2 Issuance and repayment of debt

12.2.10 Overview

This section applies to term debt, whether convertible or nonconvertible. Other forms of debt instruments such as structured payable and revolving credit arrangements are discussed in section 12.4. The classification of cash flows associated with term debt instruments is generally consistent across all types of debt arrangements, except for the classification of repayments made for a zero-coupon or deeply discounted bond.

Zero-coupon bonds are a type of debt security generally issued at significant discounts from their face amounts. Interest on zero-coupon bonds (i.e. accreted interest related to the debt discount) is not paid throughout the term of the bond. Instead, the borrower makes a single payment at maturity for the face amount that includes both interest and principal.

Deeply discounted bonds are debt instruments with coupon interest rates that are *insignificant* in relation to the effective interest rate of the instrument. They are economically similar to zero-coupon bonds and are treated in the same manner in the statement of cash flows.

Zero-coupon and deeply discounted bonds:	
Debt-related activity	**Classification of cash flows**
Issuance of debt – i.e. proceeds and debt issuance costs	Classification **consistent with** other debt instruments (see section 12.2.20)
Amortization of debt discounts/premiums and debt issuance costs	Classification **consistent with** other debt instruments (see section 12.2.30)
Repayments of amounts borrowed – i.e. principal and interest	Classification **different from** other debt instruments (see section 12.2.40)

12.2.20 Issuance of debt

Proceeds from issuing bonds, mortgages, notes and other short- or long-term borrowings are cash inflows from **financing** activities. [230-10-45-14(b)]

Question 12.2.10
How does the issuance of debt at a discount or premium affect the statement of cash flows?

Background: When the proceeds received by the debtor on issuance of the debt differ from the amount due at maturity, the debt instrument has been issued at a discount or premium. When a debtor issues a debt instrument at:

— a discount, the debtor receives less proceeds for the debt instrument than it will repay at maturity. As such, the debtor is paying an effective interest rate higher than the coupon specified in the debt agreement – i.e. paying the coupon amount and the discount.

— a premium, the debtor receives more proceeds than it will repay and pays an effective interest rate lower than the coupon rate.

A debt discount or premium is recorded as an adjustment (i.e. direct deduction or addition) to the carrying amount of the related debt liability. [835-30-45-1A]

Interpretive response: Any discount or premium on a debt instrument is reflected in the proceeds received from issuing the debt. Because proceeds received from issuing bonds, mortgages, notes and other short- or long-term borrowings are cash inflows from **financing** activities, we believe a discount or premium is merely part of these financing cash inflows. [230-10-45-14(b)]

Question 12.2.20#

How are proceeds from the issuance of debt with conversion features, options or warrants classified?

Background: The proceeds received from the issuance of debt with conversion features or options may need to be allocated between the debt component and other components; examples include equity instruments or embedded derivatives that are separately accounted for under Topic 470 (debt) and Subtopic 815-15 (embedded derivatives) on issuance. Debt conversion features or options that are accounted for separately as an embedded derivative from the debt host instrument result in a reduction to the carrying value of the debt component.

Similarly, in a debt instrument issued with detachable warrants, a portion of the proceeds is allocated to the warrants and recorded as paid-in capital if the warrants qualify for equity classification. [470-20-25-2]

Interpretive response: The proceeds allocated to the debt component are cash flows from **financing** activities.

We believe other proceeds received from the transaction and allocated to the conversion features or options or other freestanding instruments need to be assessed separately and classified according to their nature. This may also result in those proceeds being classified as cash flows from **financing** activities (e.g. when the features are equity-classified), but on a separate line from the debt proceeds.

For example, in a debt instrument issued with detachable warrants, the proceeds allocated to the detachable warrants and recognized as paid-in capital (if the warrants are equity-classified) are classified as cash flows from **financing** activities, consistent with other transactions with shareholders (see chapter 19). The proceeds allocated to the debt component are classified separately as cash flows from **financing** activities, consistent with other debt issuance transactions.

Question 12.2.30#
How are cash flows for debt issuance costs classified?

Background: Debt issuance costs are incremental costs paid to third parties by a debtor and directly related to issuing a debt instrument. Issuance costs include document preparation costs, registration and listing fees, and accounting and legal fees. Debt issuance costs exclude fees received from or paid to the creditor (see Question 12.2.40) or to a third-party intermediary (see Question 12.2.50). Similar to debt discounts or premiums, debt issuance costs are recorded as an adjustment (i.e. direct deduction) to the carrying amount of the related debt liability. [835-30-45-1A].

For additional information on the accounting for debt issuance costs see section 3.4 of KPMG Handbook, Debt and equity financing.

Interpretive response: Payments for debt issuance costs are cash outflows for **financing** activities. [230-10-45-15(e)]

Further, we believe cash inflows from the issuance of debt should not be presented net of cash outflows for debt issuance costs. This is because debt issuance costs are paid to parties unrelated to the creditor and are not settled net. As such, even though debt issuance costs are recorded as a direct deduction from the carrying amount of the related debt liability on the balance sheet, cash inflows from the issuance of debt and outflows for debt issuance costs should be presented as separate line items in cash flows from **financing** activities. [230-10-45-8, 45-26]

Question 12.2.40#
How are cash flows from/for creditor fees classified?

Interpretive response: We believe cash flows related to fees received from or paid to the creditor should be presented net in cash flows from **financing** activities as an adjustment to the cash inflows from the issuance of debt. This is because those costs increase or reduce the proceeds received from the creditor, similar to a debt premium or discount.

Example 12.2.10
Debt at a discount – issuance

On January 1, Year 1, ABC Corp. issues a debt instrument with a face amount of $1,000,000, to an investor for $750,000. On the same date, ABC incurs and pays issuance costs of $100,000 to parties other than the investor.

The following illustrates the effect of this transaction on ABC's Year 1 statement of cash flows.

$'000s	
Cash flows from financing activities	
Proceeds from issuance of long-term debt	$ 750
Payment of debt issuance costs	(100)
Net cash provided by (used in) financing activities	**$650**

Question 12.2.50

How are cash flows for creditor fees paid to a third-party intermediary classified?

Background: An issuance of debt may involve a third-party intermediary (e.g. investment bank) acting as an agent of the debtor and/or as a principal to the transaction, i.e. as a creditor. Careful consideration should be given to the gross versus net presentation of fees paid to such third-party intermediaries.

Interpretive response: If the third-party intermediary acts as a principal to the transaction, we believe cash outflows for fees paid to the intermediary should be presented net in cash flows from **financing** activities as a reduction of the cash inflows from the issuance of debt. This is because a principal is considered to be a party to the transaction and is treated as a creditor. If the intermediary acts as a principal, the actions of the intermediary should be viewed like those of a creditor.

If the third-party intermediary acts as an agent of the debtor in the transaction, we believe cash inflows from the issuance of debt and outflows for fees paid to the intermediary should generally be presented gross as separate line items in cash flows from **financing** activities. This is because the actions of an agent should be viewed like those of the debtor (principal).

In practice, when a third-party intermediary is involved it is typically acting as an agent of the debtor, even though it may be a partial creditor in the debt issuance. In these scenarios, all fees paid to the third-party intermediary should generally be presented gross as a separate line item in cash flows from **financing** activities.

12.2.30 Amortization of debt discounts/premiums and issuance costs

Debt discounts, premiums and issuance costs are generally amortized using the effective interest method. The amortization is reported as interest expense, unless some portion is capitalized on a qualifying asset. [835-30-35-2, 45-3]

The amortization of debt discounts, premiums and issuance costs reported as interest expense is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2). [230-10-45-2, 45-30, 45-31]

Question 12.2.60

How does negative amortization of debt affect the statement of cash flows?

Background: Negative amortization occurs when cash repayments are less than the contractual interest due in the period. As a result, the amount of interest not paid each period is added to the principal balance and effectively paid on settlement of the debt. [TQA 1300.22]

Interpretive response: Negative amortization of a debt instrument is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2). Additionally, a debtor should consider disclosing the treatment of the negative amortization. [230-10-45-2, 45-30 – 45-31, TQA 1300.22]

Question 12.2.65**

How is the amortization of debt premium presented?

Interpretive response: As explained in Question 12.2.10, we believe the total proceeds received when debt is issued at a premium are classified as a cash inflow from **financing** activities. Further, we believe the amortization of debt premium should be presented as a noncash reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2). As a result, the interest coupon paid for the period is classified as a cash outflow for **operating** activities in its entirety. This approach is illustrated in Example 12.2.12.

However, we believe it is also acceptable to classify the portion of the interest payment related to the effective interest rate as a cash outflow for **operating** activities and the excess as a cash outflow for **financing** activities.

The presentation approach selected should be disclosed and applied consistently.

Example 12.2.12**

Debt at a premium

On January 1, Year 1, ABC Corp. issues a four-year 10% coupon bond with a face amount of $1,000,000 for $1,150,000.

From Year 1 to Year 4, ABC's interest expense comprises the following:

— amortization of the $150,000 premium on the bond ($1,150,000 proceeds less $1 million face value) to interest expense using the interest method;
— cash interest based on the bond's 10% coupon rate.

On January 1, Year 5, ABC repays the $1 million face amount of the bond.

The following illustrates the effect of the bond issuance, servicing and settlement at maturity on ABC's Year 1 and Year 5 statement of cash flows, respectively, which is prepared under the indirect method. ABC has elected to present the interest coupon paid as a cash outflow from **operating** activities.

Year 1

$'000s	
Cash flows from operating activities	
Net income (loss)[1]	$ (63)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Amortization of premium	(37)
Net cash provided by (used in) operating activities[2]	**$ (100)**
Cash flows from financing activities	
Proceeds from issuance of long-term debt	1,150
Net cash provided by (used in) financing activities	**$ 1,150**

Notes:
1. Assumes interest expense of $63,000, composed of interest coupon $100,000, less premium amortization $37,000.
2. Assumes Year 1 interest coupon of $100,000 is paid in Year 1.

Year 5

$'000s	
Cash flows from financing activities	
Principal payments on long-term debt	(1,000)
Net cash provided by (used in) financing activities	**$ (1,000)**

12.2.40 Repayment of principal and interest

A debtor classifies cash flows for repayments of principal and interest as follows.

Principal portion of debt liability	**financing** activities [230-10-45-15(b)]
Interest on the debt liability	**operating** activities[1] [230-10-45-17(d)]

Note:
1. **Capitalization of interest cost:** Interest payments are classified as cash flows from **investing** activities to the extent they represent costs to bring another asset to the condition and location necessary for its intended use (see section 8.5.20).

Additionally, when a statement of cash flows is prepared under the indirect method, amounts of interest paid (net of amounts capitalized) during the period must be disclosed, either on the face of the statement of cash flows or in the notes (see section 3.3.30). [230-10-50-2]

Question 12.2.70
Should the settlement payment for a discounted bond be bifurcated between interest and principal?

Background: See Question 12.2.10 for a discussion of debt discounts.

Interpretive response: It depends on whether the coupon rate is either zero or *insignificant* in relation to the effective interest rate of the instrument – i.e. deeply discounted. Topic 230 requires bifurcation when settling zero-coupon bonds and other debt instruments that are deeply discounted. In this case, the debtor should separately classify the portion of cash payment attributable to the principal (cash flows from **financing** activities) from the portion attributable to the accreted interest related to the debt discount (cash flows from **operating** activities). [230-10-45-15(b), 45-17(d), ASU 2016-15.BC12]

In contrast, bifurcation is prohibited when settling debt instruments that are not deeply discounted. This means that the settlement amount attributable to accreted interest related to the debt discount should *not* be classified as cash flows from operating activities. Instead, the entire cash outflow related to the carrying amount of the debt should be classified as cash flows from **financing** activities. [ASU 2016-15.BC9]

We believe this approach applies whether the settlement occurs at or before maturity (see Examples 12.2.20 and 12.2.30). However, see section 12.3.40 for early settlement in a troubled debt restructuring scenario.

As noted in the chart above, settlement amounts that are payments of stated interest (i.e. accrued interest) are cash outflows from **operating** activities.

Question 12.2.90#
How does a debtor evaluate whether a coupon interest rate is insignificant in relation to the effective interest rate of the debt instrument?

Interpretive response: US GAAP does not provide guidance or bright-line thresholds on how to evaluate whether a coupon interest rate is insignificant in relation to the effective interest rate of the debt instrument. Therefore, a debtor needs to apply judgment. We believe a debtor should make this determination at inception of the instrument and not subsequently revise the determination (unless the debt instrument is modified).

Certain debt instruments typically have a coupon rate lower than their effective interest rate as a result of their accounting treatment. Such instruments should be carefully evaluated to assess whether the coupon interest rate is insignificant in relation to the effective interest rate. For example:

— payment-in-kind (PIK) instruments
— debt instruments with detachable warrants

— cash convertible debt instruments (applies only before adoption of ASU 2020-06)
— debt instruments with a beneficial conversion feature (applies only before adoption of ASU 2020-06)
— debt instruments with bifurcated embedded derivatives.

We believe the requirement to evaluate whether a coupon rate is insignificant in relation to the effective interest rate of the debt instrument should be applied broadly. This means it applies to all debt instruments that are recorded at a discount and that are economically similar to those that pay interest along with the principal payments.

In the context of this analysis, we believe the 'coupon rate' represents the periodic cash payments made over the term of the debt instrument rather than the stated interest rate. Therefore, for example, if all interest payments are deferred until maturity, the coupon rate would be determined to be zero and would likely be insignificant to the effective interest rate. See Example 12.2.40.

Also, a debtor should focus on the substance of a debt instrument as opposed to solely its form. For example, a PIK instrument may allow the debtor to pay interest by issuing additional amounts of debt having identical terms as the original PIK instrument. The form of the transaction may be such that the additional debt issued is a separate unit of account – i.e. an instrument different from the original instrument, as opposed to an addition to the outstanding balance of the original instrument. However, the substance of the transaction may be such that the coupon interest rate is insignificant in relation to the effective interest rate of the instrument regardless of whether additional debt is issued. See Example 12.2.50.

While the debtor should carefully consider all facts and circumstances, one method of assessing if a coupon interest rate is insignificant in relation to the effective interest rate of the debt instrument may be to establish a quantitative threshold. For example, a debtor may conclude on a threshold of 10% of the effective interest rate. If the debtor issues a convertible debt instrument with a bifurcated embedded derivative with a coupon rate of 3% and an effective interest rate of 9%, it would conclude that the 3% coupon rate is not insignificant compared to the effective interest rate of 9%, because it is 33% of the effective interest rate, which is greater than its established threshold of 10%.

Example 12.2.15**

Debt at a discount but not deeply discounted

On January 1, Year 1, ABC Corp. issues a four-year 3% interest-only coupon bond with a face amount of $1,000,000 for $750,000 and incurs third-party debt issuance costs of $100,000. Annual interest payments are due on January 1. The effective interest rate for the bond is 15%.

ABC determines that the coupon represents 20% (3% / 15%) of the effective interest rate and concludes that the coupon is not insignificant in relation to the effective interest rate and therefore the bond is not deeply discounted.

In Year 1, ABC classifies the $750,000 of proceeds from issuing the 3% coupon bond as a cash inflow from **financing** activities and the $100,000 payment for debt issuance costs as a separate cash outflow for **financing** activities (see Example 12.2.10).

From Year 1 to Year 4, ABC's interest expense comprises the following:

— accretion of the $250,000 discount on the bond ($1 million face value less $750,000 cash proceeds) to interest expense using the interest method;
— accretion of the $100,000 of debt issuance costs to interest expense over the same period;
— cash interest based on the bond's 3% coupon rate.

The accretion of the bond discount and amortization of the issuance costs are noncash expenses. Therefore, each reporting period ABC presents those amounts as reconciling items in the reconciliation of net income to net cash flows from **operating** activities (see section 3.2).

On January 1, Year 5, on settlement of the 3% coupon bond, ABC repays the $1 million face amount of the bond and the last interest payment due. Because the bond is not deeply discounted, ABC classifies the entire principal payment as a cash flow from **financing** activities. It does not bifurcate the $250,000 portion of the payment attributable to the accreted interest related to the debt discount, from the original carrying amount of $750,000.

The following illustrates the effect of the bond settlement at maturity on ABC's Year 5 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from financing activities	
Principal payments on long-term debt	$ (1,000)
Net cash provided by (used in) financing activities	**$ (1,000)**

Example 12.2.20
Zero-coupon bond – settlement at maturity

On January 1, Year 1, ABC Corp. issues a four-year zero-coupon bond with a face amount of $1 million for $750,000 and incurs debt issuance costs of $100,000.

In Year 1, ABC classifies the $750,000 of proceeds from issuing the zero-coupon bond as a cash flow from **financing** activities and the $100,000 payment for debt issuance costs as a separate cash flow from **financing** activities (see Example 12.2.10).

From Year 1 to Year 4, ABC's interest expense comprises the following:

— accretion of the $250,000 discount on the bond ($1 million face value less $750,000 cash proceeds) to interest expense using the interest method.
— amortization of the $100,000 of debt issuance costs to interest expense over the same period.

The accretion of the bond discount and amortization of the issuance costs are noncash expenses. Therefore, each reporting period ABC presents those amounts as reconciling items in the reconciliation of net income to net cash flows from operating activities (see section 3.2).

On January 1, Year 5, on settlement of the zero-coupon bond, ABC repays the $1 million face amount of the bond. As such, ABC classifies the payment for the original carrying amount of $750,000 as a cash flow from **financing** activities. The $250,000 portion of the payment attributable to the accreted interest related to the debt discount is a cash flow from **operating** activities.

The following illustrates the effect of the bond settlement at maturity on ABC's Year 5 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$ -
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Interest paid on zero-coupon bond[1]	$ (250)
Net cash provided by (used in) operating activities	**(250)**
Cash flows from financing activities	
Principal payments on long-term debt[2]	(750)
Net cash provided by (used in) financing activities	**$ (750)**

Notes:
1. Portion of payment attributable to the accreted interest.
2. Portion of payment attributable to the principal.

Example 12.2.30
Zero-coupon bond – repurchase before maturity

Assume the same fact pattern as in Example 12.2.20, except that ABC repurchases the bond for $800,000 before its maturity.

At that time, the carrying amount of the bond is $790,000, calculated as follows.

$'000s	
Original carrying amount	$750
Unamortized debt issuance costs	(60)
Accreted interest	100
Carrying amount of bond	**$790**

Consistent with Example 12.2.20, ABC separately classifies the portion of cash payment attributable to the principal from the portion attributable to the accreted interest. At the time of repurchase, the accreted interest related to the debt discount is $100,000. Therefore, $100,000 is a cash outflow for **operating** activities, and the balance of the payment of $700,000 is a cash outflow for **financing** activities.

The following illustrates the effect of the bond repurchase on ABC's statement of cash flows, which is prepared under the indirect method. Other effects related to accreting the bond discount and amortizing the issuance costs, as illustrated in Example 12.2.20, are ignored.

$'000s	
Cash flows from operating activities	
Net income (loss)[1]	$ (10)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Loss on extinguishment of debt[1]	10
Interest paid on zero-coupon bond	(100)
Net cash provided by (used in) operating activities	**(100)**
Cash flows from financing activities	
Principal payments on long-term debt[2]	(700)
Net cash provided by (used in) financing activities	**$(700)**

Notes:

1. Payment of $800 less carrying amount of bond of $790.
2. Repurchase amount of $800 less interest component included in cash flows from operating activities of $(100).

Example 12.2.40
Settlement of debt and accrued interest at maturity

On January 1, Year 1, ABC Corp. borrows $100 million with a stated interest rate of 5% that matures in three years. Interest accrues monthly on the outstanding principal and unpaid interest balance. The unpaid principal and interest is settled in cash on maturity.

In Year 1, ABC classifies $100 million as a cash inflow from **financing** activities.

During Years 1 to 3, ABC records the interest accrued over the period as interest expense and presents it as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2). This is because the interest expense is noncash in the current period.

At the end of Year 3, on maturity, the settlement payment is bifurcated between principal (cash flows from **financing** activities) and interest (cash flows from **operating** activities). This is because no interest is paid over the course of the debt's term, so the coupon rate is in substance insignificant in relation to the effective interest rate. The settlement payment effectively extinguishes the principal balance of the debt and the accrued interest balance on the debt.

Example 12.2.50
Paid-in-kind (PIK) debt instruments

On January 1, Year 1, ABC Corp. borrows $100 million with a stated interest rate of 5% that matures in three years. The interest is paid-in-kind such that it is accrued and added to the unpaid principal balance on a monthly basis. By contrast to the fact pattern in Example 12.2.40, the accrued interest legally creates new units of debt with similar terms to the original borrowing. The unpaid principal balance is settled in cash on maturity.

In Year 1, ABC classifies $100 million as a cash inflow from **financing** activities.

During Years 1 to 3, ABC records the amount of interest added to the principal balance as interest expense and presents it as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2). This is because the interest expense is noncash in the current period.

At the end of Year 3, on maturity, ABC bifurcates the portion of the settlement payment attributed to the principal (cash flows from **financing** activities) from the portion attributed to the accrued interest (cash flows from **operating** activities). By contrast to the fact pattern in Example 12.2.40, ABC has no accrued interest balance recorded on balance sheet at maturity. However, bifurcation of the settlement payment is nevertheless required because no interest is paid over the course of the debt's term, so the coupon rate is in substance insignificant in relation to the effective interest rate. The substance of this arrangement is no different from a zero-coupon bond.

Example 12.2.60
PIK construction loan

On January 1, Year 1, ABC Corp. borrows $100 million with a stated interest rate of 5%. ABC uses the proceeds to finance the construction of a new production facility, which is expected to take two years to complete. The interest is paid-in-kind during the course of the construction, such that it is accrued and added to the unpaid principal balance on a monthly basis. The interest cost recorded during the construction of the facility in Year 1 and Year 2 qualifies for capitalization under Subtopic 835-20 and is included in the cost of the asset.

On completing construction, ABC refinances the unpaid principal balance (including the first two-year PIK interest of $10.5 million) into a new debt agreement with the same lender. ABC evaluates whether the refinancing represents a modification or extinguishment of the previous debt under Subtopic 470-50 and concludes that it is treated as a debt extinguishment (see section 12.3.10).

In Year 1, ABC classifies $100 million as a cash inflow from **financing** activities.

In Year 1 and 2 (i.e. during the construction period), the amount of unpaid interest capitalized as part of the asset is disclosed as a **noncash** investing transaction (see section 4.7.20).

At the end of Year 2, on refinancing, ABC discloses the amount of debt extinguished and new debt issued of $110.5 million as a **noncash** financing activity (see Question 12.3.20).

In Year 3 onwards, ABC classifies the interest paid on the new debt of $110.5 million as cash flows from **operating** activities. The repayment of the $110.5 million principal over the course of the agreement is classified as cash flows from **financing** activities.

In this example, the repayment of the PIK interest of $10.5 million should not be bifurcated as an interest payment but rather is an outflow from **financing** activities because the refinancing is treated as a debt extinguishment. Consequently, the accrued interest balance is now like a principal balance on the new financing. An operating cash flow presentation would be inappropriate because there is no income statement effect when the 'interest' element that is now embedded in the new principal amount is incurred or repaid. An investing cash flow presentation would also be inappropriate because the PIK interest was already presented as a noncash investing activity during the construction period.

12.3 Debt restructuring

12.3.10 Overview

The terms of a debt instrument may be modified at or before maturity. For example, a debtor and creditor may agree to restructure an outstanding debt by revising its terms or by exchanging one debt instrument for another. A debtor can also renew or prepay a debt instrument.

The resulting cash flows can be affected by changes in principal amounts, interest rates or maturity. They can also be affected by fees exchanged between the debtor and creditor or by additional fees paid to third parties.

Several Subtopics apply to the accounting for debt restructuring.

— Subtopic 405-20 (extinguishment of liabilities) provides the general conditions to be met for a debtor to derecognize a liability, and defines which transactions are accounted for as extinguishments.

— Subtopic 470-50 (modifications and extinguishments) explains that an exchange of debt instruments with substantially different terms, in a nontroubled debt situation, is economically similar to a debt extinguishment and should be accounted for as such. However, if the terms of the restructured debt instrument are not substantially different, the transaction is accounted for as a debt modification.

— Subtopic 470-60 (troubled debt restructurings by debtors) addresses when and how a debtor should account for a trouble debt restructuring (TDR). A TDR occurs when a creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. The analysis is performed on a creditor-by-creditor basis.

Understanding whether a debt restructuring triggers debt extinguishment or TDR accounting, or is simply a modification, is key to determining the accounting for the transaction, and also affects how the related cash flows are presented in the statement of cash flows.

For revolving credit arrangements and changes thereto, see section 12.4.20.

Question 12.3.10#

How are cash flows for debt restructuring classified?

Background: A debt restructuring may result in a debtor receiving additional proceeds (issuance of additional debt) or making additional payments (to reduce the principal amount of the debt). A debtor will also generally incur fees to the creditor and/or a third party as a result of a debt restructuring.

Interpretive response:

Cash proceeds received by debtor

Consistent with the guidance on the issuance of debt (see section 12.2), a debtor classifies any new cash proceeds received as a result of a restructuring as cash flows from **financing** activities. This can include either additional proceeds from an existing creditor or, in the case of a loan syndicate, new proceeds from a new creditor (i.e. a new member of the syndicate). [230-10-45-14(b)]

See Question 12.3.20 and Example 12.3.05 for additional presentation and disclosure considerations regarding the refinanced amount that does not result in additional proceeds for the debtor.

Payments of accrued interest or principal to existing creditor

A debtor classifies any payment to existing creditors for accrued interest and principal, or reacquisition of the debt instrument, as a result of the restructuring in a manner consistent with the guidance in section 12.2.40, unless the restructuring is a TDR (see section 12.3.40).

Payment of fees to creditors or third parties

How the debtor classifies fees paid to the creditor or third parties in relation to the restructuring depends on whether the transaction is accounted for as a debt modification (see Question 12.3.40), a debt extinguishment (see Question 12.3.50) or a TDR (see Question 12.3.100).

Question 12.3.20#

How does a nontroubled debt restructuring with no change in principal affect the debtor's statement of cash flows?

Background: A debt restructuring may result in no immediate principal repayment or additional debt issuance (i.e. the principal amount is unchanged) although other terms may be renegotiated or there may be a change in creditor(s). Provided the restructuring is not a TDR, the debtor either:

— assesses whether debt extinguishment accounting applies under Subtopic 405-20; or
— performs a cash flow test under Subtopic 470-50 to assess whether the changes in terms are substantial and therefore debt extinguishment accounting applies.

If debt extinguishment does not apply, then the restructuring is merely a modification of the debt. This assessment is performed on a creditor-by-creditor basis, if applicable.

Interpretive response: Although a debt restructuring may result in no change to the principal amount due by the debtor, we believe the statement of cash flows may be affected as follows.

Change in creditor[1]	Debt restructuring accounted for as:	Statement of cash flows impact
✗	**Modification**	No effect
✗	**Extinguishment**	Disclose the amount of principal extinguished and new debt issued as a **noncash** financing activity
✓	**Extinguishment**	Classify the amount of principal extinguished and new debt issued as cash outflow for and inflow from **financing** activities, respectively. This is true whether actual or constructive cash flows (see section 4.7.10) are exchanged by the debtor. See Example 12.3.05.

Note:

1. Because transactions between creditors are not reflected on the debtor's books and records, and because Subtopic 470-50 requires debt modifications to be analyzed on a creditor-by-creditor basis, it is not possible to account for a debt restructuring as a modification if there is a change in creditors. Instead, such a transaction is treated as an extinguishment.

Example 12.3.05**
Refinancing treated as debt extinguishment

ABC Corp. has an existing secured term loan with Bank A (existing creditor) that it accounts for as long-term debt. The loan principal outstanding is $25 million and matures in five years with a variable interest rate based on SOFR plus a spread, currently set at 5.5%.

On March 31, Year 2, ABC refinances the loan to a new lender Bank B (new creditor) because it offers a fixed interest rate of 5% with a seven-year maturity. The principal amount is increased to $30 million and the loan remains secured by collateral. Bank B pays $5 million to ABC then pays off Bank A directly for $25 million as part of issuing the new secured term loan. The transaction is accounted for as a debt extinguishment under Topic 470.

This example does not address the accounting and presentation of extinguishment costs for simplicity purposes.

Applying the approach discussed in Question 12.3.20, ABC notes that the transaction involves a change in creditor and is accounted for as an extinguishment. It classifies the amount of principal extinguished and new debt issued as a cash outflow for and inflow from **financing** activities, respectively. The following illustrates the effect of this transaction on ABC's Year 2 statement of cash flows.

$'000s	
Cash flows from financing activities	
Proceeds from issuance of long-term debt	$30,000
Principal payments on long-term debt	(25,000)
Net cash provided by (used in) financing activities	**$5,000**

Question 12.3.30
How does the rollover of a loan affect the debtor's statement of cash flows?

Background: Lenders may roll over commercial loans at maturity, meaning that the lender essentially renews the loan with the debtor on the same terms.

Interpretive response: A rollover of a commercial loan does not generally result in an actual exchange of cash between the debtor and the lender for the amounts borrowed. Therefore, such transactions should not be presented in the statement of cash flows.

However, we believe the disclosure of a noncash financing transaction may be required if the renewal is accounted for as an extinguishment of the original debt (see Question 12.3.20).

12.3.20 Debt modification

If the changes to a debt instrument do not substantially change the present value of the cash flows as compared to the original instrument, the restructuring is accounted for as a debt modification. [470-50-40-10]

Question 12.3.40
How are fees paid to the creditor of the modified debt and other fees paid to third parties in a debt modification classified?

Background: When a debt restructuring is considered a debt modification for accounting purposes, any new fees paid by the debtor to the creditor of the modified debt are capitalized as a reduction of the carrying amount of the debt. These amounts are then amortized as interest expense over the remaining term of the modified debt instrument using the interest method. Conversely, fees paid to third parties are expensed as incurred. [470-50-40-17(b), 40-18(b)]

Interpretive response: For debt modifications, we believe the payment of fees to the creditor of the modified debt by the debtor are cash outflows from **financing** activities. For guidance on how the amortization of capitalized fees affects the statement of cash flows, see section 12.2.30. [230-10-45-14(b)]

However, we believe fees paid to third parties by the debtor are cash outflows from **operating** activities, unless the fees relate to a debt prepayment (see Question 12.3.50). This treatment is consistent with the definition of **operating** activities, which states, "[c]ash outflows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income." [230-10-45-15(e), 230-10 Glossary]

12.3.30 Debt extinguishment

A debtor derecognizes a liability if and only if the liability has been extinguished, meaning that the debtor is legally relieved from its obligation to the creditor. [405-20-40-1]

A restructuring of a debt instrument is accounted for as an extinguishment of the original debt instrument (and issuance of a new debt instrument) if the changes to a debt instrument result in a substantial change in the present value of the cash flows as compared to the original instrument – i.e. 10% or greater. [470-50-40-6, 40-10]

For discussion about the extinguishment of debt in a business combination, see Question 18.5.20.

Question 12.3.50

How are cash flows for debt prepayment or debt extinguishment costs classified?

Background: Debt prepayment or debt extinguishment costs are paid by a debtor in connection with settling a debt financing arrangement before the maturity date. The amount of the prepayment penalty can be based on a number of factors, including an approximation of the interest that will not be paid as a result of the early settlement.

Interpretive response: Topic 230 requires that any debt prepayment or debt extinguishment costs are classified as cash flows from **financing** activities. Debt extinguishment costs include third-party costs, premiums paid and other fees paid to creditors that are directly related to the debt prepayment or extinguishment. However, debt extinguishment costs exclude accrued interest, which is classified as a cash flow from **operating** activities. [230-10-45-15(g), ASU 2016-15.BC7]

Question 12.3.70

How does a debt extinguishment gain or loss affect the statement of cash flows?

Background: The extinguishment of debt can result in the recognition of a gain or loss. The gain or loss is calculated as the difference between the net carrying amount of the extinguished debt instrument and its reacquisition price. If a debt restructuring is accounted for as a debt extinguishment, the gain or loss is calculated as the difference between the net carrying amount of the extinguished debt instrument and the fair value of the new debt. [470-50-40-2, 40-13]

The reacquisition price is the amount paid on extinguishment, including any call premium and costs of reacquisition and the fair value of any other consideration provided to the old creditor – e.g. an equity interest.

The reacquisition price may constitute payment for principal, accrued interest, fees and penalties. Previously deferred fees and costs for existing debt are part of the net carrying amount of the extinguished debt and therefore included in calculating the gain or loss on extinguishment. [470-50-40-2]

Interpretive response: Any extinguishment gain or loss is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2).

Actual payments for accrued interest and principal made on reacquiring the debt instrument should be classified consistent with the guidance in section 12.2.40, unless the restructuring is a TDR (see section 12.3.40).

Payments for extinguishment fees and penalties should be classified as explained in Question 12.3.50.

Question 12.3.75**

How does the extinguishment of debt through the issuance of equity securities affect the statement of cash flows?

Background: Debt may be settled in part or in full through the issuance of common stock or other equity securities instead of remitting cash. This may happen because the debt was issued with conversion features or options. Question 12.2.20 addresses how to classify proceeds from convertible debt. See chapters 10 and 10A of KPMG Handbook, Debt and equity financing, for additional guidance on the accounting for convertible instruments.

Interpretive response: The debtor discloses the amount of the debt extinguished through the issuance of equity securities as a **noncash** financing transaction (see section 4.7.20). However, any cash payment made as part of the transaction is reported in the statement of cash flows following the guidance explained in Question 12.3.10. [230-10-50-4 – 50-5]

Question 12.3.80

How does the extinguishment of debt through the transfer of property affect the statement of cash flows?

Background: Debt may be secured by collateral that provides security to the creditor if the debtor defaults on the loan. For example, a loan for the purchase of a building may be secured by the building itself. If a default occurs, the creditor can demand the collateral be transferred to it. However, the transfer does not result in extinguishment of the debt unless the debtor is legally released from the obligation and the criteria in Topic 405 (liabilities) for extinguishment are met.

Interpretive response: We believe the statement of cash flows presentation of debt extinguishment through the transfer of property may vary based on which party initiates the transaction and how it is structured.

For example, a debtor may sell a piece of property to obtain the cash needed to pay off a loan – i.e. the creditor does not take possession of the property. In this case, the debtor presents the two transactions as a typical cash sale of PP&E and other productive assets (i.e. investing cash inflow – see section 8.4) followed by a debt repayment (i.e. financing cash outflow – see section 12.2.40).

Alternatively, a creditor may foreclose on a debtor's collateralized loan and seize the collateral. In this case, no cash is typically exchanged. The debtor discloses the extinguishment as a **noncash** investing and financing transaction (see section 4.7.20). Moreover, it reports any gain or loss on the extinguishment of debt as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2). [230-10-50-3]

There are two steps to determine the gain or loss resulting from the transaction.

— First, a gain or loss is recognized on disposal of the asset by comparing the fair value of the asset to its carrying amount.

— Second, a gain or loss resulting from extinguishment of the debt is recognized as the difference between the fair value of the asset transferred and the carrying amount of the debt.

Example 12.3.10

Extinguishment of debt through transfer of property

ABC Corp. is in default of a loan it has with Bank, so Bank forecloses on the collateral securing the loan. The loan is collateralized by a building with a fair value of $850,000. On the date of foreclosure, the carrying amounts of the building and the loan are $800,000 and $1 million, respectively.

ABC transfers the building to Bank to satisfy its obligation. As a result, ABC is legally released from the obligation and the transfer has met all of the criteria for extinguishment of a liability. As a result of the transfer, ABC recognizes a gain on disposal of the building of $50,000 ($850,000 fair value less $800,000 carrying amount) and a gain on extinguishment of debt of $150,000 ($1 million carrying amount of the debt less $850,000 fair value of the building).

The following illustrates the effect of this transaction on ABC's statement of cash flows, which is prepared under the indirect method, including the supplemental schedule of **noncash** investing and financing activities.

$'000s	
Cash flows from operating activities	
Net income (loss)	$ 200
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Gain on extinguishment of debt	(150)
Gain on disposal of PP&E	(50)
Net cash provided by (used in) operating activities	**$ -**
Supplemental schedule of noncash investing and financing activities	
Transfer of real property to extinguish debt	$ 800

12.3.40 Troubled debt restructuring

A debt restructuring is considered troubled if a creditor grants concessions on its debt obligations that it would not otherwise grant, but for the fact that the debtor is experiencing financial difficulties. [470-60-15-5]

The effect of a troubled debt restructuring (TDR) in the statement of cash flows depends on the accounting treatment of the transaction. The accounting treatment of a TDR depends on the substance of the transaction. [470-60-35-1 – 35-5]

Structure of the TDR	Accounting treatment	Classification
Scenario 1: Debtor transfers assets to creditor to fully settle a debt	Gain on restructuring of debt recognized to the extent the carrying amount of the debt exceeds the fair value of the asset(s) transferred. Gain or loss on transfer of assets recognized for the difference between the fair value and the carrying amount of the assets.	Extinguishment disclosed as a **noncash** investing and financing transaction. See Question 12.3.80
Scenario 2: Debtor grants equity to creditor to fully settle a debt	Gain on restructuring of debt recognized to the extent the carrying amount of the debt exceeds the fair value of the equity interests transferred.	Extinguishment disclosed as a **noncash** financing transaction. [230-10-50-4]
Scenario 3: TDR involves only a modification of	**A. Debt carrying amount is greater than the total future payments** Carrying amount of debt adjusted to the amount of total future cash payments.	See Question 12.3.90

Structure of the TDR	Accounting treatment	Classification
terms – i.e. no transfer of assets or equity	Gain on restructuring of debt recognized.	
	B. Debt carrying amount less than or equal to total future payments Carrying amount of the debt is not adjusted. The effects of changes to amounts and/or timing of future cash payments are reflected in future periods, through the effective interest rate. No gain or loss recognized.	

Question 12.3.90

How are post-TDR payments classified?

Background: In Scenario 3A above, at the date of modification the debt carrying amount in a TDR is adjusted to the gross future payments of the modified debt. In that scenario, future cash payments, although legally designated as interest payments (or a combination of interest and principal payments), are generally accounted for as a reduction of the carrying amount of the debt. Therefore, no interest expense is recognized. [470-60-35-6]

In Scenario 3B above, at the date of modification the debt carrying amount in a TDR is adjusted to the gross future payments of the modified debt, which will be less than or equal to total future payments. In that scenario, a portion of the future cash payments, although legally designated as interest payments (or a combination of interest and principal payments), may be accounted for as a reduction of the carrying amount of the debt and interest expense but in amounts different from their legal designation. This is because interest expense is computed so that a constant effective interest rate is applied to the carrying amount of the debt at the beginning of each period between restructuring and maturity, consistent with Subtopic 835-30 (imputation of interest). [470-60-35-5]

Interpretive response: When payments that are legally designated as interest on a TDR are accounted for as a reduction of the debt carrying amount as opposed to interest expense, we believe these payments should be classified as cash flows from **financing** activities. This is consistent with the classification for repayment of principal (see section 12.2.40).

Additionally, we believe these payments are not disclosed as interest paid in the supplemental disclosures for the statement of cash flows (see section 3.3.30). Instead, only the portion of the payments that is accounted for as interest cost is disclosed as interest paid.

Example 12.3.20

TDR – debt carrying amount exceeds total future payments post TDR (Scenario 3A)

ABC Corp. had old debt with a carrying amount of $2 million and a coupon rate of 8%. Under the old debt arrangement, interest was paid quarterly, and the principal was due at December 31, Year 2.

On December 31, Year 1, ABC exchanges the old debt for new debt with a principal amount of $1.5 million and a coupon rate of 9%. Interest payments are due quarterly, and the principal is due at December 31, Year 3.

The undiscounted future cash flows of the new debt arrangement are as follows, for each quarter ended.

Year 2				Year 3				Total
3/31	6/30	9/30	12/31	3/31	6/30	9/30	12/31	
$33,750[1]	$33,750	$33,750	$33,750	$33,750	$33,750	$33,750	$1,533,750	$1,770,000

Note:

1. $1,500,000 × 9% / 4 = $33,750.

Assume the transaction meets the criteria to be accounted for as a TDR.

ABC determines that the undiscounted future cash flows under the terms of the new debt are $1.77 million and records a gain of $230,000 (carrying amount of old debt of $2 million less undiscounted future cash flows related to new debt of $1.77 million) on December 31, Year 1.

The following illustrates the effect of this transaction on ABC's Year 1 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$230
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Gain on extinguishment of debt	(230)
Net cash provided by (used in) operating activities	**$ -**

Going forward, ABC will not recognize interest expense on the new debt for accounting purposes. Instead, all payments (whether legally designated as interest or principal) will decrease the new debt balance.

The following illustrates the effect of this transaction on ABC's Year 2 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$ -
Net cash provided by (used in) operating activities	**-**
Cash flows from financing activities	
Principal payments on long-term debt[1]	(135)
Net cash provided by (used in) financing activities	**$(135)**

Note:
1. $33,750 × 4 = $135,000.

Question 12.3.100
How are fees paid as part of a TDR classified?

Background: Legal fees and other direct costs the debtor incurs to execute a TDR are expensed at the time of the TDR, unless recorded as a reduction of equity when equity interests have been granted. If a gain on restructuring of debt is recognized, the fee is deducted from the gain. [470-60-35-12]

Interpretive response: We believe payments for legal fees and other direct costs that the debtor expenses as part of a TDR should be classified as cash flows from **operating** activities.

This classification is consistent with the definition of **operating** activities, which states, "[c]ash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income." [230-10 Glossary]

For a discussion of fees incurred in connection with transactions with shareholders, see chapter 19.

12.4 Other financing arrangements

12.4.10 Structured payable arrangements

Structured payable arrangements generally involve a debtor negotiating extended payment terms with one or more vendors (e.g. going from 30 days to 60 days), while also entering into a payables processing agreement with a paying agent (e.g. a lender or other financial institution) that will make payments to vendors on the debtor's behalf.

Under the terms of the payables processing agreement, the debtor provides invoice information to the paying agent, including the total due, payment due date, and other terms negotiated between the debtor and the vendor. The paying agent then remits invoice payments to vendors based on the debtor's instructions. The paying agent may use the invoice information to identify the debtor's vendors and attempt to enter into a factoring arrangement in which the paying agent agrees to purchase from the vendor amounts owed by the debtor.

These arrangements are commonly referred to as structured payable, reverse factoring, supply chain financing, supplier financing and vendor financing arrangements.

For a discussion of working capital accounts, see chapter 7. For capital expenditures financed by a third-party lender see section 8.3.

Question 12.4.10

How are cash flows for structured payable arrangements classified by the debtor?

Background: There is no specific guidance in US GAAP that addresses the accounting for trade accounts payable affected by a structured payable arrangement. Generally, transactions among creditors (e.g. a debt instrument transferred from one debt holder to another) are disregarded for accounting purposes by the debtor. However, a thorough analysis of all the facts and circumstances specific to the individual transaction is necessary to determine the appropriate accounting for trade accounts payable affected by a structured payable arrangement.

For example, the SEC staff believes the substance of a structured payable arrangement may equate to the debtor obtaining financing from a creditor to pay amounts due to its vendors. In these circumstances, the SEC staff has concluded that, under paragraph 405-20-40-1, the debtor's liability was extinguished when the paying agent remitted payment to the vendor, and that the liability should be reflected as an amount payable to a lender for borrowings rather than as an amount payable to a trade creditor under Regulation S-X 5-02.19. [2003 AICPA Conf, 2004 AICPA Conf]

Interpretive response: If a debtor concludes that it has obtained financing from a creditor to pay amounts due to its vendors, we believe the debtor should present constructive cash flows when the paying agent remits payment to the vendor, even though the purchase occurred without the debtor physically delivering cash to the vendor (see section 4.7.10).

These constructive cash flows should be presented as:

— a cash inflow from **financing** activities to reflect the borrowing obtained from the paying agent; and
— a cash outflow for **operating** activities to reflect the payment of the trade payable.

In substance, the paying agent paid the vendor for the invoice on behalf of the debtor using amounts the debtor borrowed from the paying agent. This presentation is further supported by the fact that the trade accounts payable would be reclassified on the balance sheet to a bank or similar borrowing.

Subsequent payments to the paying agent to settle the amount owed are then classified as cash flows from **financing** activities.

However, if the debtor can demonstrate that it has not obtained financing from a creditor to pay amounts due to its vendors, this transaction does not affect the statement of cash flows.

See section 3.7.70 of KPMG Handbook, Debt and equity financing, for further guidance on structured payable arrangements, including required disclosures.

12.4.20 Revolving credit arrangements

A line-of-credit or revolving-debt arrangement (revolver) is an agreement that provides the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and to then reborrow under the same contract. The arrangement may include both (1) amounts drawn by the debtor (a debt instrument), which may be subject to an underlying note with a specified maturity date, and (2) a commitment by the creditor to make additional amounts available to the debtor under predefined terms (a loan commitment). [470-50 Glossary]

Question 12.4.20

Can draws and repayments on a revolving credit arrangement be presented on a net basis?

Interpretive response: It depends on the repayment terms. As noted in section 3.5, items that qualify for net reporting must have quick turnover, occur in large volumes and have short maturities (i.e. less than 90 days). Draws and repayments on a revolver qualify for net reporting only if the revolver (the facility itself or the underlying note if any) is either repayable on demand or has an original maturity of three months or less.

Conversely, draws and repayments must be reported in the statement of cash flows on a gross basis when the revolver (the facility itself or the underlying note if any) has an original maturity longer than three months. [230-10-45-7 – 45-9]

A revolver is repayable on demand if the lender has the ability to request repayment at any time. A right for the borrower to early repay does not make the revolver repayable on demand.

For classification of the interest component included in the repayment of the amounts borrowed, see Question 12.2.70.

Example 12.4.10

Revolver – original maturity of three years

ABC Corp. enters into a three-year revolving facility with a maximum drawing capacity of $10 million. The bank does not have the ability to demand repayment before the maturity date. ABC does not enter into separate promissory notes for each draw. During the reporting period, ABC draws and repays $10 million five times.

ABC concludes that the draws and repayments do not qualify for net reporting because the revolver is not repayable on demand and the maturity is more than three months. It presents a $50 million cash inflow from and $50 million cash outflow for **financing** activities.

Question 12.4.30**

How are cash flows for creditor fees and third-party costs related to a revolver classified?

Background: We believe fees paid to the creditor and third-party costs related to a revolver can be deferred and presented as an asset and subsequently amortized over the term of the revolver. However, an entity may follow another accounting approach if it is rational and consistently applied. [835-30-S35-1, S45-1]

For additional information on the accounting for fees incurred related to revolvers, see sections 3.4.20 and 4.8 of KPMG Handbook, Debt and equity financing.

Interpretive response: We believe the cash outflows related to creditor fees and third-party costs are classified as **financing** activities because they are related to future debt. The amortization of these fees and costs is presented as a reconciling item in the reconciliation of net income to net cash flows from **operating** activities (see section 3.2).

13. Derivative instruments

Detailed contents

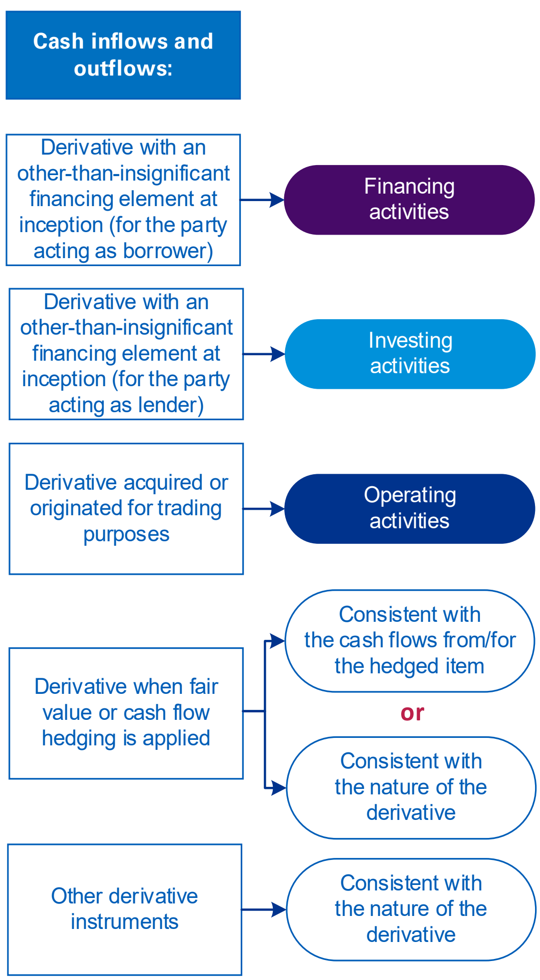
13.1 How the standard works

Derivative instruments involve a variety of cash flows, at inception and throughout the life of the instrument, such as:

- cash payments for purchases of derivative instruments
- cash receipts for sales of derivative instruments
- cash receipts and payments of cash collateral
- cash settlements for periodic payments for a swap
- cash payments to exercise the strike price of an option
- cash payments or receipts at the maturity or extinguishment of derivative instruments.

Generally, cash receipts and payments from/for a derivative are classified based on the instrument's nature. However, there are some exceptions, with the most difficult to apply being for derivatives with 'other-than-insignificant' financing elements – i.e. providing financing to one of the contracting parties. Such instruments have their own classification principles, irrespective of whether they are used as hedging instruments.

The following chart summarizes some of the classification issues encountered, which are explained in more detail in this chapter.



13.2 Derivatives with an 'other-than-insignificant' financing element

13.2.10 Overview

Excerpt from ASC 815-10

> Cash Flow Statement Classification

>> Derivative Instrument with a Financing Element

45-11 An instrument accounted for as a derivative instrument under this Subtopic that, at its inception, includes off-market terms, or requires an up-front cash payment, or both often contains a financing element. Identifying a financing element within a derivative instrument is a matter of judgment that depends on facts and circumstances.

45-12 If an other-than-insignificant financing element is present at inception—other than a financing element inherently included in an at-the-market derivative instrument with no prepayments (that is, the forward points in an at-the-money forward contract)—then the borrower shall report all cash inflows and outflows associated with that derivative instrument in a manner consistent with financing activities as described in paragraphs 230-10-45-14 through 45-15.

45-13 An at-the-money plain-vanilla interest rate swap that involves no payments between the parties at inception would not be considered as having a financing element present at inception even though, due to the implicit forward rates derived from the yield curve, the parties to the contract have an expectation that the comparison of the fixed and variable legs will result in payments being made by one party in the earlier periods and being made by the counterparty in the later periods of the swap's term.

45-14 If a derivative instrument is an at-the-money or out-of-the-money option contract or contains an at-the-money or out-of-the-money option contract, a payment made at inception to the writer of the option for the option's time value by the counterparty shall not be viewed as evidence that the derivative instrument contains a financing element.

45-15 In contrast, if the contractual terms of a derivative instrument have been structured to ensure that net payments will be made by one party in the earlier periods and subsequently returned by the counterparty in the later periods of the derivative instrument's term, that derivative instrument shall be viewed as containing a financing element even if the derivative instrument has a fair value of zero at inception.

Generally, cash receipts and payments from/for a derivative are classified based on the instrument's nature. However, this general classification principle does not apply to cash flows from/for a derivative with an other-than-insignificant financing element. Instead, the 'borrower' (i.e. the entity benefiting from the financing) applies the classification principles in section 13.2.40, regardless of whether the derivative is used as a hedging instrument.

Subtopic 815-10 (derivatives and hedging) explains which derivatives may contain a financing element for purposes of the statement of cash flows classification. Assessing whether a given derivative actually contains a financing element and whether the financing element is other-than-insignificant is a matter of judgment. [230-10-45-27, 815-10-45-11 – 45-15]

13.2.20 Does a financing element exist?

When a financing element exists in a derivative, one of the parties is essentially borrowing money from the other party during all or part of the instrument's term. The existence of a financing element is assessed at the inception date. [815-10-45-11]

Question 13.2.10

What are the general characteristics of derivatives that contain a financing element?

Interpretive response: Several characteristics are often associated with a derivative that contains a financing element: [815-10-45-11]

- off-market terms – e.g. terms, rates or prices that are not consistent with the current market for that type of contract;
- up-front cash payments – e.g. a partially prepaid forward contract or interest rate swap agreement; or
- a combination of off-market terms and up-front cash payments.

However, such characteristics require careful analysis because some at-market derivatives with no prepayment (i.e. with a fair value of zero at inception) may still contain a financing element. [815-10-45-15]

Conversely, some derivatives with prepayment may not contain a financing element for purposes of the statement of cash flows classification – e.g. option contracts where the payment made at inception to the writer of the option is only for the option's time value (see Question 13.2.20). [815-10-45-14]

Question 13.2.20

Are all financing elements in derivatives relevant for determining the classification of cash flows?

Background: All derivatives inherently include a financing element. The following are examples.

- The forward points in an at-market forward contract represent the time value of the forward.
- The terms of a plain vanilla interest rate swap with no prepayments reflect the implicit forward rates derived from the yield curve. Therefore, the parties to the contract expect that the comparison of the fixed and variable

legs will result in payments being made by one party in the earlier periods and being made by the counterparty in the later periods of the swap's term.

— The premium paid for an at-market option contract represents the time value of the option. The risk-free interest rate is a component of an option's time value.

Interpretive response: No. While all derivatives contain a financing element, the financing element inherently included in an at-market derivative with no prepayments is not relevant when of assessing classification of the derivative's cash flows. [230-10-45-15(d), 815-10-45-14]

Accordingly, the following derivatives do not contain financing elements for purposes of classifying the derivative's cash flows:

— an at-market forward contract that involves no prepayments; [815-10-45-12]
— an at-market plain vanilla interest rate swap that involves no prepayments; and [815-10-45-13]
— an option contract where the payment made at inception to the writer of the option is only for the option's time value. [815-10-45-14]

However, when the derivative functions similar to a borrowing, the financing element should be assessed to determine whether it is other-than-insignificant (see section 13.2.30). This may be the case when the derivative is designed to provide net cash inflows to one party in the earlier period of the instrument's term, which are subsequently repaid to the counterparty in the later period of the instrument's term. [815-10-45-15]

Example 13.2.10
Plain vanilla interest rate swap

ABC Corp. enters into an at-market plain vanilla interest rate swap to hedge its variable-rate debt. The terms of the interest rate swap state that ABC will pay a fixed amount and will receive a variable amount based on 3-month LIBOR plus a spread. No payments are made between ABC and the counterparty at inception. The inception date fair value of the interest rate swap is zero.

ABC determines that the interest rate swap does not contain a financing element for purposes of assessing classification of the derivative's cash flows. This is because it is a plain vanilla interest rate swap and there are no prepayments at inception.

ABC classifies all cash flows from/for the interest rate swap based on the guidance in section 13.3 for derivatives without other-than-insignificant financing elements.

Question 13.2.30

What is considered the inception date when evaluating whether a financing element exists?

Interpretive response: We believe the inception of the derivative for purposes of evaluating whether a financing element exists is the date the entity enters into the derivative.

This date may be later than the derivative's original inception date if the instrument was purchased in the secondary market or as part of a business combination (see Question 13.2.70), or was subject to novation (i.e. change in counterparty).

Further, we believe the modification of terms of a derivative that changes the timing and/or amount of cash flows is in substance the inception of a new derivative, except when the contract modifications practical expedient in Topic 848 (see ASU 2020-04 in chapter 1) is applied, as explained below. As a result, the entity needs to evaluate whether a financing element exists at the date of the modification.

Topic 848 includes a temporary practical expedient that permits an entity to account for a contract modification as a continuation of the existing contract when all of the changes to the contractual terms are related to reference rate reform. We believe this practical expedient extends to the statement of cash flows; therefore, the entity does not need to reassess whether an other-than-insignificant financing element exists at the date of modification.

13.2.30 Is a financing element other-than-insignificant?

When a derivative functions as a borrowing (see Question 13.2.20), the entity needs to assess whether the financing element in the derivative is other-than-insignificant. This determination is a matter of judgment that depends on the relevant facts and circumstances. [815-10-45-11 – 45-12]

Question 13.2.40

When is a financing element considered other-than-insignificant?

Interpretive response: We believe there are several approaches for assessing whether a financing element is other-than-insignificant. For each of these approaches, the financing element is compared to a reference amount. The reference amount used may be, for example:

— an established percentage of the derivative's notional amount;

— an established fixed dollar amount applied to all derivative instruments – e.g. a financing element greater than $100,000 is deemed to be other-than-insignificant; or

— for nonfinancial derivatives, an established percentage of the instrument's expected gross proceeds based on the spot price of the asset related to the underlying at inception of the derivative instrument – e.g. a financing element greater than 10% of the derivative's notional amount multiplied by the current spot price of the underlying.

The above reference points and numerical thresholds are meant to be illustrative only. An entity should select an approach and a reference point and numerical threshold that is appropriate considering its facts and circumstances and consistently apply the approach.

Example 13.2.20

Interest rate swap – financing element is insignificant

ABC Corp. enters into an interest rate swap to hedge $300 million of variable-rate debt. The terms of the interest rate swap state that ABC will pay a fixed amount and will receive a variable amount based on 3-month LIBOR plus a spread. The interest rate swap is structured so that ABC receives net payments of $6 million in the earlier periods of the swap and subsequently returns the net payments to the counterparty in the later periods of the swap. The inception date fair value of the interest rate swap is zero.

ABC determines that this interest rate swap contains a financing element, and next evaluates whether the financing element is other-than-insignificant.

ABC's policy is to evaluate a financing element by comparing it to the derivative's notional amount. Under the policy, financing elements greater than 10% of the notional amount are other-than-insignificant.

ABC calculates the financing element of the interest rate swap as 2% of the notional amount ($6 million / $300 million). Because 2% is less than the established percentage, ABC determines that the financing element in the interest rate swap is insignificant.

ABC classifies all of the cash flows from/for the interest rate swap based on the guidance in section 13.3 for derivative instruments without other-than-insignificant financing elements.

Example 13.2.30

Interest rate swap – financing element is other-than-insignificant

ABC Corp. enters into a forward starting interest rate swap to hedge $300 million of variable-rate debt. ABC expects to issue variable-rate debt within the next three months. The terms of the interest rate swap state that ABC will pay a below-market fixed amount and will receive a variable amount based on 3-month LIBOR plus a spread.

The interest rate swap is structured to start 90 days (i.e. the first interest rate setting and settlement period) after its inception to align with the expected timing of the debt issuance. At inception of the swap, ABC will receive $1 million due to the off-market terms.

ABC determines that this interest rate swap contains a financing element, and next evaluates whether the financing element is other-than-insignificant.

ABC's policy is to evaluate a financing element by comparing it to an established fixed dollar amount of $500,000.

Because the financing element of $1 million is greater than ABC's established dollar amount, the interest rate swap has an other-than-insignificant financing element.

13.2.40 Classifying cash flows from/for a derivative with an other-than-insignificant financing element

A borrower in a derivative with an other-than-insignificant financing element classifies all cash flows from/for the instrument as cash flows from **financing** activities. This is true regardless of whether the instrument is designated as a hedge. [230-10-45-14(d), 45-15(d), 815-10-45-12]

Question 13.2.50

Which party is considered the borrower when a derivative contains a financing element?

Interpretive response: The party to the derivative benefiting from the financing in the earlier periods of the instrument's term is considered the borrower. The counterparty is considered the lender.

For example, if the derivative involves the payment of an up-front premium for the off-market nature of its terms, the party receiving the premium (i.e. recording the derivative as a liability at inception) is the borrower.

Question 13.2.60

How does a lender classify cash flows from/for a derivative with an other-than-insignificant financing element?

Interpretive response: There is no specific guidance for lenders. We believe a lender in a derivative with an other-than-insignificant financing element should generally classify all cash flows from/for the instrument as cash flows from **investing** activities; the exception is instruments held for trading (see Question 13.4.20).

Example 13.2.40

Cash flows from/for an interest rate swap with an other-than-insignificant financing element

ABC Corp. enters into an interest rate swap to hedge its variable-rate debt. The terms of the interest rate swap state that ABC will pay a fixed amount and will receive a variable amount based on 3-month LIBOR plus a spread. ABC has concluded that the interest rate swap contains an other-than-insignificant financing element and that it is the borrower.

Therefore, ABC classifies all cash flows from/for the interest rate swap as cash flows from **financing** activities. This includes:

— receipt of any up-front payment;
— receipt and payment of the periodic settlements – e.g. the cash inflow of LIBOR plus spread and the cash outflow of a fixed amount;
— receipt and payment of cash collateral; and
— receipt and payment of amounts at maturity of the interest rate swap.

Question 13.2.70

How are cash payments from/for derivatives acquired in a business combination classified?

Background: An acquirer in a business combination may assume derivatives that are in a liability or asset position at the acquisition date.

Interpretive response: How an entity classifies cash flows from/for a derivative instrument depends on whether the instrument has an other-than-insignificant financing element on its inception date (see Question 13.2.40).

We believe the inception date of a derivative acquired in a business combination is the acquisition date (see Question 13.2.30). Therefore, if a derivative instrument is in a liability position at the acquisition date, it contains an element of borrowing (i.e. a financing element) at inception. We believe the acquirer should classify subsequent cash settlements for those instruments as cash flows from **financing** activities if the financing element is determined to be other-than-insignificant on the acquisition date.

Conversely, if a derivative instrument is in an asset position at the acquisition date, the acquirer is considered a lender and applies the guidance in Question 13.2.60.

We believe this guidance also applies to an acquiree that applies pushdown accounting.

13.3 Derivatives without other-than-insignificant financing elements

13.3.10 Overview

Excerpt from ASC 230-10

> Classification

>> Cash Receipts and Payments Related to Hedging Activities

45-27 Generally, each cash receipt or payment is to be classified according to its nature without regard to whether it stems from an item intended as a hedge of another item. For example, the proceeds of a borrowing are a financing cash inflow even though the debt is intended as a hedge of an investment, and the purchase or sale of a futures contract is an investing activity even though the contract is intended as a hedge of a firm commitment to purchase inventory. However, cash flows from a derivative instrument that is accounted for as a fair value hedge or cash flow hedge may be classified in the same category as the cash flows from the items being hedged provided that the derivative instrument does not include an other-than-insignificant financing element at inception, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments (that is, the forward points in an at-the-money forward contract) and that the accounting policy is disclosed. If the derivative instrument includes an other-than-insignificant financing element at inception, all cash inflows and outflows of the derivative instrument shall be considered cash flows from financing activities by the borrower. If for any reason hedge accounting for an instrument that hedges an identifiable transaction or event is discontinued, then any cash flows after the date of discontinuance shall be classified consistent with the nature of the instrument.

If a derivative does not contain an other-than-insignificant financing element (as defined in section 13.2), then generally cash flows from/for the instrument are classified based on the instrument's nature. However, if such an instrument is designated as a fair value or cash flow hedge, an entity may elect to classify its cash flows in the same category as the cash flows from/for the item being hedged. An entity is required to disclose this election. [230-10-45-27]

For a discussion of derivatives held for trading purposes, see Question 13.4.20.

13.3.20 Derivatives not designated as hedges

Generally, when a derivative is not designated as a hedge (i.e. hedge accounting is not applied), the nature of the derivative drives its cash flow classification. [230-10-45-27]

Question 13.3.10
How is the nature of a derivative determined?

Interpretive response: Unless a derivative is held for trading (see Question 13.4.20) or physically settled, its nature is that of an investment. Therefore, we believe it is appropriate to classify cash flows from/for a derivative not designated in a hedging relationship as cash flows from **investing** activities. Alternatively, we believe classifying cash flows based on how the derivative is used in the context of the entity's operations is also reflective of its nature.

A derivative that is intended to be physically settled is similar in nature to an executory contract. Therefore, cash flows from/for such derivative instruments are generally classified consistent with other similar nonderivative contracts, typically as cash flows from **operating** activities.

The following chart provides examples of some common derivatives and the related acceptable cash flow classification.

Derivative	Cash flow classification
Interest rate swap An entity enters into an interest rate swap to economically hedge the interest cost on its variable-rate debt.	**operating** activities. This is consistent with the nature of the derivative and its use to hedge the entity's interest costs. [230-10-45-17(d)] or **investing** activities. This is consistent with the general nature of derivatives not held for trading. [230-10-45-27]
Commodity forward contract An entity enters into a forward corn purchase contract for use in its production process. **The entity expects to take physical delivery under the contract**.	**operating** activities. This is consistent with the nature of the derivative because it allows physical settlement, and the entity uses corn in its production process. [230-10-45-17(a)] Because the entity expects to take physical delivery of the corn to be used in the production process, classification of the associated cash flows as investing is not appropriate.
Commodity futures contract An entity enters into a natural gas futures contract to economically hedge its exposure to natural gas used in its production process. **The entity does not expect to take physical delivery under the contract**.	**operating** activities. This is consistent with the nature of the derivative as it relates to the entity's ongoing production activities. An entity classifies cash flows related to sales and costs of goods sold as cash flows from **operating** activities. [230-10-45-16(a), 17(a)] or **investing** activities. This is consistent with the general nature of derivatives not held for trading. [230-10-45-27]

Derivative	Cash flow classification
Foreign currency forward contract A US based entity enters into a foreign currency forward contract to economically hedge currency changes related to its foreign-currency denominated debt. The forward contract matures on the same day as the entity's debt and will alter the US dollar equivalent amount the entity pays at the debt's maturity.	**financing** activities. This is consistent with the nature of the derivative and movements in its underlying (foreign currency). The entity entered into the derivative to alter the amount payable for the debt on maturity. An entity classifies cash payments for amounts borrowed as cash flows from **financing** activities. [230-10-45-15(b)] or **investing** activities. This is consistent with the general nature of derivatives not held for trading. [230-10-45-27]
Equity forward contract An entity enters into an equity forward contract for the purchase of an S&P 500 Index at a future date. The entity plans to hold the S&P 500 Index for investment purposes. The forward contract is not held in a trading account.	**investing** activities. This is consistent with the general nature of derivatives not held for trading, and how an entity classifies payments to acquire equity investments. [230-10-45-13(b), 45-27]

13.3.30 Derivatives designated in hedging relationships

Question 13.3.20
How are cash flows from derivatives designated as a fair value or cash flow hedge classified?

Interpretive response: If a derivative instrument is designated as a fair value or cash flow hedge and does not contain an other-than-insignificant financing element (see section 13.2), then its cash flows may be reflected: [230-10-45-27]

— based on the nature of the instrument (see Question 13.3.10); or
— in the same category as the cash flows from/for the item being hedged.

An entity should consistently apply its classification.

The following chart contains common uses for derivatives and the related classification of the hedged item.

Derivative instruments used to manage:	Classification of cash flows
Risks attributable to operating activities – e.g. purchase of inventory	**operating** activities [230-10-45-16, 45-17]
Foreign currency risk attributable to purchases or sales of capital assets – e.g. property, plant and equipment	**investing** activities [230-10-45-12(c), 45-13(c)]

Derivative instruments used to manage:	Classification of cash flows
Foreign currency risk attributable to an entity's foreign-currency denominated debt	**financing** activities [230-10-45-14(b), 45-15(b)]
Interest rate risk attributable to an entity's variable-rate debt	**operating** activities [230-10-45-17(d)]

Sometimes, the classification of cash flows is similar whether or not a derivative is designated in a hedging relationship. This is because the application of hedge accounting is most impactful to an entity's income statement (see Example 13.3.10). However, all facts and circumstances should be considered when concluding on the appropriate cash flow classification.

Question 13.3.30

Does discontinuing hedge accounting affect the classification of cash flows?

Background: Hedge accounting may be discontinued for a number of reasons. For example:

- the derivative is novated;
- the forecasted transaction does not occur; or
- the entity elects to dedesignate the hedging relationship.

Interpretive response: Yes. When an entity discontinues hedge accounting, it can no longer elect to classify the derivative's cash flows in the same category as the cash flows from/for the item being hedged. All cash flows subsequent to the discontinuance of hedge accounting are classified based on the nature of the derivative (see Question 13.3.10). [230-10-45-27]

However, as noted in Question 13.3.20, sometimes classifying cash flows based on the nature of the derivative or consistent with the hedge results in the same presentation.

Example 13.3.10

Cash flows after discontinuing hedge accounting

ABC Corp. purchases a forward contract to lock in the cost of a forecasted purchase of inventory. ABC does not expect to take physical delivery under the contract.

For a period of time, ABC chooses to apply cash flow hedge accounting to the forward contract, and elects to classify the forward contract cash flows as cash flows from **operating** activities consistent with the classification of the hedged item (i.e. the payments for inventory). Subsequently, ABC decides to dedesignate the cash flow hedging relationship to simplify the accounting.

Because hedge accounting is discontinued, ABC can no longer support the existing classification of the forward contract cash flows by looking at the classification of the cash flows of the inventory. Cash flows subsequent to the termination of hedge accounting are classified based on the nature of the forward contract.

However, ABC can continue to classify the derivative's cash flows as cash flows from **operating** activities, because the forward contract relates to ABC's ongoing production activities.

Alternatively, ABC could elect to classify the cash flows as cash flows from **investing** activities. This is because ABC does not expect to take physical delivery under the contract and the forward contract is by nature an investment.

Question 13.3.40

How does a debtor classify cash flows for terminating an interest rate swap used in a hedge of debt?

Interpretive response: Topic 230 does not address how debtors should classify payments made for terminating interest rate swaps designated as cash flow or fair value hedges of debt. Because the swap is terminated, hedge accounting is discontinued (see Question 13.3.30).

Cash flows for terminating an interest rate swap used in a hedge of debt represent the acceleration of interest payments within the interest rate swap that would have been recognized as interest expense through the remaining life of the swap. Those interest payments within the interest rate swap would have been classified as cash flows from **operating** activities. Accordingly, we believe it is appropriate to classify interest rate swap termination cash flows as cash flows from **operating** activities. [230-10-45-17(d)]

However, we believe it is also acceptable to classify cash flows for terminating an interest rate swap used in a hedge of debt as cash flows from **financing** activities if the termination was part of a financing decision that resulted in the contemporaneous settlement of the hedged debt.

We believe a debtor's classification policy for interest rate swap termination cash flows should be disclosed and consistently applied but need not be the same as its policy for classifying cash receipts or payments related to ongoing interest rate swap activity. That is, a debtor should classify payments or receipts related to ongoing interest rate swap activity the same way in its statement of cash flows. The debtor also should consistently classify interest rate swap termination cash flows, but need not classify them in the same category as the ongoing interest rate swap activity.

Question 13.3.50

How are cash flows from/for a net investment hedge classified?

Background: Entities with foreign operations often hedge the foreign currency exposure related to their net investment in a foreign subsidiary. The gain or loss related to the hedging transaction in a net investment hedge is reported in the same manner as a currency translation adjustment (i.e. as a component of OCI). The gain or loss remains in OCI until the entity sells its investment in the foreign subsidiary, or the subsidiary is substantially liquidated.

Entities may use derivatives or nonderivative financial instruments in a net investment hedge. For additional information on net investment hedges, see chapter 12 of KPMG Handbook, Derivatives and hedging.

Interpretive response: If an entity designates a derivative as a net investment hedge and uses the forward method to assess hedge effectiveness (see Question 13.3.60), we believe it should classify the cash flows from/for the derivative based on the hedged item – i.e. the investment in the foreign subsidiary. Because an entity typically classifies cash flows from/for the purchase or sale of the subsidiary as cash flows from **investing** activities, the cash flows from/for the derivative are also classified as cash flows from **investing** activities.

For example, a US parent company enters into a foreign currency forward contract to hedge its investment in a foreign operation in Canada. The parent designates the foreign currency forward contract as a hedge of the beginning balance of the net investment in the Canadian subsidiary and uses the forward method to assess effectiveness (see Question 13.3.60). The entity classifies all cash flows from/for the forward contract as cash flows from **investing** activities.

However, if an entity uses the spot method to assess hedge effectiveness for a derivative designated in a net investment hedge, see Question 13.3.60 for classifying the cash flows from/for the derivative.

In contrast, if an entity uses a nonderivative financial instrument for a net investment hedge, the cash flows from/for the net investment hedge follow the classification of the nonderivative instrument.

For example, if the hedging instrument in a net investment hedge is foreign-currency denominated debt, the entity classifies interest payments on the debt as cash flows from **operating** activities and principal payments on the debt as cash flows from **financing** activities.

Question 13.3.60

How are cash flows from/for excluded components in a derivative designated in a net investment hedging relationship classified?

Background: The effectiveness of the hedging relationship in a net investment hedge is assessed at inception and subsequently. Entities using derivatives such as a foreign currency forward contract, a cross-currency interest rate swap contract or a purchased option as hedging instruments, can assess effectiveness based on changes in spot exchange rates (the spot method) or changes in forward exchange rates (the forward method). [815-35-35-4]

This election affects how the forward element included in the forward rate is recognized. The forward element is the forward points of a forward contract (i.e. the spot-forward difference) or the time value of an option.

- **Forward method**. The forward element is part of the hedged foreign currency risk. Total changes in the fair value of the hedging derivative are recognized in OCI.
- **Spot method**. Only the changes in the fair value of the hedging derivative that are attributable to changes in the spot exchange rate are recognized in OCI. The forward element (i.e. the excluded portion of the hedging relationship) is recognized in earnings using either a mark-to-market approach or an amortization approach.

For additional discussion of net investment hedges, see chapter 12 of KPMG Handbook, Derivatives and hedging.

Interpretive response: As mentioned in Question 13.3.50, if an entity uses a derivative for a net investment hedge, we believe it should classify the cash flows from/for the derivative based on the hedged item – i.e. as cash flows from **investing** activities. This would ordinarily include cash flows from/for forward elements, even if they are excluded from the net investment relationship for assessing effectiveness under the spot method. Under this view, the derivative is considered a single unit of account.

However, we believe it is also acceptable to classify cash flows from/for forward elements excluded from the net investment hedging relationship under the spot method based on their nature – i.e. as cash flows from **operating** activities. This view is consistent with the accounting for changes in the fair value of the hedging derivative as two separate components, and the rationale for cash flows from/for variation margin on STM derivatives explained in Question 13.4.60.

The presentation approach selected should be disclosed and applied consistently.

13.4 Other presentation issues

The following is a series of questions and answers to provide guidance on select derivative scenarios.

Question 13.4.10

Do derivatives meet the definition of a cash equivalent?

Interpretive response: No. We believe the nature of derivatives is such that even if their original maturity is three months or less, they are exposed to more than *an insignificant risk of change in value* and as such fail to meet the second criterion in the definition of a cash equivalent (see section 6.3.10). Therefore, we believe that derivatives should not be presented as cash equivalents. [230-10 Glossary]

Question 13.4.20

Are cash flows from/for derivatives held in a trading account classified as operating activities?

Interpretive response: Yes. We believe cash receipts and cash payments resulting from nonhedging derivative instruments are **operating** cash flows if those instruments are acquired specifically for resale in the near term, are measured at fair value in a trading account, and do not contain an other-than-insignificant financing element. This is consistent with the classification of debt and equity trading securities (see section 9.2).

Question 13.4.30

How are changes in the fair value of derivatives that do not result in cash receipts or payments presented?

Interpretive response: Changes in the fair value of derivative instruments that do not result in cash receipts or payments in the period of change are presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2).

For example, unrealized gains (losses) are reported as a reconciling item within operating activities. [230-10-45-28]

Question 13.4.40

Can a buyer present the cash flows for the settlement of a forward placement commitment contract on a net basis?

Background: A forward placement commitment contract obligates a seller to deliver a specific security to a buyer at a specific date and price in the future. On settlement of the contract, the buyer makes one or more cash payments that represent (1) the purchase of the specified securities and (2) the settlement of the related derivative asset or liability.

Other types of forward contracts include to-be-announced (TBA) mortgage-backed securities. The seller of mortgage-backed securities agrees on a sale price, but does not specify which particular securities will be delivered to the buyer on the settlement date – i.e. the underlying securities are to be announced at a later date.

Interpretive response: No. We believe cash flows for the settlement of a forward placement commitment contract should be presented as two separate transactions in the statement of cash flows even if one net payment is made.

Both cash flows should be presented as cash flows from **investing** activities unless the nature of the derivative supports a different classification. For example, cash flows may be classified as cash flows from **operating** activities when the acquired securities are measured at fair value in a trading account.

We believe TBA mortgage-backed securities should also apply this guidance.

Question 13.4.50

How are cash flows from/for variation margin on CTM derivatives classified?

Background: Some entities clear certain derivative transactions through an agent that acts as a clearing member (e.g. a financial institution) to settle the transaction with a central clearing party (CCP).

Derivatives cleared through CCPs require clearing members and end users to post cash collateral based on the daily changes in fair value of the derivative and pay interest to the party posting the collateral (i.e. price alignment interest). In addition, derivatives not cleared through CCPs may also require the counterparties to post cash collateral based on changes in fair value of the derivative and pay interest to the party posting the collateral. These are commonly referred to as 'collateralized-to-market' (CTM) contracts.

Variation margin (i.e. the cash collateral and price alignment interest) paid or received on a CTM contract is considered a separate unit of account from the derivative.

Interpretive response: There is no guidance on how variation margin payments and receipts on CTM derivatives should be classified.

Some entities classify these cash flows consistent with the derivative settlement cash flows. Other entities classify variation margin payments and receipts depending on whether the collateral account is in an asset position (as cash flows from **investing** activities) or a liability position (as cash flows from **financing** activities).

We believe it is acceptable to apply either approach as an accounting policy election that should be disclosed and applied consistently.

However, it would not be appropriate to separately present cash flows from/for variation payments if the related derivative contained an other-than-insignificant financing element at inception. All cash inflows and outflows of such derivatives are classified as cash flows from **financing** activities (see section 13.2).

Question 13.4.60

How are cash flows from/for variation margin on STM derivatives classified?

Background: Rule changes implemented by certain CCPs require entities to treat variation margin payments as the legal settlement of the outstanding derivative contract exposure instead of the posting of collateral. This does not change the amount of cash flows exchanged between the parties, including interest paid/received on the collateral (now referred to as price alignment amount, or PAA).

For these contracts, referred to as 'settled-to-market' (STM), the variation margin, PAA and the related derivative are considered a single unit of account.

For additional guidance on these rule changes, see KPMG Defining Issues, SEC staff clarifies effect of rule changes on hedge accounting.

Interpretive response: We believe an entity may classify all cash flows from/for STM contracts as a single unit of account, consistent with the derivative settlement cash flows.

However, it is our understanding that the SEC staff would not object to presenting variation margin (and PAA) cash flows on STM derivatives separately from the derivative settlement cash flows. This is based on the view that variation margin payments are separately identifiable sources and uses of cash flows. Under this view, an entity could continue to present variation margin payments and receipts on STM derivatives similar to those of CTM derivatives (see Question 13.4.50).

The accounting policy elected should be disclosed and applied consistently.

However, it would not be appropriate to separately present cash flows from/for variation payments if the related derivative contained an other-than-insignificant financing element at inception. All cash inflows and outflows of such derivatives are classified as cash flows from **financing** activities (see section 13.2).

14. Leases – Topic 842

Detailed contents

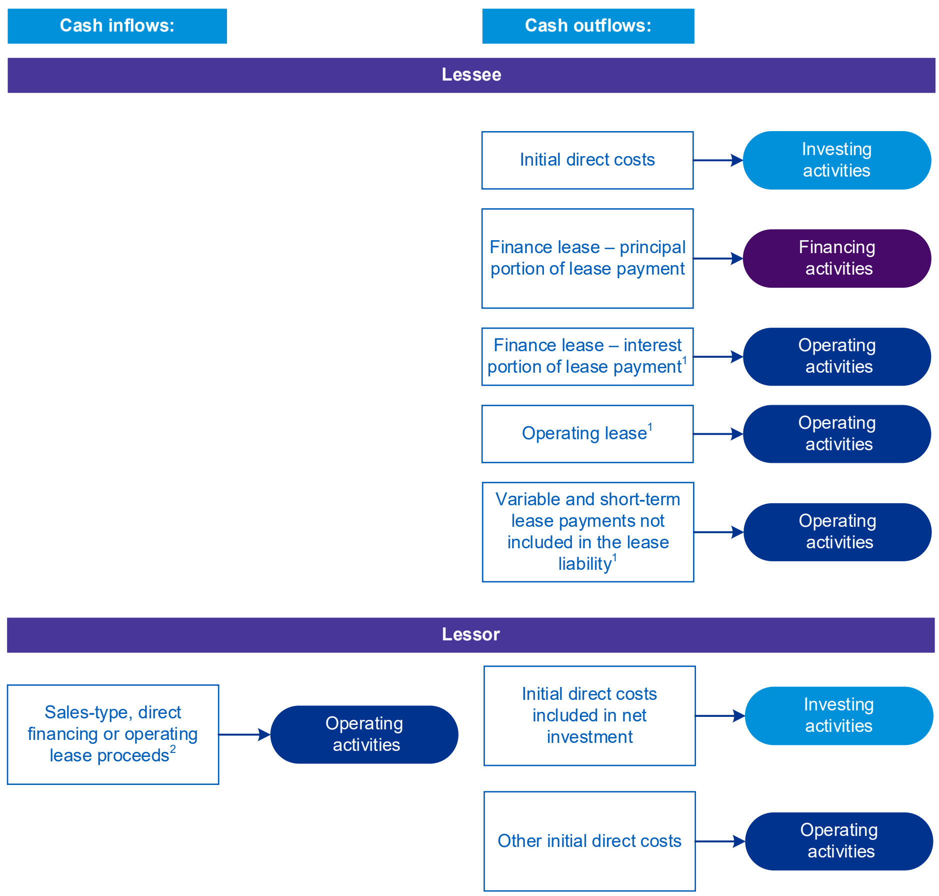
14.4 Sale-leaseback transactions

Questions

14.1 How the standard works

This chapter addresses how to classify cash flows from/for leasing activities, from both the perspective of the lessee (see section 14.2) and the lessor (see section 14.3) following the adoption of Topic 842.

The following chart summarizes some of the classification issues encountered, which are explained in more detail in this chapter. 'Lease payments' as described in this chapter exclude payments (or portions of payments) related to non-lease components.



Notes:

1. Included in cash flows from **investing** activities to the extent that payments represent costs to bring another asset to the condition and location necessary for its intended use (see section 8.5.20).
2. For financial institutions in the scope of Topic 942, see Questions 14.3.30 and 14.3.40.

Recent ASUs reflected in this chapter

This chapter reflects the amendments in the following:

— ASU 2016-02, Leases (Topic 842)

— ASU 2019-01, Leases (Topic 842): Codification Improvements.

See chapter 1 for an overview of these ASUs and their transition requirements. Excerpts from the Codification included in this chapter reflect these amendments – i.e. the Codification is reproduced as if the pending content were currently effective for all entities.

The classification of cash flows from leasing activities under Topic 840 (i.e. before adoption of Topic 842) is discussed in chapter 14A.

14.2 Lessee accounting

Question 14.2.10
How does a lessee classify payments for non-lease components?

Background: A contract may include lease and non-lease components (e.g. maintenance services). In this case, the consideration in the contract is allocated to those components. The consideration may include payments before or at/after the lease commencement, lease incentives or termination payments. Lease components are accounted for under Topic 842; non-lease components are accounted for under other applicable US GAAP. [842-10-15-31]

As a practical expedient, a lessee may elect not to separate the lease and non-lease components; see paragraph 4.4.30 of KPMG Handbook, Leases. In that case, the lease and non-lease components are treated as one single lease component. [842-10-15-37]

Interpretive response: In general, 'lease payments' refer to payments that relate to the lease components. However, for a lessee that has elected the practical expedient not to separate the lease and non-lease components, 'lease payments' refer to the payments allocable to all of the components combined under the expedient.

If the lessee does not elect the practical expedient, payments allocated to a non-lease component are not lease payments and are presented in the statement of cash flows consistent with how the lessee would classify payments for the component if it were obtained without the lease – e.g. cash outflows for maintenance services on an owned asset.

14.2.10 Overview

Under Topic 842, a lessee is required to recognize an ROU asset and a lease liability for all leases other than 'short-term' leases, whether classified as operating or finance leases. While the lease classification distinction from Topic 840 continues to exist in Topic 842, it now affects how a lessee measures and presents lease expense and cash flows – not whether the lease is on- or off-balance sheet. [842-20-25-1]

A simplified form of accounting can be elected for short-term leases – i.e. those with an accounting lease term of 12 months or less – whereby the lease payments are recognized as lease cost on a straight-line basis over the lease term (the 'short-term lease exemption'). [842-20-25-2]

The lease term and lease classification are determined at lease commencement. [842-10-30-2, 842-20-25-1]

Lease payments are classified as follows.

— Short-term lease exemption applies: cash flows from **operating** activities (see Question 14.2.50).
— Short-term lease exemption does **not** apply:

Lease payments	Question	Before lease commencement[1]	At or after lease commencement
Lease payments, including termination payments	14.2.40	N/A	**operating** or **financing** activities depending on lease classification and nature of payment
Prepayments and nonrefundable deposits	14.2.60 14.2.70	**investing** activities or[2] **operating** or **financing** activities depending on lease classification	**operating** or **financing** activities depending on lease classification
Refundable deposits	14.2.70	**operating** activities	**operating** activities
Initial costs:			
— Initial direct costs	14.2.90	**investing** activities	**investing** activities
— Origination costs that are not initial direct costs	14.2.100	**operating** activities	**operating** activities
— Costs associated with shipping, delivery, installation or other similar activities	14.2.110	**operating** or **investing** activities depending on capitalization policy	**operating** or **investing** activities depending on capitalization policy
Cash incentives received	14.2.120	**investing** activities or[2] **operating** or **financing** activities depending on lease classification	**operating** or **financing** activities depending on lease classification

Notes:

1. Lease classification is not determined until lease commencement under Topic 842. [842-10-25-1]
2. Policy election.

14.2.20 Lease commencement

Excerpt from ASC 842-20

50-4 For each period presented in the financial statements, a lessee shall disclose the following amounts relating to a lessee's total lease cost, which includes both amounts recognized in profit or loss during the period and any amounts capitalized as part of the cost of another asset in accordance with other Topics, and the cash flows arising from lease transactions: …

g. Amounts segregated between those for finance and operating leases for the following items: …

2. Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets.

Question 14.2.20

How does recognition of an ROU asset and a lease liability affect a lessee's statement of cash flows?

Interpretive response: A lessee's recognition of an ROU asset and a lease liability at lease commencement is a noncash transaction that is not presented in the statement of cash flows.

Instead, this transaction is separately disclosed as a **noncash** investing and financing activity because the lessee is obtaining the right to use an underlying asset for the lease term in exchange for a lease liability (see Question 14.2.30). [230-10-50-3 – 50-4, 842-20-50-4(g)(2)]

Question 14.2.30

Are lessees required to disclose all changes to ROU assets and lease liabilities that arise from noncash activities?

Background: Topic 842 only explicitly requires lessees to disclose supplemental **noncash** information about 'lease liabilities arising from obtaining ROU assets'. [842-20-50-4(g)(2), 55-53]

Some stakeholders, in evaluating this question, have asked whether this disclosure requirement also applies to:

— increases in the lessee's ROU assets and lease liabilities resulting from remeasurements or modifications that do not involve obtaining a new ROU asset – e.g. obtaining a new right to use an additional asset; and
— activities that decrease the lessee's ROU assets and lease liabilities – e.g. remeasurements or modifications.

The following table lists events whose occurrence could change the carrying amount of recognized ROU assets and lease liabilities without an expenditure or receipt of cash by the lessee (not exhaustive).

Event	Increase to ROU asset and lease liability	Decrease to ROU asset[1] and lease liability
Modifications accounted for as a separate contract	✓	
Modifications granting the lessee an additional right of use, but not accounted for as a separate contract	✓	

Event	Increase to ROU asset and lease liability	Decrease to ROU asset[1] and lease liability
Modifications that change the terms of an existing lease – e.g. change the lease term, add/remove a lessee purchase option or change the terms of a residual value guarantee	✓	✓
Modifications that change only the price of an existing lease	✓	✓
Modifications fully or partially terminating a lease – e.g. reducing the amount of space being leased		✓
Remeasurement events – e.g. changes to the lease term, the assessment of a lessee purchase option or the amount probable of being owed under a residual value guarantee	✓	✓

Note:

1. The ROU asset will not be decreased for one of these events if its pre-event carrying amount is already $0.

For additional guidance on remeasurement events and modifications, see sections 6.6 and 6.7 in KPMG Handbook, Leases, respectively.

Interpretive response: To the extent material, yes. We believe the requirements of Topics 842 and 230, taken together, effectively require supplemental disclosure of all material noncash changes to ROU assets and lease liabilities.

There are differing views as to the extent of the specific Topic 842 requirement to disclose 'supplemental noncash information on lease liabilities arising from obtaining right-of-use assets'. For example, when considering the background questions, some believe the Topic 842 disclosure requirement applies only to events that result from adding a new ROU asset; others believe the disclosure was intended to capture either (1) any increases to ROU assets and lease liabilities or (2) all changes (increases and decreases) in those asset or liability amounts.

Regardless of the interpretation of Topic 842, we believe that Topic 230 requires disclosure of information about *all* investing and financing activities of an entity during a period that affect recognized assets or liabilities but do not result in cash receipts or cash payments in the period. Topic 230 makes no distinction between noncash activities that result in increases or decreases to recognized assets or liabilities. It therefore requires disclosure of *any* noncash changes to ROU assets and lease liabilities that are not required to be disclosed or presented elsewhere in the financial statements by another Topic (e.g. Topic 842). [230-10-50-3]

Consequently, any material noncash leasing activities would need to be disclosed under Topic 230 regardless of whether they are required to be disclosed by Topic 842.

Neither Topic 842 nor Topic 230 specify where in the financial statements the required supplemental noncash disclosures must be made.

14.2.30 Lease payments

Excerpt from ASC 842-20

> Statement of Cash Flows

45-5 In the statement of cash flows, a **lessee** shall classify all of the following:

a. Repayments of the principal portion of the lease liability arising from finance leases within financing activities
b. Interest on the lease liability arising from finance leases in accordance with the requirements relating to interest paid in Topic 230 on cash flows
c. Payments arising from operating leases within operating activities, except to the extent that those payments represent costs to bring another asset to the condition and location necessary for its intended use, which should be classified within investing activities
d. Variable lease **payments** and **short-term lease** payments not included in the lease liability within operating activities.

Question 14.2.40
How does a lessee classify lease payments?

Interpretive response: Under Topic 842, a lessee classifies lease payments as follows, unless the short-term lease exemption applies to the lease (see Question 14.2.50).

Finance lease	
Repayment of principal portion of lease liability	**financing** activities [842-20-45-5(a)]
Interest on the lease liability	**operating** activities[1] [842-20-45-5(b)]
Variable lease payments not included in the lease liability	**operating** activities[1] [842-20-45-5(d)]
Operating lease	
Lease payments	**operating** activities[1] [842-20-45-5(c)]

Operating lease	
Variable lease payments not included in the lease liability	**operating** activities[1][842-20-45-5(d)]
Note: 1. Included in cash flows from **investing** activities to the extent that payments represent costs to bring another asset to the condition and location necessary for its intended use (see section 8.5.20).	

For classification of payments made by the lessee to terminate a lease see section 14.2.60.

Question 14.2.50

How does a lessee classify lease payments when the short-term exemption applies?

Background: A lessee may elect the short-term lease exemption, by class of underlying asset, for leases that have a lease term of 12 months or less; see section 6.3.1 in KPMG Handbook, Leases.

Interpretive response: Lease payments for short-term leases to which the exemption is applied ('short-term lease payments') are classified as cash flows from **operating** activities. [842-20-45-5(d)]

The 'lease term' is assessed at lease commencement. Therefore, when a lease payment is made before lease commencement, a lessee may not *definitively* know that a lease will qualify for the short-term lease exemption unless the maximum possible lease term is 12 months or less. In this case, we believe a lessee should classify the payment in its statement of cash flows based on the best information it has available about whether the lease will qualify for the short-term lease exemption when assessed at lease commencement.

Short-term lease payments are cash outflows from **investing** activities to the extent that payments are for costs to bring another asset to the condition and location necessary for its intended use (see section 8.5.20).

This interpretive response applies equally to incentives received, prepayments, deposits, and termination payments paid or received related to short-term leases.

Question 14.2.60

How does a lessee classify lease payments made before the lease commencement date?

Background: A lessee may be required to make lease payments (i.e. nonrefundable payments to the lessor) before the lease commencement date (lease prepayments), which is when lease classification and the lease term are assessed.

Interpretive response: We believe lease prepayments can be classified as cash outflows for **investing** activities, regardless of expected lease classification as operating or finance – unless the lessee expects the lease will be a short-term lease (see Question 14.2.50). This is because such payments are made to acquire the productive ROU asset; they do not reflect payment of an existing lease liability because the liability does not exist until lease commencement.

Alternatively, we believe it is also acceptable for a lessee to classify lease prepayments in the same manner it expects to classify lease payments made after lease commencement, i.e. based on the expected lease classification (which is determined at lease commencement) (see Question 14.2.40). When adopting this approach, a lessee should use the best information it has available about lease classification as of the date the financial statements are issued (or available to be issued).

The approach selected should be disclosed and consistently applied.

Question 14.2.70

How does a lessee classify a deposit paid to the lessor?

Background: Lease agreements frequently require the lessee to remit a cash deposit to the lessor, typically before or at the lease commencement date. Cash deposits are usually refundable and represent additional collateral for the lessor. However, they can also be nonrefundable, similar to a lease prepayment (see Question 14.2.60) – e.g. representing the lessee's intent to lease the asset.

Interpretive response: The classification of a lessee deposit depends on whether it is refundable when it is paid and whether lease classification is known at that time. For short-term leases, see Question 14.2.50.

Deposit is nonrefundable and is paid before lease commencement

If the deposit is nonrefundable and is paid before lease commencement, we believe the lessee should classify the cash outflow consistent with lease prepayments (see Question 14.2.60).

Deposit is nonrefundable and is paid at or after lease commencement

If the deposit is nonrefundable and is paid at or after the lease commencement date, we believe the lessee should classify the cash outflow consistent with other payments made at or after lease commencement (see Question 14.2.40).

Deposit is refundable

If the lessor is expected to refund the deposit at a future date, that deposit is not part of the consideration in the contract, regardless of the timing of payment. We believe the lessee's initial cash outflow and subsequent cash inflow are cash flows from **operating** activities because they do not meet the definition of investing or financing activities. Furthermore, we believe interest accrued on the deposit that is refunded is also a cash inflow from **operating** activities. [230-10-45-16(b) – 45-16(c), 45-17(f)]

Question 14.2.80

How does a lessee classify cash flows for land-use rights?

Background: In certain countries, such as China, land is government-owned and restrictions exist over the transfer of legal title to real property. However, the governments of such countries may grant land-use rights permitting an entity to exclusively use the property for a specified number of years for a fee. This fee is commonly paid up-front and the land-use rights do not include the right to purchase the land at the end of the term.

Interpretive response: How payments for land-use rights are classified depends on whether the rights meet the definition of a lease. If the land-use rights meet the definition of a lease (see chapter 3 of KPMG Handbook, Leases), the lessee's payments are classified based on the classification guidance for any other lease payments (see Question 14.2.40).

If the land-use rights do not meet the definition of a lease, the payments for those rights are classified consistently with the nature of those rights. For example, the payments could be cash outflows for **investing** activities if the entity concludes that the land-use rights: [230-10-45-13l]

— are an intangible asset; or
— permit the construction of real property on the land, and therefore the payments represent costs to bring another asset to the condition and location necessary for its intended use.

Question 14.2.85

For operating leases, should the periodic reduction in the ROU asset carrying amount and the change in lease liability be presented separately within operating activities?

Background: Topic 842 does not address how to reconcile the lease expense to the lease payments in the reconciliation of net income to net cash flows from operating activities. Consistent with legacy US GAAP (Topic 840), a lessee generally recognizes straight-line operating lease expense under Topic 842. However, that straight-line expense now comprises two components:

— amortization of the ROU asset; and
— accretion of the discounted lease liability.

The ROU asset amortization is noncash and is therefore an adjustment to reconcile net income to net cash flows from operating activities.

The lease liability is reduced by the cash payments for leases, offset by accretion. Consistent with other working capital adjustments (see chapter 7), this change in the lease liability is also presented as an adjustment to reconcile net income to net cash flows from operating activities.

Adjustments to net income and changes in net assets should be clearly identified in the reconciliation of net income to net cash flows from operating activities. [230-10-45-32]

Interpretive response: We expect that most entities will present the ROU asset amortization (a noncash expense) and the change in the lease liability (a change in net assets) in different line items (approach one). This is because those adjustments are of a different nature.

However, we believe it is also acceptable to combine those two reconciling items in the same line item in the reconciliation (approach two). This is because Topic 842 does not characterize the single operating lease cost as the combination of two separately derived components. Further, the basis for conclusions to ASU 2016-02 acknowledges that, for operating leases, the Board did not intend for lessees to break down the single cost between the ROU asset amortization and the lease liability accretion. [ASU 2016-02.BC64]

The presentation approach selected should be disclosed and applied consistently.

We believe either of these approaches can be achieved by including the separate amounts (approach one) or combined amount (approach two) in existing line items such as 'Change in liabilities', or by creating new line items such as 'Reduction in the carrying amount of ROU assets' or 'Change in operating lease liabilities'. However, we believe that adjustments attributable to ROU asset amortization should *not* be characterized as 'amortization' or included with other amounts labelled as amortization. The SEC staff has objected to that characterization in the statement of cash flows by a registrant in a comment letter. We believe the staff's objection stems from the fact that Topic 842 does not characterize the reduction in the ROU asset that occurs over the lease term as 'amortization'. Rather, it refers only to recognition of a 'single lease cost' by lessees, of which the periodic reduction in the carrying amount of the ROU asset is only one element (together with accretion of the lease liability).

14.2.40 Initial direct costs

Initial direct costs are incremental costs that would not have been incurred if the lease had not been obtained. Examples of such costs are commissions and payments made to an existing tenant to incentivize them to terminate their lease. [842-10 Glossary, 842-10-30-9]

Topic 842 requires a lessee to include initial direct costs in the initial measurement of the ROU asset. Such costs are subsequently amortized over the lease term as part of total lease cost. [842-10-55-242, 842-20-30-5]

For additional guidance on initial direct costs, see section 5.5 in KPMG Handbook, Leases.

Question 14.2.90

How does a lessee classify cash flows for initial direct costs?

Interpretive response: We believe that a lessee's cash payments for initial direct costs are cash outflows for **investing** activities. This classification is appropriate because initial direct costs are included in the initial measurement of the ROU asset (a productive asset). [230-10-45-13(c)]

However, if the short-term lease exemption applies to the lease, we believe the payment is a cash outflow for **operating** activities because no ROU asset is recognized (see Question 14.2.50). It does not matter that the initial direct costs are deferred and recognized to expense over the lease term.

Question 14.2.100

How does a lessee classify lease origination costs that are not initial direct costs?

Background: Costs to negotiate or arrange a lease that would have been incurred regardless of whether the lease was obtained do not meet the definition of initial direct costs under Topic 842; these costs are expensed as incurred. Examples of such costs include legal fees that are not contingent on lease execution, costs of negotiating lease terms and conditions and general overheads. [842-10-30-10, ASU 2016-02.BC221–BC222, BC304]

Interpretive response: Cash flows for these costs are cash outflows for **operating** activities. This classification is consistent with the definition of **operating** activities, which 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." [230-10 Glossary]

Question 14.2.110

How does a lessee classify costs associated with shipping, delivery, installation or similar activities?

Background: A lessee may pay a third party that is unrelated to the lessor to undertake shipping, delivery, installation or similar activities – e.g. to deliver the underlying asset to the lessee's desired operating location. These payments are neither lease prepayments nor payments for initial direct costs. We believe there are two acceptable approaches to accounting for such costs incurred by the lessee (see Question 5.1.10 in KPMG Handbook, Leases):

- capitalize the costs by analogy to the guidance in Topic 360 (property, plant and equipment); or
- expense them as incurred.

Interpretive response: The cash flow classification of the third-party payments depends on the lessee's accounting policy election for the related costs.

If the lessee elects to capitalize the costs, the related payments are cash outflows for **investing** activities. This classification is consistent with other payments that will be recognized as part of the ROU asset – e.g. initial direct costs (see Question 14.2.90).

If the lessee elects to expense the costs as incurred, the related payments are cash outflows for **operating** activities. This classification is consistent with the definition of **operating** activities, which 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." [230-10 Glossary]

14.2.50 Lease incentives received

A lessor may offer incentives to the lessee to sign the lease agreement. Lease incentives include both: [842-10-55-30]

— payments made by the lessor to or on behalf of the lessee; and
— losses incurred by the lessor as a result of assuming a lessee's pre-existing lease with a third party.

All payments made by a lessor to a lessee are an incentive, reducing the consideration in the contract, unless the payments are for a distinct good or service provided by the lessee to the lessor – e.g. for construction of, or managing the construction of, the lessor's assets. In addition, even if the lessee provides a distinct good or service to the lessor, any amount of the lessor's payments in excess of the fair value of the distinct good or service is an incentive.

Lease incentives may be contingent on future events or lessee actions. For example, a lessor may agree to reimburse a lessee for the cost of leasehold improvements, with payment contingent on the lessee's construction or installation of the improvements.

— Lease incentives that are not contingent (whether paid before or at/after lease commencement) affect the initial measurement of the ROU asset and, depending on the facts and circumstances, the lease liability. See section 5.4.3 of KPMG Handbook, Leases.

— Contingent lease incentives may affect the lessee's measurement of the ROU asset and the lease liability, depending on the lessee's accounting policy. See Question 6.6.20 in KPMG Handbook, Leases.

Lease incentives may be paid before lease commencement, which is when lease classification and the lease term are assessed.

Question 14.2.120
How does a lessee classify lease cash incentives?

Interpretive response: Cash incentives received from the lessor are part of the consideration in the contract, despite being a deduction rather than an addition thereto (see Question 14.2.10). Therefore, lease cash incentives should be classified consistent with other lease payments in the contract (see Question 14.2.40). [842-10-15-35(a)]

Classification in the statement of cash flows may depend on the timing of payment (before or on/after lease commencement), unless the lease is a short-term lease (see Question 14.2.50).

Before lease commencement

We believe that a lessee can classify lease cash incentives received before lease commencement as cash flows from **investing** activities. This is because the cash inflows reduce the capitalized ROU asset that is recorded on lease commencement – i.e. the opposite of the situation in Question 14.2.90.

Alternatively, we believe it is also acceptable to classify lease cash incentives received before lease commencement based on the expected lease classification (which is determined at lease commencement). When adopting this approach, a lessee should use the best information it has available about lease classification as of the date the financial statements are issued (or available to be issued).

The approach selected should be disclosed and consistently applied. It should also be consistent with the approach taken for lease prepayments (see Question 14.2.60).

At or after lease commencement

For an operating lease, any lease cash incentives the lessee receives are cash inflows from **operating** activities. This is because lease cash incentives effectively reduce operating lease payments, which are cash outflows from **operating** activities. [TQA 5600.17]

The SEC staff expressed the same views in a February 7, 2005 letter to the Center for Public Company Audit Firms, in the context of leasehold improvement incentives.

For a finance lease, we believe that any lease cash incentives received from the lessor are generally cash inflows from **financing** activities, consistent with the classification of the principal portion of the lease payments (see Question 14.2.40).

Example 14.2.10

Receipt of tenant improvement cash allowance from the lessor in an operating lease after lease commencement

Lessee enters into an operating lease in which Lessor provides a tenant improvement allowance. The allowance is paid directly to Lessee when it presents invoices that evidence the leasehold improvement costs incurred.

Lessee makes the improvements after lease commencement (see Example 5.1.10 in KPMG Handbook, Leases), and concludes that the improvements are its assets, rather than Lessor's, for accounting purposes (see Question 5.4.80 in KPMG Handbook, Leases).

Lessee recognizes the full cost of the improvements as PP&E and classifies its payments for the improvements as cash flows from **investing** activities.

The cash allowance received from Lessor is an adjustment to Lessee's lease payments – i.e. in effect it either reduces future payments or refunds a portion of past payments. Therefore, any cash allowance received from Lessor is a cash flow from **operating** activities.

Question 14.2.130

How does a lessee classify tenant improvement allowance payments made by the lessor directly to a third party when leasehold improvements are the lessee's assets?

Interpretive response: It depends on whether the payment is made to the third party merely as a matter of convenience. If the lessor directly pays a third party for leasehold improvements that are the lessee's assets for accounting purposes, judgment is required to determine whether such payment represents a cash flow for the lessee – i.e. constructive receipt and disbursement (see section 4.7.10).

The following are examples.

— If the lessor pays on behalf of the lessee as a matter of convenience and the lessee is entitled to receive the cash directly from the lessor, we believe the lessee has received a cash incentive (see Question 14.2.120). This cash incentive is a constructive receipt (see section 4.7.10). Additionally, the lessee reflects a cash outflow for **investing** activities for the leasehold improvements acquired consistent with Example 14.2.10.

— If the lessor pays directly a third party and the lessee is not entitled to receive the cash directly from the lessor, we believe the acquisition of the asset(s) and the lessor payment for the asset(s) should be disclosed as a **noncash** investing activity (see section 4.7.20).

Question 14.2.140

How does a lessee classify termination fees received from a lessor?

Background: In certain circumstances, a lessor may exit a lease before the end of the lease term and compensate the lessee for the early termination. Reasons for an early lease termination may include an alternative use for the leased asset providing greater economic benefit, the ability to enter into a more profitable lease agreement with a different lessee, or an intent to sell the leased asset.

Interpretive response: Termination fees received from the lessor are a form of a lease incentive (see Question 14.2.120). Therefore, cash consideration the lessee receives as a result of the lessor terminating:

— an operating lease, is a cash inflow from **operating** activities;

— a finance lease, is a cash inflow from **financing** activities, because it extinguishes the lease liability.

Additionally, any gain or loss on the lease termination is a reconciling item in the reconciliation of net income to net cash flows from **operating** activities (see section 3.2).

14.2.60 Lease termination

Termination penalties are included in the lease payments unless it is reasonably certain that the lessee will *not* exercise an option to terminate the lease, and therefore will not incur the penalty. Therefore, the lease term governs whether a termination penalty is included in the lease payments. [842-10-30-5(d)]

When a lease is terminated before the lease term expires, the lessee accounts for the termination by removing the ROU asset and the lease liability, with a gain or loss recognized for the difference. [842-10-40-1]

See sections 5.4.5 and 6.8 of KPMG Handbook, Leases.

Question 14.2.150

How does a lessee classify termination penalties?

Interpretive response: Termination penalties are part of the consideration in the contract (see Question 14.2.10) regardless of whether they are:

— part of the consideration in the contract from lease commencement; or

— added subsequently as a result of a modification to, or reassessment of, the lease – e.g. on exercise of the termination option, if the lessee was previously reasonably certain that it would not be exercised.

Therefore, the portion of the termination penalty allocable to the lease is a 'lease payment', which is classified consistently with other lease payments (see Question 14.2.40), as follows. [842-10-30-5(d)]

Finance lease	
Repayment of accrued interest on the lease liability	**operating** activities
Other termination penalties	**financing** activities
Operating lease	
Termination penalties	**operating** activities

For lessee payments that terminate a lease by purchasing the underlying asset, see Question 14.2.160.

Question 14.2.160

How does a lessee classify payments to purchase the underlying asset?

Background: A lessee may decide to purchase the underlying asset from the lessor, thereby terminating the lease. The purchase may result from:

— the exercise of a purchase option for which the price was (or was not) included in the lease payments at lease commencement because the lessee was (or was not) reasonably certain at that date to exercise the option; or

— the lessee separately negotiating the purchase of the leased asset before the lease expires.

Any difference between the purchase price and the carrying amount of the lease liability immediately before the purchase is recorded by the lessee as an adjustment to the carrying amount of the asset. [842-20-40-2]

See section 6.8 in KPMG Handbook, Leases.

Interpretive response: Neither Topic 230 nor Topic 842 address the classification of payments to purchase the underlying asset in a lease. Therefore, we believe it is acceptable to apply either of the following approaches as an accounting policy election that should be disclosed and applied consistently by lease classification. We believe it is acceptable to elect a different accounting policy for finance leases and operating leases given the different nature of those lease transactions.

Approach 1: Termination cash outflow extinguishes the lease liability

Under this approach, the asset is purchased in a noncash exchange of the ROU asset for the underlying asset. This transaction is disclosed as a **noncash** investing activity (see Question 14.2.30).

The termination cash outflow extinguishes the liability and is classified consistently with other lease payments under the lease.

Any amount paid in excess of the outstanding lease liability is classified as cash flows from **investing** activities, consistent with the purchase of PP&E and other productive assets (see Question 8.2.10).

	Finance lease	Operating lease
Payment of accrued interest on the lease liability	**operating** activities	**operating** activities
Payment of lease liability	**financing** activities	**operating** activities
Residual payment	**investing** activities	**investing** activities

Approach 2: Termination cash outflow is for the purchase of the underlying asset

Under this approach, the termination of the lease first results in removing the ROU asset and lease liability in a noncash transaction, thereby reversing the noncash transaction that initially established them (see Question 14.2.20). This transaction is disclosed as a **noncash** investing and financing activity (see Question 14.2.30). [842-20-40-1]

The lease liability may exceed the carrying amount of the ROU asset; this is more commonly the case in a finance lease. The portion of the termination cash outflow that extinguishes any remaining liability is classified consistently with other lease payments under the lease.

The residual payment is classified as cash flows from **investing** activities, consistent with the purchase of PP&E and other productive assets (see Question 8.2.10).

	Finance lease	Operating lease
Payment of accrued interest on the lease liability	**operating** activities	**operating** activities
Payment of excess of lease liability over ROU asset (if applicable)	**financing** activities	**operating** activities
Residual payment	**investing** activities	**investing** activities

Difference between the approaches

The principal difference between the two approaches is that a lessee will generally recognize significantly greater investing cash outflows under Approach 2 because the lease liability will largely be eliminated in the noncash transaction to also eliminate the ROU asset.

In contrast, under Approach 1, most of the cash outflows will be treated as repayments of the lease liability because a significant portion of the underlying asset's purchase price will be 'paid for' by the return of the remaining ROU asset.

Example 14.2.20
Purchase of leased asset by lessee before end of lease term

Lessee leases an equipment asset for 10 years. There is no termination option. At lease commencement, Lessee recognized a lease liability of $100,000 and an ROU asset of $105,000.

At the end of Year 3, Lessee reaches an agreement with Lessor to purchase the equipment immediately for $85,000. The ending balances of the lease liability and ROU asset at the time of purchase are $84,000 and $73,000 respectively. Under Topic 842, no gain or loss is recognized.

Using Approach 1 or Approach 2 described in Question 14.2.160, Lessee classifies the payment of $85,000 in its Year 3 statement of cash flows as follows.

Scenario 1: the lease is a finance lease

$'000s	Approach 1	Approach 2
Cash flows from investing activities		
Capital expenditures[1]	(1)	(74)
Net cash provided by (used in) investing activities	**$(1)**	**$(74)**

$'000s	Approach 1	Approach 2
Cash flows from financing activities		
Principal payments on finance lease obligations	(84)[2]	(11)[3]
Net cash provided by (used in) financing activities	**$(84)**	**$(11)**
Supplemental schedule of noncash investing and financing activities		
Purchase of PP&E through exchange of lease ROU asset	73	-
Derecognition of ROU assets	(73)	(73)
Derecognition of lease liabilities		73

Notes:
1. Difference between total cash payment of $85,000 and the amount classified in financing activities.
2. Repayment of lease liability of $84,000.
3. Excess of lease liability ($84,000) over ROU asset ($73,000).

Scenario 2: the lease is an operating lease

$'000s	Approach 1	Approach 2
Cash flows from operating activities		
Net income (loss)	$ -	$ -
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Operating lease payments	(84)[1]	(11)[2]
Net cash provided by (used in) operating activities	**$(84)**	**$(11)**
Cash flows from investing activities		
Capital expenditures[3]	(1)	(74)
Net cash provided by (used in) investing activities	**$(1)**	**$(74)**
Supplemental schedule of noncash investing and financing activities		
Purchase of PP&E through exchange of lease ROU asset	73	-
Derecognition of ROU assets	(73)	(73)
Derecognition of lease liabilities		73

Notes:
1. Repayment of lease liability of $84,000.
2. Excess of lease liability ($84,000) over ROU asset ($73,000).
3. Difference between total cash payment of $85,000 and the amount classified in financing activities.

14.3 Lessor accounting

Question 14.3.10

How does a lessor classify payments for non-lease components?

Background: A contract may include lease and non-lease components (e.g. maintenance services). In general, the consideration in the contract is allocated among those components. Lease components are accounted for under Topic 842; non-lease components are accounted for under other applicable US GAAP. The consideration may include payments before or at/after lease commencement, lessor incentives or termination payments. [842-10-15-31]

However, as a practical expedient, a lessor may elect, if specified criteria are met, not to separate the lease and non-lease components that would be in the scope of Topic 606 (revenue) if accounted for separately; see paragraphs 4.4.51– 4.4.57 of KPMG Handbook, Leases. If the non-lease component is predominant, the combined component is accounted for under Topic 606; otherwise, the combined component is treated as a single operating lease component. [842-10-15-42A – 15-42C]

Interpretive response: In general, 'lease payments' refer to payments that relate to lease components. However, for a lessor that has elected the practical expedient not to separate the lease and non-lease components, 'lease payments' refer to the payments allocable to all of the components combined under the expedient.

Payments allocated to a non-lease component accounted for under Topic 606 (e.g. maintenance services) are cash flows from **operating** activities (see Question 7.2.10). Similarly, for a lessor that (1) has elected the practical expedient not to separate the lease and non-lease components, and (2) accounts for the combined component as a revenue transaction, payments under the contract are cash flows from **operating** activities.

14.3.10 Overview

Under Topic 842, a lessor determines lease classification for each separate lease component, which is the unit of account, at the lease commencement date. However, leveraged lease classification and accounting no longer exists prospectively from the effective date of Topic 842 (see chapter 1). [842-10-25-1]

In the statement of cash flows, a lessor classifies lease payments as follows.

Lease payments	Question	Before lease commencement	At or after lease commencement
Lease payments received[1]	14.3.30	N/A	**operating** activities
Prepayments received[1]	14.3.50	**operating** activities	**operating** activities

Lease payments	Question	Before lease commencement	At or after lease commencement
Deposits received[1]	14.3.60	**operating** activities	**operating** activities
Initial costs — Initial direct costs[1]	14.3.70	**operating** or **investing** activities depending on lease classification[2]	**operating** or **investing** activities depending on lease classification
— Origination costs that are not initial direct costs	14.3.80	**operating** activities	**operating** activities
Lease incentives paid[1]	14.3.90	**operating** activities	**operating** activities

Notes:

1. Except for financial institutions in the scope of Topic 942 (see Question 14.3.30).
2. Lease classification is not determined until lease commencement under Topic 842; however, when a lessor makes payments for initial direct costs before lease commencement, we believe it should use the best information available about classification of the lease at the time it must classify the cash flows for financial reporting purposes.

14.3.20 Lease commencement

In a sales-type lease, at lease commencement the lessor treats the transaction as if it sold the leased asset in exchange for a net investment in the lease (a financial asset) and recognizes any selling profit or loss from the sale of the leased asset. [842-30-25-1]

In a direct financing lease, at lease commencement the lessor also recognizes a financial net investment in the lease and any selling *loss* resulting from the lease. However, any selling *profit* is deferred, reducing the carrying amount of the net investment in the lease. Deferred selling profit is therefore recognized in income in a manner consistent with the interest income resulting from the lease. [842-30-25-7 – 25-8]

In an operating lease, a lessor records no journal entry at lease commencement other than for the effects of accrual accounting – e.g. to reflect a lessee prepayment of rent.

Question 14.3.20

How does lease commencement affect a lessor's statement of cash flows?

Interpretive response: The following table summarizes the effect of lease commencement under Topic 842 on a lessor's statement of cash flows.

All lease types	
Purchase of leased asset	Generally, cash outflow for **investing** activities, but see predominance principle in section 8.5.10. [230-10-45-13(c)]
Sales-type lease	
Sale of leased asset in exchange for net investment in the lease	**Noncash** investing activity (see section 4.7.20).
Selling profit or loss recognized at lease commencement	Reconciling item in the reconciliation of net income to net cash flows from **operating** activities (see section 3.2).
Direct financing lease	
Recognition of net investment in the lease (net of any selling profit)	**Noncash** investing activity (see section 4.7.20).
Selling loss recognized at lease commencement	Reconciling item in the reconciliation of net income to net cash flows from **operating** activities (see section 3.2).
Operating lease	
Lease commencement	No effect on lessor's statement of cash flows, and no noncash investing and financing activity disclosure requirement. However, if the lessee makes a deposit or lease prepayment before or at commencement, there is an effect on the lessor's statement of cash flows (see Questions 14.3.50 and 14.3.60).

14.3.30 Lease payments

Excerpt from ASC 842-30

> Sales-Type and Direct Financing Leases

>> Statement of Cash Flows

45-5 In the statement of cash flows, a **lessor** shall classify cash receipts from **leases** within operating activities. However, if the lessor is within the scope of Topic 942 on financial services—depository and lending, it shall follow the guidance in paragraph 942-230-45-4 for the presentation of principal payments received from leases.

> Operating Leases

>> Statement of Cash Flows

45-7 In the statement of cash flows, a **lessor** shall classify cash receipts from **leases** within operating activities.

Excerpt from ASC 942-230

45-4 Entities within the scope of this Subtopic shall classify principal payments received under sales-type and direct financing leases within investing activities.

Question 14.3.30

How does a lessor classify lease payments received?

Interpretive response: Under Topic 842, a lessor (other than a financial institution in the scope of Topic 942) classifies all lease payments as cash flows from **operating** activities. [842-30-45-5, 45-7]

Financial institution lessors in the scope of Topic 942 present: [942-230-55-1 – 55-2]

— the principal portion of lessee payments made on sales-type or direct financing leases as cash flows from **investing** activities, consistent with the classification of similar cash flows from other lending activities; and

— all other lessee payments, including the interest portion of lessee payments made on sales-type or direct financing leases, as cash flows from **operating** activities.

Question 14.3.40

May a lessor classify lease payments received for a sales-type or direct financing lease as cash inflows from investing activities?

Interpretive response: Generally, no, unless the lessor is a financial institution in the scope of Topic 942 (see Question 14.3.30). Despite the fact that some lessors adopted that practice under Topic 840, Topic 842 is explicit that all cash payments from leases are classified as cash flows from **operating** activities. [842-30-45-5]

Question 14.3.50

How does a lessor classify lease payments received before the lease commencement date?

Interpretive response: Nonrefundable lease payments received before lease commencement (i.e. lease prepayments) are part of the consideration in the contract (see Question 14.3.10). A lessor classifies prepayments consistent with how it classifies other lessee payments of the consideration in the contract, which is generally as a cash inflow from **operating** activities. For an exception for some financial institutions, see Question 14.3.30.

Question 14.3.60
How does a lessor classify a deposit received?

Interpretive response: Deposits from the perspective of the lessee are discussed in Question 14.2.70. How the lessor classifies a deposit received from the lessee before or at the lease commencement date depends on whether the deposit is refundable.

Deposit is nonrefundable

If the deposit is nonrefundable, we believe the lessor classifies the cash inflow consistent with lease prepayments (see Question 14.3.50).

Deposit is refundable

If the deposit is refundable, it is not part of the consideration in the contract. A refundable deposit received from the lessee is recognized as a liability on the lessor's balance sheet. If it is expected that the lessor will refund the deposit in cash at a future date, we believe its initial cash inflow and subsequent cash outflow are cash flows from **operating** activities because these cash flows do not meet the definition of investing or financing activities. We do not believe such cash flows are financing cash flows because most refundable deposits are placed into an escrow account whereby the lessor has no use of the lessee's cash. Any interest paid on the deposit is a cash outflow for **operating** activities. [230-10-45-16(c), 45-17(d), 45-17(f)]

14.3.40 Initial direct costs

See section 14.2.40 for the definition of initial direct costs.

In an operating lease, the lessor recognizes initial direct costs to expense over the lease term on the same basis as lease income. [842-30-25-11(c)]

In a sales-type lease where the fair value of the underlying asset equals its carrying amount at lease commencement and in a direct financing lease, the lessor includes initial direct costs in the initial measurement of the net investment in the lease. [842-30-25-1(c), 25-8]

In a sales-type lease where the fair value of the underlying asset differs from its carrying amount at lease commencement, the lessor expenses initial direct costs at lease commencement. [842-30-25-1(c)]

For additional guidance on initial direct costs, see section 5.5 in KPMG Handbook, Leases.

Question 14.3.70

How does a lessor classify cash flows for initial direct costs?

Interpretive response: We believe a lessor's classification of its cash outflows for initial direct costs depends on the lease classification and the related accounting treatment of such costs at lease commencement.

Lease classification[1]	Initial direct costs	Classification
Operating lease	Expense over lease term on same basis as lease income	**operating** activities[2]
Sales-type – fair value of the asset differs from its carrying amount at lease commencement	Expense at lease commencement	**operating** activities[2]
Sales-type – fair value of the asset equals its carrying amount at lease commencement	Include in initial measurement of net investment in the lease	**investing** activities
Direct financing lease	Include in initial measurement of net investment in the lease	**investing** activities

Notes:

1. Lease classification is determined at lease commencement. Therefore, a lessor may not *definitively* know the classification of a lease when a payment for an initial direct cost is made. In this case, we believe a lessor should classify the payment in its statement of cash flows based on the best information it has available as to how the lease will be classified when assessed at lease commencement.
2. This classification is consistent with the definition of **operating** activities, which 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." [230-10 Glossary]

However, because Topic 842 does not specifically address how to classify payments made for initial direct costs in the statement of cash flows, and it appears that no change from the legacy treatment under Topic 840 was intended, we would not object to a lessor continuing to classify initial direct costs as it did under Topic 840 (see Question 14A.3.10).

Question 14.3.80

How does a lessor classify lease origination costs that are not initial direct costs?

Background: See Question 14.2.100 for additional discussion of costs that are not initial direct costs.

Interpretive response: These costs are cash outflows for **operating** activities. This classification is consistent with the definition of **operating** activities, which 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." [230-10 Glossary]

14.3.50 Lease incentives paid

See section 14.2.50 for background on lease incentives.

Question 14.3.90
How does a lessor (other than a financial institution) classify lease incentives paid to the lessee?

Background: Lease incentives that are paid or payable to the lessee (or a third party on the lessee's behalf) at lease commencement reduce the initial measurement of the lessor's net investment in the lease for sales-type and direct financing leases. In an operating lease, the lessor defers the cost of any lease incentives paid or payable and recognizes that cost as a reduction of lease income over the lease term. [842-30-25-11(a), 30-1]

Interpretive response: Because all lease payments received by the lessor are classified as cash flows from **operating** activities, except for some financial institutions (see Question 14.3.30), any lease incentives paid to the lessee (or a third party on the lessee's behalf) reduce those lease payments and therefore are cash outflows for **operating** activities. [230-10-45-16(c)]

Example 14.3.10
Leasehold improvements paid by the lessor in an operating lease

Scenario 1: Lessor is the owner of improvements

Lessor's primary business is leasing real estate to third-party lessees under operating leases. Lessor often pays for improvements before tenant occupancy and is the owner of the improvements for accounting purposes.

Because Lessor's primary business is leasing real estate, Lessor's real estate properties are productive assets and payments to acquire such assets are cash outflows for **investing** activities. Similarly, Lessor owns the improvements for accounting purposes, and they are productive assets. Therefore, the payments to acquire those improvements are also cash outflows for **investing** activities.

Scenario 2: Lessor does not own improvements

Assume the same facts as Scenario 1, except that Lessee (not Lessor) owns the improvements for accounting purposes.

In this scenario, the payments are lease incentives and therefore are cash outflows for **operating** activities (see Question 14.3.90). Such payments are not cash outflows for investing activities because they do not relate to the acquisition or improvement of assets Lessor owns.

For additional guidance on determining the accounting owner of leasehold improvements, see Question 5.4.80 in KPMG Handbook, Leases.

14.4 Sale-leaseback transactions

14.4.10 Overview

In a sale-leaseback transaction, one entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and then the seller-lessee leases the asset back from the buyer-lessor.

Sale-leaseback accounting applies only to transactions that qualify for sale accounting based on specific requirements in Subtopic 842-40. Transactions that do not qualify for such accounting are known as 'failed' sale-leaseback transactions. Sections 9.2 and 9.3 of KPMG Handbook, Leases, discuss the accounting for successful and failed sale-leaseback transactions, respectively.

14.4.20 Accounting for sale-leaseback transactions

Question 14.4.10
How are cash flows from/for a sale-leaseback transaction classified?

Background: This interpretive response assumes that a transaction qualifies for sale-leaseback accounting. Section 14.4.30 addresses transactions that do not qualify for sale-leaseback accounting – i.e. 'failed' sale-leaseback transactions.

Interpretive response: Because a sale-leaseback transaction involves two transactions – a sale/purchase of an asset followed by a lease of that asset – the two transactions are separately classified.

Seller-lessee

Transaction	Classification
Proceeds from sale of underlying asset up to fair value[1]	**investing** activities [230-10-45-12(c)]
Proceeds from sale of underlying asset in excess of fair value[1]	**financing** activities [230-10-45-14(b)]

Transaction	Classification
Lease payments	Consistent with classification of other operating lease[2] payments made by lessee (see section 14.2.30)

Buyer-lessor

Transaction	Classification
Payment to purchase underlying asset	**investing** activities[3] [230-10-45-13(c)]
Receipt of lease payments	Consistent with other operating lease[2] payments received by lessor (see section 14.3.30)

Notes:

1. When the sale price exceeds the fair value of the leased asset, the excess represents additional financing from the buyer-lessor to the seller-lessee; see section 9.2.2 of KPMG Handbook, Leases.
2. All leasebacks in successful sale-leaseback transactions under Topic 842 are classified as operating leases. If the leaseback were classified as a finance lease, the transfer of the underlying asset would not qualify as a sale – i.e. the transaction would be accounted for as a 'failed' sale-leaseback. [842-40-25-2]
3. This is regardless of whether the sale price exceeds the fair value of the underlying asset. Cash out-flows to originate loans are also classified as investing activities (see Question 11.2.10).

14.4.30 Accounting for 'failed' sale-leaseback transactions

Question 14.4.20
How are cash flows from/for a 'failed' sale-leaseback transaction classified?

Interpretive response:

Seller-lessee

In a 'failed' sale-leaseback transaction, the seller-lessee continues to reflect the asset it 'sold' on its balance sheet as if it still legally owns the asset. Further, the seller-lessee reflects the sale proceeds received from the buyer-lessor as a financing on its balance sheet. [842-40-25-5(a)]

Transaction	Classification
Proceeds received from buyer-lessor in 'failed' sale	**financing** activities [230-10-45-14(b)]
Principal payments on deemed financing transaction (i.e. the contractual lease payments)	**financing** activities [230-10-45-15(b)]
Interest payments on deemed financing transaction (i.e. the contractual lease payments)	**operating** activities[1] [230-10-45-17(d)]

Note:

1. Included in cash flows from **investing** activities to the extent that the payments are for costs to bring another asset to the condition and location necessary for its intended use (see section 8.5.20).

Buyer-lessor

In a 'failed' sale-leaseback transaction, the buyer-lessor does not recognize the transferred asset on its balance sheet. Further, the buyer-lessor accounts for the proceeds paid to the seller-lessee on the 'purchase' as a receivable (financial asset) on its balance sheet. [842-40-25-5(b)]

Transaction	Classification
Payment to/from buyer-lessor in 'failed' sale	**investing** activities [230-10-45-13(a)]
Principal payments received on deemed financing transaction (i.e. the contractual lease payments)	**investing** activities [230-10-45-12(a)]
Interest payments received on deemed financing transaction (i.e. the contractual lease payments)	**operating** activities [230-10-45-16(b)]

14A. Leases – Topic 840

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Example

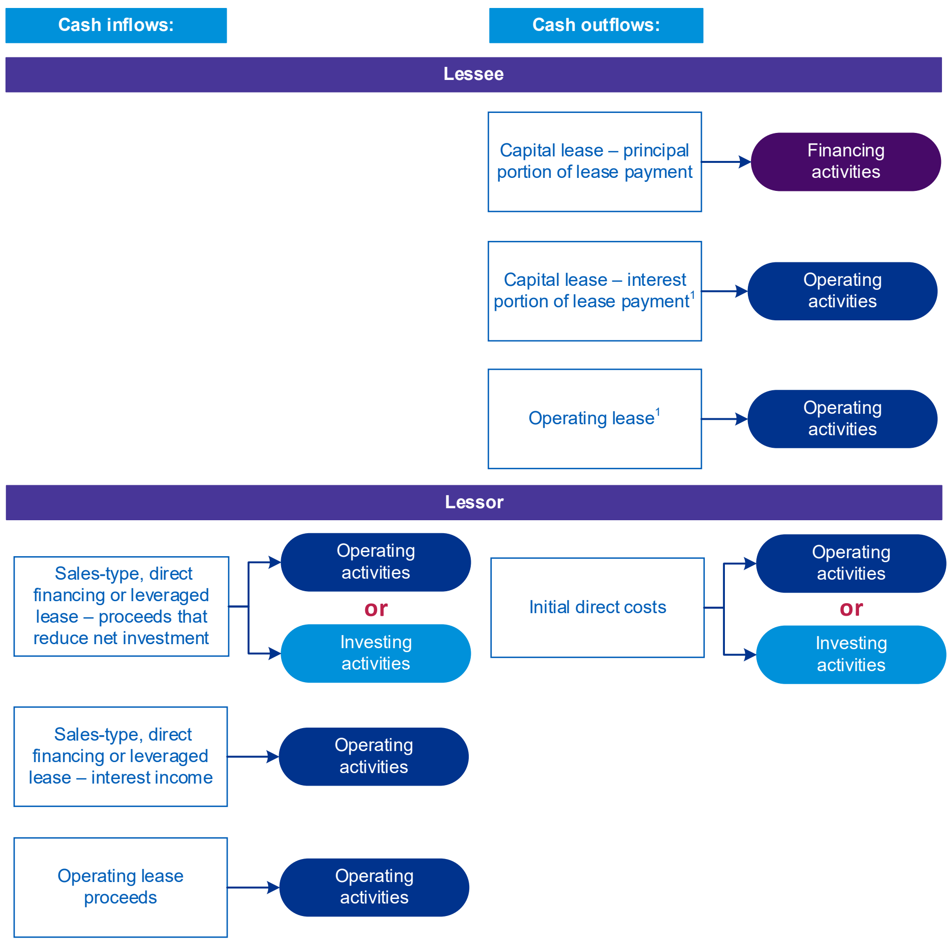
14A.4 Sale-leaseback transactions

Questions

14A.1 How the standard works

This chapter addresses how to classify cash flows from leasing activities, from both the perspective of the lessee (see section 14A.2) and the lessor (see section 14A.3) under Topic 840 (i.e. before adoption of Topic 842).

The following chart summarizes some of the classification issues encountered, which are explained in more detail in this chapter.



Note:

1. Included in cash flows from **investing** activities to the extent the payments represent costs to bring another asset to the condition and location necessary for its intended use (see section 8.5.20).

14A.2 Lessee accounting

14A.2.10 Overview

Lease classification (i.e. capital or operating lease) is critical in lessee accounting under Topic 840 because lease assets and lease liabilities are recognized only for capital leases. The lease classification distinction under Topic 840 also affects how a lessee measures and presents lease expense and cash flows.

14A.2.20 Commencement of a lease

On commencement of a capital lease, a lessee recognizes an asset and obligation on its balance sheet for the right to use the asset. [840-30-25-1]

Leases that do not meet any of the criteria for capital leases are classified as operating leases. In an operating lease, a lessee does not recognize an asset or obligation on its balance sheet for the right to use the asset. [840-10-25-1]

Question 14A.2.10

How does the commencement of a capital lease affect a lessee's statement of cash flows?

Interpretive response: A lessee's recognition of an asset and obligation on commencement of a capital lease is a noncash transaction that is not presented in its statement of cash flows.

Instead, this transaction is separately disclosed as a **noncash** investing and financing activity because the lessee is obtaining the right to use an underlying asset for the lease term in exchange for a lease liability (see section 4.7.20). [230-10-50-3 – 50-4]

Question 14A.2.20

How does the commencement of an operating lease affect a lessee's statement of cash flows?

Interpretive response: Because no lease asset or obligation is recognized on a lessee's balance sheet at commencement of an operating lease, there is generally no effect on the lessee's statement of cash flows, and no noncash investing and financing activity disclosure requirement.

However, if the lessee makes a deposit or lease prepayment at or before lease commencement, the lessee's statement of cash flows is affected (see Question 14A.2.30).

Question 14A.2.30
How does a lessee classify a deposit paid to the lessor at or before the lease commencement date?

Background: Lease agreements frequently include requirements for the lessee to remit a cash deposit to the lessor on or before the lease commencement date. Cash deposits are usually refundable and represent additional collateral for the lessor. However, they can also be nonrefundable when representing the lessee's intent to lease the asset.

Interpretive response: The classification of a lessee's deposit depends on whether it is refundable.

If the deposit is nonrefundable, it is part of the minimum lease payments (if there are no non-lease elements) or total arrangement consideration (if there are non-lease elements that the consideration will be partially allocated to). Therefore, the lessee classifies the cash flows consistent with its classification of payments for leasing transactions (see section 14A.2.30). [840-10-15-19]

In contrast, if the deposit is refundable, it is not part of the minimum lease payments (or total arrangement consideration). If the deposit is expected to be refunded by the lessor at a future date, we believe the lessee's initial cash outflow and subsequent cash inflow are cash flows from **operating** activities because they do not meet the definition of investing or financing activities. Further, interest accrued on the deposit that is refunded is also a cash inflow from **operating** activities. [230-10-45-16(b), 45-16(c), 45-17(f)]

14A.2.30 Lease payments

Question 14A.2.40
How does a lessee classify lease payments?

Interpretive response: Under Topic 840, a lessee classifies cash flows from/for a leasing transaction as follows.

Capital lease	
Repayment of principal portion of lease liability	**financing** activities [230-10-45-15(b)]
Interest on the lease liability	**operating** activities[1] [230-10-45-17(d)]
Operating lease	
Lease payments	**operating** activities[1] [230-10-45-17(f)]

Note:

1. Included in cash flows from **investing** activities to the extent the payments represent costs to bring another asset to the condition and location necessary for its intended use (see section 8.5.20).

Question 14A.2.50

How does a lessee classify cash flows for land-use rights?

Background: In certain countries, such as China, land is government-owned and restrictions exist over the transfer of legal title to real property. However, the government in such countries may grant land-use rights permitting an entity to exclusively use the property for a specified number of years for a fee. This fee is commonly paid up-front and the land-use rights do not include the right to purchase the land at the end of the term.

Interpretive response: How payments for land-use rights are classified depends on whether those rights are accounted for as a lease.

If the land-use rights are accounted for as a lease, the lessee's payments are classified based on the classification guidance for other lease payments (see Question 14A.2.40). [840-10-15-6 – 15-9]

If the land-use rights are not accounted for as a lease, the payments for those rights are classified consistently with the nature of those rights. For example, the payments would be cash outflows for **investing** activities in the following circumstances: [230-10-45-13(c)]

- if the entity accounts for the land-use rights as an intangible asset; or
- if the entity concludes that the land-use rights permit the construction of real property on the land, and therefore that the payments represent costs to bring another asset to the condition and location necessary for its intended use.

Question 14A.2.60

How does a lessee classify cash flows from termination fees received from a lessor?

Background: In certain circumstances, a lessor may exit a lease before the end of the lease term and compensate the lessee for the early termination. Reasons for an early lease termination may include an alternative use for the leased asset that is more economically beneficial, the ability to enter into a more profitable lease agreement with a different lessee or an intent to sell the leased asset.

Interpretive response: How a lessee classifies termination fees received from the lessor depends on whether the lease is an operating or capital lease.

For an operating lease, we believe cash consideration the lessee receives as a result of the lessor terminating the lease is a cash flow from **operating** activities. This is because such consideration does not meet the definition of investing or financing activities. Also, the fees are analogous to a refund from a vendor (a refund of previous lease payments), which are cash outflows for **operating** activities. [230-10-45-16(c)]

For a capital lease, we believe the lessee should generally classify a termination fee as a cash flow from **financing** activities because it releases the lessee as the obligor under the lease liability (i.e. extinguishment of capital lease obligation). Additionally, any resulting gain or loss recognized on the transaction is a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2).

14A.2.40 Receipt of lease incentives

A lessor may offer incentives to the lessee to sign the lease agreement. Lease incentives include both: [840-20-25-7]

— payments made by the lessor to or on behalf of the lessee; and
— losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party.

Incentive payments may be made before and/or after lease commencement and may be structured to be contingent on future events or lessee actions. For example, a lessor may agree to reimburse a lessee for the cost of leasehold improvements, with payment contingent on the lessee constructing or installing the improvements.

All payments made by a lessor to a lessee are an incentive, reducing the minimum lease payments, unless the payments are for a distinct good or service provided by the lessee to the lessor – e.g. for constructing, or managing the construction of, the lessor's assets. In addition, even if the lessee provides a distinct good or service to the lessor, any amount of the lessor's payments in excess of the fair value of the distinct good or service is an incentive. [606-10-32-25, 32-26]

In an operating lease, lease incentives received by the lessee represent a reduction of its minimum lease payments and are recognized as a liability that is amortized on a straight-line basis over the lease term as a reduction of rent expense. [840-20-25-6, 55-3]

In contrast, in a capital lease, lease incentives received by the lessee are factored into the initial measurement of the capital lease asset and obligation. [840-30-30-1]

Question 14A.2.70

How does a lessee classify lease incentive payments received from the lessor?

Interpretive response: It depends on whether the lease is an operating lease or capital lease.

For an operating lease, lease incentive payments the lessee receives are cash inflows from **operating** activities. This is because lease incentives effectively reduce the operating minimum lease payments, which are cash outflows for **operating** activities. [TQA 5600.17]

For a capital lease, we believe lease incentive payments the lessee receives are generally cash inflows from **financing** activities, consistent with the classification of the principal payments (see Question 14A.2.40).

Example 14A.2.10

Receipt of tenant improvement allowance payments from the lessor in an operating lease

Lessee enters into an operating lease in which Lessor provides a tenant improvement allowance. The allowance is paid directly to Lessee when it presents invoices that evidence the leasehold improvement costs incurred. Lessee has concluded that the improvements are its assets for accounting purposes – i.e. Lessee is not receiving the payments from Lessor in the capacity of an agent or a customer of Lessor.

Lessee recognizes the full cost of the improvements as PP&E and classifies its payments for the improvements as cash flows from **investing** activities.

The cash allowance received from Lessor is an adjustment to Lessee's minimum lease payments – i.e. in effect it either reduces future payments or refunds a portion of past payments. Therefore, any cash allowance received from Lessor is a cash inflow from **operating** activities.

The SEC staff expressed the same views in a February 7, 2005 letter to the Center for Public Company Audit Firms.

Question 14A.2.80

How does a lessee classify tenant improvement allowance payments made by the lessor directly to a third party when leasehold improvements are the lessee's asset?

Interpretive response: It depends on whether the payment is made to the third party merely as a matter of convenience. If the lessor pays a third party directly for leasehold improvements that are the lessee's assets for accounting purposes, judgment is required to determine whether such payment represents a cash flow for the lessee – i.e. constructive receipt and disbursement (see section 4.7.10).

The following are examples.

— If the lessor makes a payment on behalf of the lessee as a matter of convenience and the lessee is entitled to receive the cash directly from the lessor, we believe that the lessee has received a cash incentive (see Question 14A.2.70). Additionally, the lessee reflects a cash outflow for **investing** activities for the leasehold improvements acquired consistent with Example 14A.2.10. [230-10-45-13(c), TQA 5600.17]

— If the lessor pays a third party directly and the lessee is not entitled to receive the cash directly from the lessor, we believe the acquisition of the asset(s) and the lessor payment for the asset(s) should be disclosed as a **noncash** investing activity (see section 4.7.20). [230-10-50-3]

14A.3 Lessor accounting

14A.3.10 Overview

Under Topic 840, a lessor classifies a lease as a (1) sales-type, (2) direct financing, (3) leveraged, or (4) operating lease. The classification of a lease determines its accounting, presentation and disclosure. [840-10-25-43]

14A.3.20 Lease commencement

In a sales-type lease, at lease commencement the lessor treats the transaction as if it sold the leased asset in exchange for a net investment in the lease (a financial asset) and recognizes any selling profit or loss from the sale of the leased asset. [840-10-25-43(a), 840-30-25-6]

In a direct financing lease, at lease commencement the lessor also recognizes a financial net investment in the lease. However, there is no selling profit or loss. [840-10-25-43(b), 840-30-25-7]

In a leveraged lease, the accounting is similar to a direct financing lease except that the lease agreement is partially financed by the lessor through a third-party lender. The lender holds the title to the leased asset. The lessor creates the agreement with the lessee, collects the payments and passes them on to the lender. [840-10-25-43(c), 840-30-25-8]

In an operating lease, no journal entry is recorded by a lessor at lease commencement other than for the effects of accrual accounting, such as to reflect a lessee prepayment of rent.

The table summarizes the effect of lease commencement under Topic 840 on a lessor's statement of cash flows.

All lease types	
Purchase of leased asset	Generally **investing** activities (see consideration of predominance principle in section 8.5.10) [230-10-45-13(c)]
Sales-type lease	
Sale of the leased asset in exchange for net investment in the lease	**noncash** investing activity (see section 4.7.20)
Selling profit or loss recognized at lease commencement	Reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2)
Direct financing lease	
Recognition of net investment in the lease	**noncash** investing activity (see section 4.7.20)
Leveraged lease[1]	
Cash received by lessor from debt incurred	**financing** activities [230-10-45-14(b)]
Recognition of net investment in the lease	**noncash** investing activity (see section 4.7.20)

Operating lease	
Lease commencement	No effect on lessor's statement of cash flows, and no noncash investing and financing activity disclosure requirement. However, if the lessee makes a deposit or lease prepayment at or before commencement, there is an effect on the lessor's statement of cash flows (see Question 14A.3.20).

Note:

1. Accounting for a leveraged lease by the lessor requires net presentation on the balance sheet of the investment in the leased asset and the related nonrecourse debt obligation that finances part of the cost of the leased asset. [840-30-30-14]

Question 14A.3.10

How does a lessor classify cash flows for initial direct costs?

Background: Initial direct costs are those costs incurred by a lessor that are directly associated with the origination of a lease. Examples of such costs are commissions, legal fees, credit checks, and preparing and processing documents. [840-20-25-17]

In a sales-type lease, initial direct costs are expensed at lease commencement. [840-30-25-6]

In a direct financing lease and a leveraged lease, initial direct costs are recognized as an asset that is amortized to income together with unearned income. [840-30-30-11]

In an operating lease, the lessor recognizes initial direct costs as expenses over the lease term on the same basis as lease income. [840-20-25-16]

Interpretive response: There is diversity in practice in the classification of a lessor's cash flows for initial direct costs.

Classification as cash flows from **operating** activities is consistent with the definition of **operating** activities, which 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." Further, because lessors are generally in the business of entering into leases, such payments generally represent payments to vendors that are cash flows from **operating** activities. However, some lessors present initial direct costs as cash flows from **investing** activities. [230-10 Glossary, 230-10-45-17(b)]

We would not object to a lessor presenting these payments for initial direct costs as cash flows from either **operating** or **investing** activities if that classification is disclosed and consistently applied.

Question 14A.3.20

How does a lessor classify a deposit received on or before the lease commencement date?

Background: See Question 14A.2.30 for additional discussion of deposits made on or before the lease commencement date.

Interpretive response: How the lessor classifies a deposit received from the lessee on or before the lease commencement date depends on whether the deposit is refundable.

If the deposit is nonrefundable, it is part of the minimum lease payments (if there are no non-lease elements) or total arrangement consideration if the consideration will be partially allocated to non-lease elements. In this case, the lessor classifies the cash received consistent with its classification of the lessee's other minimum lease payments (or total arrangement consideration). [840-10-15-19]

If the deposit is refundable, it is not part of the minimum lease payments (or total arrangement consideration). The lessor recognizes a refundable deposit received from the lessee as a liability on its balance sheet. If the deposit is expected to be refunded by the lessor in cash at a future date, we believe the lessor's initial cash inflow and subsequent cash outflow are cash flows from **operating** activities because these cash flows do not meet the definition of investing or financing activities. We do not believe such cash flows are financing cash flows because most refundable deposits are placed into an escrow account and the lessor does not have use of the lessee's cash. Any interest paid on the deposit is a cash outflow for **operating** activities. [230-10-45-16(c), 45-17(d), 45-17(f)]

14A.3.30 Lease payments

Question 14A.3.30

How does a lessor classify payments received in a leasing transaction?

Interpretive response: A lessor classifies all payments after lease commencement as:

Sales-type lease	
Portion of lease payment received that reduces net investment in the lease	**operating** or **investing** activities[1]
Portion of lease payment received that relates to interest	**operating** activities [230-10-45-16(b)]
Direct financing lease	
Portion of lease payment received that reduces net investment in the lease	**operating** or **investing** activities[1]
Portion of lease payment received that relates to interest	**operating** activities [230-10-45-16(b)]

Leveraged lease	
Portion of lease payment received that reduces net investment in the lease	**operating** or **investing** activities[1]
Portion of lease payment received that relates to interest	**operating** activities [230-10-45-16(b)]
Portion of debt payment made by lessor that relates to principal	**financing** activities [230-10-45-15(b)]
Portion of debt payment made by lessor that relates to interest	**operating** activities [230-10-45-17(d)]
Operating lease	
Lease payment received	**operating** activities [230-10-45-16(c)]

Note:

1. Neither Topic 230 nor Topic 840 addresses the classification of lease payments received from a sales-type, direct financing or leveraged lease. Some lessors classify principal payments received as cash flows from **operating** activities because the lease represents a revenue-generating activity. Other lessors have adopted the practice of classifying these types of cash receipts from a lessee as cash flows from **investing** activities. We believe that either approach is acceptable if it is consistently applied, and the lessor discloses its policy.

14A.3.40 Lease incentive payments

See section 14A.2.40 for background on lease incentives.

Question 14A.3.40
How does a lessor classify lease incentive payments made to the lessee?

Background: Lease incentives that are paid or payable to the lessee (or a third party on the lessee's behalf) at lease commencement are deferred and recognized as a reduction of lease income over the lease term. [840-20-25-6]

Interpretive response: Because any lease incentive payments made by a lessor reduce a lessee's minimum lease payments, the lessor should classify the resulting cash outflow in a consistent manner with other minimum lease payments (see Question 14A.3.30).

Example 14A.3.10
Leasehold improvements paid by the lessor in an operating lease

Scenario 1: Lessor is the owner of improvements

Lessor's primary business is leasing real estate to third-party lessees under operating leases. Lessor often pays for improvements before tenant occupancy and is the owner of the improvements for accounting purposes.

Because Lessor's primary business is leasing real estate, Lessor's real estate properties are productive assets and payments to acquire such assets are cash outflows for **investing** activities. Similarly, the improvements are owned by Lessor for accounting purposes and are productive assets. Therefore, the payments to acquire those improvements are also cash outflows for **investing** activities. [230-10-45-13(c)]

Scenario 2: Lessor is not the owner of improvements

Assume the same facts as Scenario 1, except that Lessor is not the owner of the improvements for accounting purposes – e.g. the lessee is the accounting owner of the improvements.

In this scenario, the payments are lease incentives and are classified as cash flows from **operating** activities (see Question 14A.3.30). Such payments are not cash outflows for investing activities because they do not relate to the acquisition or improvement of real property owned by Lessor. [230-10-45-16(c)]

14A.4 Sale-leaseback transactions

In a sale-leaseback transaction, one entity (the seller-lessee) transfers an asset to another entity (the buyer-lessor) and then the seller-lessee leases the asset back from the buyer-lessor.

Sale-leaseback accounting under Subtopic 840-40 applies to qualifying transactions. Transactions that do not qualify for this accounting are known as 'failed' sale-leaseback transactions.

14A.4.10 Accounting for sale-leaseback transactions

Question 14A.4.10

How are cash flows from/for a sale-leaseback transaction classified?

Background: This response assumes that a transaction qualifies for sale-leaseback accounting. Section 14A.4.20 addresses 'failed' sale-leaseback transactions.

Interpretive response: Because a sale-leaseback transaction involves two transactions – a sale/purchase of an asset followed by a lease of that asset – the two transactions are separately classified.

Seller-lessee

Transaction	Classification
Sale of leased asset	**investing** activities [230-10-45-12(c)]
Lease payments	Consistent with classification of other lease payments made by lessee (see section 14A.2.30)

Buyer-lessor

Transaction	Classification
Purchase of leased asset	**investing** activities [230-10-45-13(c)]
Receipt of lease payments	Consistent with classification of other lease payments received by lessor (see section 14A.3.30)

14A.4.20 Accounting for 'failed' sale-leaseback transactions

Question 14A.4.20

How are cash flows from/for a 'failed' sale-leaseback transaction classified?

Interpretive response:

Seller-lessee

In a 'failed' sale-leaseback transaction, the seller-lessee continues to reflect the asset it 'sold' on its balance sheet as if it still legally owns the asset. Further, the seller-lessee generally reflects the sale proceeds received from the buyer-lessor as a financing on its balance sheet. However, as an exception, using the deposit method is also permitted when the sales price of the underlying asset is paid to the seller-lessee over time. [840-40-25-11]

Transaction	Classification
Proceeds received from buyer-lessor in 'failed' sale	**financing** activities [230-10-45-14(b)]
Principal payments on deemed financing transaction (i.e. the contractual lease payments)	**financing** activities [230-10-45-15(b)]
Interest payments on deemed financing transaction (i.e. the contractual lease payments)	**operating** activities[1] [230-10-45-17(d)]

Note:

1. Included in cash flows from **investing** activities to the extent the payments represent costs to bring another asset to the condition and location necessary for its intended use (see section 8.5.20).

Buyer-lessor

In a 'failed' sale-leaseback transaction, the buyer-lessor accounts for the purchase and lease of the asset as separate, stand-alone transactions and is not required to evaluate the transactions under the same guidance that results in 'failed' sale-leaseback transactions for the seller-lessee. As such, the buyer-lessor should follow the guidance in Question 14A.4.10.

15. Employee benefit plans

Detailed contents

Item significantly updated in this edition: #

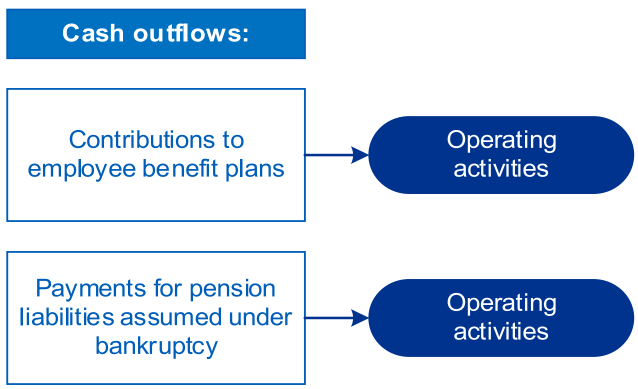
15.1 How the standard works

Employee benefit plans are any benefits (other than salary or other individual compensation benefits) granted by an employer to its employees that are generally subject to a written plan document or that may be established through well-understood policies.

This chapter addresses classification matters from the employer/plan sponsor perspective related to employee benefit plans, which include defined benefit pension plans, defined contribution pension plans, postretirement plans and health and welfare plans.

For an in-depth understanding of the accounting requirements for employee benefits, see KPMG Handbook, Employee benefits.

The following chart summarizes some of the classification issues encountered, which are explained in more detail in this chapter.



See chapter 16 for guidance over classification matters relating to share-based payment arrangements with employees.

15.2 Contributions to employee benefit plans

Question 15.2.10#

How are cash flows for contributions to an employee benefit plan classified?

Interpretive response: Employer's contributions to an employee benefit plan are cash outflows for **operating** activities because they represent payments for employee compensation. Classification is not affected by the required or discretionary nature of the contribution. [230-10-45-17(b)]

When the statement of cash flows is prepared under the direct method, we believe cash contributions should be presented on one line in cash flows from **operating** activities, irrespective of the fact that Topic 715 requires the net benefit cost to be reported in the income statement based on the nature of the expense (e.g. service cost, interest cost).

For further guidance about the presentation under the indirect method, see Question 15.2.30.

Question 15.2.30#

How is the change in the pension liability or asset presented?

Background: The change in the pension liability or asset on the balance sheet includes items recorded through OCI and net income, as well as cash and noncash items. Items recorded through OCI include remeasurement adjustments such as actuarial gains and losses. The net periodic pension cost or credit for the period (inclusive of amortization of actuarial gains and losses and prior service costs or credits previously recorded through OCI) is recorded through net income and is noncash. Conversely, the employer's contributions to the pension plan are not recorded through net income but are cash outflows (see Question 15.2.10).

Interpretive response: Remeasurement adjustments recorded in OCI do not impact the statement of cash flows. In our experience, there is diversity in practice related to the presentation of the other pension activities when the statement of cash flows is prepared under the indirect method. Many entities present separately in the reconciliation of net income to net cash flows from operating activities (see section 3.2):

- the net periodic pension cost or credit for the period, and
- the employer's cash contributions to the pension plan.

Such a presentation is illustrated in Example 15.2.10 for an entity other than a NFP entity and in Example 22.2.10 for a NFP entity.

Example 15.2.10#
Change in pension liability

ABC Corp. provides a noncontributory defined benefit pension plan to its employees.

The changes in ABC's net pension liability (projected benefit obligation, net of plan assets) during Year 2 are as follows.

$'000s	
December 31, Year 1 net pension liability	$4,000
Service cost	1,100
Interest cost	200
Expected return on plan assets	(400)
Current year actuarial gain	(800)
Employer cash contributions **(B)**	(900)
December 31, Year 2 net pension liability	**$3,200**

The components of net periodic pension cost for Year 2 are as follows.

$'000s	
Service cost	$1,100
Interest cost	200
Expected return on plan assets	(400)
Amortization of actuarial gain	(150)
Amortization of prior service credit	(50)
Net periodic pension cost (A)	**$ 700**

The components of other changes recognized in OCI for Year 2 are as follows.

$'000s	
Current year actuarial gain	$ (800)
Amortization of actuarial gain	150
Amortization of prior service credit	50
Total recognized in OCI	**$ (600)**

The following illustrates one approach to presenting the effect of the change in the net pension liability on ABC's Year 2 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$ (700)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	

Net periodic pension cost **(A)**	700
Change in assets and liabilities:	
Contributions to pension plan **(B)**	(900)
Net cash provided by (used in) operating activities	**$ (900)**

Question 15.2.40
How are cash flows from the termination of an overfunded pension plan classified?

Background: On December 31, Year 1, ABC has an overfunded pension plan. The pension asset is $30 million ($40 million of plan assets and a $10 million benefit obligation).

During Year 2, ABC requests an IRS determination letter to approve the termination of the benefit plan and receives the IRS's approval. With the termination of the plan, the benefit obligation is settled and ABC receives $28 million in cash.

Interpretive response: The cash received on termination of an overfunded pension plan is classified as cash flows from **operating** activities because the cash flow does not relate to an investing or financing activity. [230-10-45-16(c)]

We believe this cash inflow (i.e. the $28 million) can be presented as either a separate line or included with the overall pension asset change in the reconciliation of net income to net cash flows from operating activities. If the amount is included with the overall pension asset change, we believe the entity should consider disclosing it separately in the notes to the financial statements.

15.3 Payments for pension liabilities assumed under bankruptcy

Question 15.3.10
How are cash flows for payments to the Pension Benefit Guaranty Corporation for pension liabilities assumed classified?

Background: The Pension Benefit Guaranty Corporation (PBGC) often enters into agreements to assume the pension liabilities of entities that reorganize in bankruptcy. As part of the agreements, the emerging entity generally must pay some amount for the pension liabilities that the PBGC assumes. These payments may extend for several years.

Interpretive response: Though payments to the PBGC may continue for many years, the SEC staff views these payments as cash outflows for **operating** activities, not financing activities. The form of the settlement of this pension liability does not change the substance of the activity for which the cash is being paid (i.e. employee compensation). [230-10-45-17(b), CA&DI II.C.2]

Classifying these payments as cash flows from **operating** activities also applies when the entity adopts fresh-start reporting under Topic 852 (reorganizations). [CA&DI II.C.2]

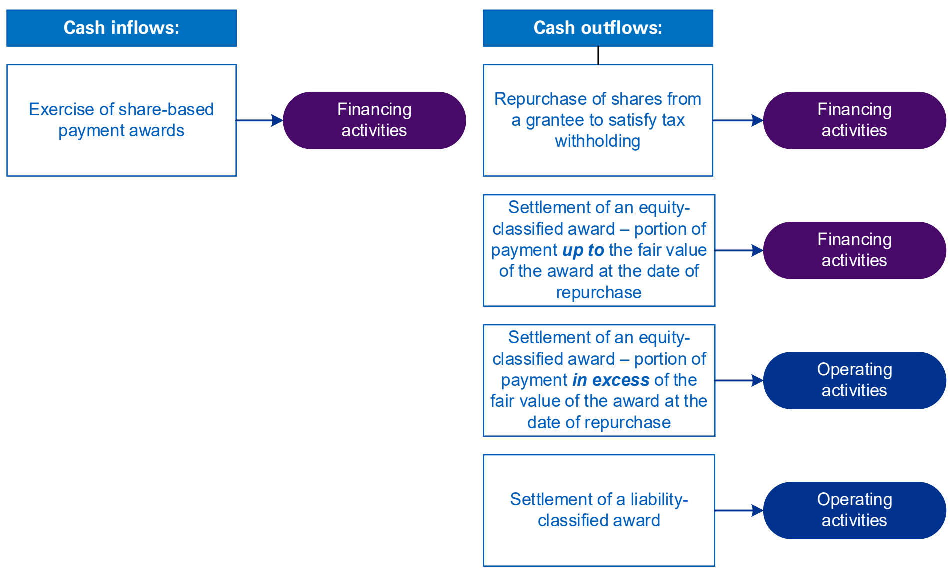
16. Share-based payment arrangements

Detailed contents

16.1 How the standard works

The complexity of share-based payment arrangements with employees and nonemployees ('grantees') often creates additional issues in the statement of cash flows of the grantor (e.g. employer). Generally, the cash flows from share-based payment arrangements occur when the awards are exercised or settled. The initial grant of the awards and any forfeitures are not presented in the statement of cash flows; however, any related compensation cost recognized is included as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2). Furthermore, any excess tax benefits are classified – along with other income tax cash flows – as cash flows from **operating** activities.

The following chart summarizes some of the cash flow classification issues encountered, which are explained in more detail in this chapter.



16.2 Grant of share-based payment awards

Share-based payment arrangements provide equity ownership rights to grantees. The objective of share-based compensation is to align the interests of an entity's employees, management and shareholders, and also to compensate nonemployees for providing goods or services.

See KPMG Handbook, Share-based payments, for additional guidance.

Question 16.2.10

How is the grant of a share-based payment award presented?

Interpretive response: The grant of a share-based payment award in exchange for goods or services received is a noncash event on the grant date. Therefore, the transaction is not presented in the statement of cash flows.

However, after the grant date, any compensation cost recognized in net income in relation to the share-based payment award is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2). [230-10-45-2]

Example 16.2.10

Grant of share-based payment awards

On January 1, Year 1, ABC Corp. grants 10,000 share options to its CEO with a grant-date fair value of $10 and an exercise price of $20.

The awards cliff vest after four years of service and ABC estimates zero forfeitures. As such, ABC will recognize compensation cost of $100,000 (10,000 share options × $10) over the four-year requisite service period. ABC has no other share-based payment arrangements.

In ABC's Year 1 statement of cash flows, which is presented under the indirect method, the grant of 10,000 share options on January 1 is not presented because it is a noncash event. However, the $25,000 ($100,000 / 4 years) recognized as compensation expense in Year 1 is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities.

The following illustrates the effect of this transaction on ABC's Year 1 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$(25)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Share-based compensation expense	25
Net cash provided by (used in) operating activities	**$ -**

16.3 Exercise of share-based payment awards

Question 16.3.10

How are cash flows from the exercise of share-based payment awards classified?

Interpretive response: The cash received from the exercise of a share-based payment award represents proceeds from the issuance of an equity instrument and therefore is a cash inflow from **financing** activities. [230-10-45-14(a)]

Example 16.3.10

Exercise of share-based payment awards

Assume the same facts as Example 16.2.10. On November 15, Year 5, when the CEO's awards are fully vested and the stock price is $33, the CEO exercises all of the 10,000 share options at the exercise price of $20.

In ABC Corp.'s Year 5 statement of cash flows, the $200,000 (10,000 share options × $20 exercise price) received from the exercise of the CEO's awards represents proceeds from the issuance of equity securities. As such, ABC classifies the cash proceeds as cash flows from **financing** activities.

The following illustrates the effect of this transaction on ABC's Year 5 statement of cash flows.

$'000s	
Cash flows from financing activities	
Proceeds from exercise of options	$200
Net cash provided by (used in) financing activities	**$200**

Question 16.3.20

How are cash flows from the early exercise of a share-based payment award by employees classified?

Background: To achieve a more favorable tax position for its employees, an entity may grant awards to employees that are exercisable before vesting so that the employee's holding period for the underlying stock begins at an earlier date.

An early exercise of a share-based payment award is not considered to be a substantive exercise for accounting purposes. Because the award is not deemed exercised, the related share is not considered issued or outstanding for accounting purposes until the employee provides the requisite service to earn the share. [718-10-55-31(a)]

Interpretive response: Although the share is not considered issued, we believe the cash received from the early exercise represents proceeds from the issuance of an equity instrument. Therefore, the cash received is a cash inflow from **financing** activities. [230-10-45-14(a)]

It would not be appropriate to classify these cash receipts as cash flows from operating activities. Cash flows from operating activities are "generally the cash effects of transactions and other events that enter into the determination of net income." A transaction in which cash is received from an employee who elects to early exercise an option does not affect net income. [230-10 Glossary]

Question 16.3.30

Are there required disclosures related to the exercise of share-based payment awards?

Interpretive response: Yes. For each year that a statement of cash flows is presented, an entity is required to disclose the amount of cash received from exercise of share options and similar instruments granted under share-based payment arrangements. See Question 16.4.20 for additional disclosure requirements. [718-10-50-2(k)]

In general, an entity is required to separately disclose information related to share-based payment transactions if this information is necessary to understand their effect on the financial statements.

While there is no specific provision for an entity to separately disclose agreements with nonemployees, if this information is important to understanding their effect, separate disclosure should be provided.

16.4 Excess tax benefit from share-based payment awards

In most instances, there is a difference between the amount and timing of compensation cost recognized for share-based payment awards for financial reporting purposes and compensation cost that is deductible for income tax purposes. The temporary difference related to the compensation expense for financial reporting purposes is eliminated when the tax deduction is taken.

If the tax deduction for an award (generally at option exercise or vesting) exceeds the cumulative amount of compensation cost recognized in the financial statements for that award, the result is an excess tax benefit or windfall benefit. Conversely, if the tax deduction for an award is less than the cumulative amount of compensation cost recognized in the financial statements for that award, the result is a tax deficiency or shortfall.

Question 16.4.10

How are excess tax benefits and tax deficiencies classified?

Interpretive response: An entity recognizes excess tax benefits and tax deficiencies as income tax benefit or expense in the income statement and classifies the net of the excess tax benefits and tax deficiencies as cash flows from **operating** activities, which is consistent with other cash flows related to income taxes. [230-10-45-17(c), 718-740-35-2]

Example 16.4.10

Excess tax benefit

Assume the same facts as Example 16.3.10, and that ABC's applicable tax rate is 21%.

For financial reporting purposes, ABC records a $21,000 tax benefit (10,000 share options × $10 grant-date fair value × 21% tax rate) and a related deferred tax asset over the requisite service period of the options.

On November 15, Year 5, when the CEO's share options are fully vested and all of the share options are exercised, ABC receives an income tax deduction on the basis of the difference between the fair value of the stock on the exercise date and the amount the CEO pays to exercise the options ($130,000 = ($33 fair value of ABC's common stock - $20 exercise price) × 10,000 options).

As a result of the increase in ABC's share price, ABC realizes a tax benefit of $27,300 ($130,000 income tax deduction × 21% tax rate) for income tax purposes. The $27,300 tax benefit exceeds the tax benefit recognized for financial reporting purposes by $6,300 ($27,300 - $21,000 original deferred tax asset), i.e. there is an excess tax benefit of $6,300.

On November 15, Year 5, ABC records the following journal entry to recognize the realization of the tax benefit.

$'000s	*Debit*	*Credit*
Income tax payable[1]	27	
Deferred tax expense[2]	21	
Current tax expense		27
Deferred tax asset		21

Notes:

1. $130 × 21%.
2. $100 × 21%.

In the period of exercise, the total income tax deduction generated reduces income tax payable and current income tax expense. The original deferred tax asset is reversed as a deferred tax expense.

The following illustrates the effect of this transaction on ABC's Year 5 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$ 6
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Deferred tax expense	21
Change in assets and liabilities:	
Decrease in income taxes payable	(27)
Net cash provided by (used in) operating activities	**$ -**

Example 16.4.20
Excess tax benefit resulting from a business combination

In Year 1, Parent acquires Target in a business combination. In conjunction with the consummation of the business combination, Parent issues vested share options to Target's employees. The fair value of the share options is $2 million. Parent's tax rate is 21% and a deferred tax asset of $420,000 ($2 million × 21%) is recognized in the acquisition accounting.

In Year 2, the share options are exercised. On exercise, Parent receives a tax deduction of $2.5 million. Parent records the following journal entry to recognize the realization of the tax benefit.

$'000s	*Debit*	*Credit*
Income tax payable[1]	525	
Deferred tax expense[2]	420	
Current tax expense		525
Deferred tax asset		420

Notes:
1. $2,500 × 21%.
2. $2,000 × 21%.

The following illustrates the effect of this transaction on Parent's Year 2 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$ 105
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Deferred tax expense	420
Change in assets and liabilities:	
Decrease in income taxes payable	(525)
Net cash provided by (used in) operating activities	**$ -**

Question 16.4.20

Are there required disclosures related to excess tax benefits from share-based payment awards?

Interpretive response: Yes. For each year that a statement of cash flows is presented, an entity is required to disclose the tax benefit from stock options exercised during the year as well as total income tax paid in each year that a statement of cash flows is presented. See Question 16.3.30 for additional disclosure requirements. [230-10-45-25(f), 50-2, 718-10-50-2A]

16.5 Repurchase of shares from an employee to satisfy tax withholding

When an employee exercises stock options or other share-based payment awards, the employer often, at the employee's discretion, withholds shares from the exercise in an amount sufficient to satisfy its income tax withholding requirement triggered by the exercise. It then remits the cash to the taxing authority. The amount withheld cannot exceed the employee's maximum statutory tax rate in the applicable jurisdictions; if it does, a previously equity-classified award will become liability-classified.

Question 16.5.10

How are cash flows for the repurchase of shares from an employee to satisfy tax withholding classified?

Interpretive response: A grantor classifies cash paid to a taxing authority for shares withheld to satisfy its statutory withholding tax obligation as a cash flow from **financing** activities. The financing outflow is presented in the period that cash is actually paid to the taxing authority, not in the period the shares are withheld. [230-10-45-15(a)]

The FASB discussed and ultimately concluded that withholding shares from an award is in substance a repurchase of shares – i.e. the employer has issued the gross number of shares to an employee and repurchased a portion of those shares to satisfy its withholding obligation. Therefore, the financing classification of the cash remittances to the taxing authority is consistent with how other repurchases of an entity's equity instruments are classified. [ASU 2016-09.BC19]

This accounting treatment is the same for all net share settlements of share-based payment awards. Whether a share-based award is liability- or equity-classified does not have an effect on the classification of the cash remitted to the taxing authority on the employee's behalf.

Example 16.5.10
Repurchase of shares to satisfy tax withholding

Assume the same facts as Example 16.4.10, except that the plan allows the CEO to net-settle the awards to cover the statutory tax withholding requirement, up to the maximum statutory withholding requirement in the relevant jurisdiction.

For the $200,000 of share-based payment awards, assume the tax withholding requirement is $50,000. Based on the stock price of $33 on the day of the exercise, this results in 1,515 shares to be withheld, if elected by the CEO.

Upon exercise, the CEO elects this option and ABC withholds 1,515 shares to cover the statutory withholding requirement and issues the CEO the remaining 8,485 shares.

In its Year 5 statement of cash flows, ABC classifies the gross issuance of the 10,000 shares (see section 16.3) and the repurchase of 1,515 shares at fair value to satisfy the statutory withholding requirement as cash flows from **financing** activities.

The following illustrates the effect of this transaction on ABC's Year 5 statement of cash flows.

$'000s	
Cash flows from financing activities	
Proceeds from exercise of options	$200
Payments to taxing authorities in connection with shares directly withheld from employees	(50)
Net cash provided by (used in) financing activities	**$150**

Question 16.5.20

How are taxes withheld upon the vesting of restricted shares classified if these taxes are remitted to the taxing authority after the vesting occurred?

Interpretive response: The result of this situation is a liability recorded at period-end as an accrued expense or within the taxes payable account.

An entity should ensure that the change in the account is not inadvertently included in operating cash flows as a change in a liability account in one period and reclassified in a later period when paid as a financing outflow. Instead, an entity should disclose a **noncash** financing activity (see section 4.7.20). [230-10-50-3]

The fact that the entity has sufficient cash to settle the liability on the balance sheet date, or expects to pay the liability shortly after the balance sheet date, is irrelevant.

16.6 Cash settlement of share-based payment awards

16.6.10 Settlement of equity-classified share-based payment awards

Entities will sometimes repurchase equity-classified awards issued to grantees for cash or other assets (or liabilities incurred). Depending on the facts and circumstances, an agreement (or offer) to repurchase an equity-classified award for cash may have different accounting consequences.

The agreement (or offer) to repurchase may be accounted for as a settlement of the equity-classified award. Conversely, it may be accounted for as a modification that changes the award's classification from equity to liability, followed by a settlement of the now liability-classified award (see section 16.6.20).

Question 16.6.10

How are cash flows for the settlement of an equity-classified award classified?

Interpretive response: When settling an equity-classified share-based payment award in cash, an entity presents the settlement in its statement of cash flows on the basis of the amount paid as compared to the fair value of the award at the date of the repurchase.

— **Amount paid to settle the award does not exceed the fair value of the award at the date of repurchase.** The repurchase of the equity-classified award is viewed as a reacquisition of the entity's equity instruments; therefore, the cash paid to repurchase the award is charged to equity. As such, the cash paid is a cash outflow for **financing** activities. [230-10-45-15(a), 718-20-35-7]

— **Amount paid to settle the award exceeds the fair value of the award at the date of repurchase.** The amount of cash paid in excess of the award's fair value on the date of settlement is recognized as additional compensation expense. As such, the cash payment to settle the stock award should be bifurcated, with a cash outflow for **financing** activities equal to the settlement date fair value and a cash outflow for **operating** activities for the amount paid in excess of the settlement date fair value. [230-10-45-15(a), 45-17(b), 718-20-35-7]

Example 16.6.10

Cash settlement of equity-classified restricted stock units

On January 1, Year 1, ABC Corp. grants 25,000 shares of equity-classified restricted stock at $5 per share (the current fair value). The restricted stock cliff vests after three years of service.

ABC recognizes compensation cost of $125,000 (25,000 shares × $5 grant-date fair value) over the three-year requisite service period because no restricted stock awards are forfeited. ABC's accounting policy is to recognize forfeitures as they occur.

On January 1, Year 5, one year and a day after the shares have vested, ABC offers to settle the outstanding shares for cash at $10 per share. ABC's stock price on that date is $8 per share. Assume all 25,000 shares are still outstanding.

ABC pays $10 per outstanding share, or $250,000 (25,000 shares × $10 settlement amount), and records additional compensation cost of $50,000 (25,000 shares × ($10 settlement amount - $8 settlement date fair value)) for the amount of the purchase price in excess of the fair value of the award at the date of repurchase.

ABC bifurcates the $250,000 cash payment to settle the outstanding awards and classifies:

— $200,000 (i.e. amount paid equal to settlement date fair value) as a cash flow from **financing** activities; and
— $50,000 (i.e. amount paid in excess of settlement date fair value) as a cash flow from **operating** activities.

The following illustrates the effect of this transaction on ABC's Year 5 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$ (50)
Net cash provided by (used in) operating activities	**(50)**
Cash flows from financing activities	
Repurchase of employee restricted stock	(200)
Net cash provided by (used in) financing activities	**$(200)**

16.6.20 Settlement of liability-classified share-based payment awards

Question 16.6.20

How are cash flows for the settlement of a liability-classified award classified?

Background: The grant-date fair value and any subsequent changes in the fair value of a liability-classified award through the settlement date are recognized as compensation cost. [718-30-35-2]

Interpretive response: The cash paid to settle a liability-classified award is effectively payment for goods or services and is a cash outflow for **operating** activities. [230-10-45-17(b)]

16.7 Forfeiture of share-based payment awards

Forfeitures are awards that are terminated when a grantee fails to deliver the promised good or to render service. An entity makes an accounting policy decision to either: [718-10-35-1D, 35-3]

- estimate the number of forfeitures in determining its accrual of compensation cost; or
- recognize the effects of forfeitures of awards as they occur as an adjustment to compensation cost.

When awards are forfeited, compensation cost previously recognized is reversed. [718-10-35-3]

See KPMG Handbook, Share-based payment, for additional guidance.

Question 16.7.10

How is the forfeiture of a share-based payment award presented?

Interpretive response: The forfeiture of a share-based payment award is a noncash event; therefore, the transaction is not presented in the statement of cash flows. However, any compensation cost (reduced for the effect of forfeitures) recognized in net income is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2). [230-10-45-2]

Example 16.7.10
Forfeiture of share-based payment awards

On January 1, Year 1, ABC Corp. grants 30,000 share options to employees that cliff vest in three years.

The grant date fair value is $10 per unit. ABC's accounting policy is to account for forfeitures of awards when they occur. There are no forfeitures in Year 1, and ABC recognizes compensation cost of $100,000 (30,000 share options × $10 / 3 years).

On June 30, Year 2, employees forfeit 5,000 share options. ABC's total compensation cost to date is $125,000 (25,000 share options × $10 × 1.5 / 3 years). ABC recognizes $25,000 of compensation cost for the first six months of Year 2 ($125,000 cumulative compensation cost - $100,000 recognized in Year 1).

The following illustrates the effect of this transaction on ABC's June 30, Year 2 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$(25)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Share-based compensation expense	25
Net cash provided by (used in) operating activities	**$ -**

17. Insurance premiums and proceeds

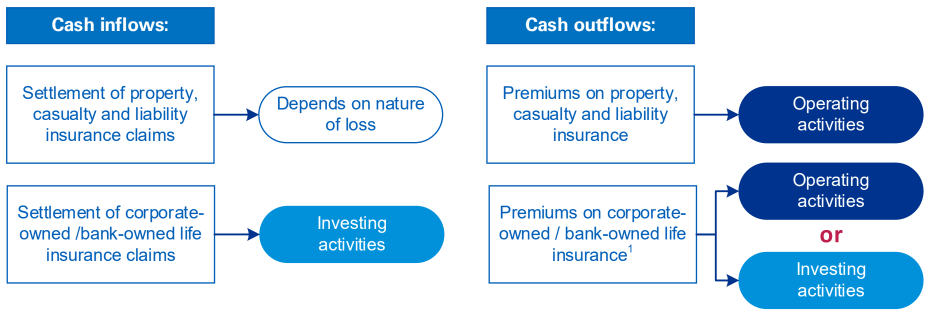
Detailed contents

17.1 How the standard works

This chapter addresses how the holder of an insurance policy classifies premiums paid for and claim proceeds received from:

— property, casualty and liability insurance policies; and
— corporate-owned and bank-owned life insurance policies.

The following chart summarizes some of the classification issues encountered, which are explained in more detail in this chapter.



Note:

1. Classified as **operating** activities, **investing** activities or a combination of **operating** and **investing** activities.

17.2 Property, casualty and liability insurance policies

Excerpt from ASC 230-10

> Classification

>> Proceeds from the Settlement of Insurance Claims

45-21B Cash 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). For insurance proceeds that are received in a lump-sum settlement, an entity shall determine the classification on the basis of the nature of each loss included in the settlement.

17.2.10 Premiums paid

Question 17.2.10

How are cash flows for the payment of insurance premiums on property, casualty and liability insurance policies classified?

Interpretive response: Premiums paid on property, casualty and liability insurance policies are cash outflows for **operating** activities similar to payments to vendors for goods and services. [230-10-45-17(b)]

17.2.20 Settlement proceeds

Question 17.2.20

How are cash flows from the settlement of insurance claims on PP&E classified?

Interpretive response: We believe insurance proceeds received for damaged PP&E that is owned or under a capital/finance lease for the lessee are cash inflows from **investing** activities. This classification is appropriate even if those proceeds are not reinvested. [230-10-45-21B]

These proceeds generally should not be netted against cash outflows to repair or replace insured PP&E. [230-10-45-8]

Question 17.2.30

How are cash flows from the settlement of insurance claims for business interruption, inventory or minor repairs of PP&E classified?

Interpretive response: We believe insurance proceeds received for business interruption, inventory or minor repairs of property and equipment are cash inflows from **operating** activities. [230-10-45-21B]

Question 17.2.40

How are cash flows from the settlement of multiple insurance claims classified?

Interpretive response: If a lump-sum settlement relates to more than one loss, an entity allocates the settlement payment to each underlying loss and classifies each allocated amount based on the nature of the associated loss. [230-10-45-21B]

Example 17.2.10

Allocating a lump-sum settlement payment for more than one loss

Retailer has insurance coverage for property damage as well as business interruption through the same insurance carrier (Insurer) for all of its owned retail stores. A tornado severely damages one of the owned retail stores in the current year.

Insurer provides Retailer with a lump-sum settlement of $1 million covering Retailer's property and business interruption claims. Retailer determines that $700,000 relates to the property damage and $300,000 relates to business interruption.

The following illustrates the effect of this settlement on Retailer's statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$1,000
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Gain on insurance proceeds received for damage to property	(700)
Net cash provided by (used in) operating activities	**300**
Cash flows from investing activities	
Insurance proceeds received for damage to property	700
Net cash provided by (used in) investing activities	**$ 700**

17.3 Corporate-owned and bank-owned life insurance policies

Excerpt from ASC 230-10

> Classification

>> Proceeds from the Settlement of Insurance Claims

45-21C Cash receipts resulting from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies, shall be classified as cash inflows from investing activities. Cash payments for premiums on corporate-owned life insurance policies, including bank-owned life insurance policies, may be classified as cash outflows for investing activities, operating activities, or a combination of cash outflows for investing and operating activities.

Corporate-owned life insurance policies, or COLI (including bank-owned life insurance policies, or BOLI), are typically purchased by an employer to fund the cost of employee benefits (e.g. death benefits) and to protect against loss of income due to the deaths of key personnel. An entity may also purchase these types of policies for investment purposes.

17.3.10 Premiums paid

Question 17.3.10

How are cash flows for insurance premiums on corporate-owned life insurance policies classified?

Interpretive response: An entity may classify premiums paid on a corporate-owned life insurance policy as cash flows from **investing** activities to align the classification of premiums paid with the classification of settlement proceeds received (see Question 17.3.20). [230-10-45-21C]

However, an entity need not classify these premiums entirely as cash flows from **investing** activities if it believes the premiums are more appropriately classified as either cash flows from **operating** activities or a combination of cash flows from **operating** and **investing** activities. [230-10-45-21C]

For example, it is reasonable to classify a premium payment as a cash flow from **investing** activities to the extent the proceeds are expected to exceed the amounts necessary to replace income or to fund employee benefits. On the other hand, entities may classify the premium payment as a cash flow from **operating** activities if the proceeds from the policy would be used entirely for income replacement or to fund employee benefits (i.e. the primary purpose of the policy is for employee benefits). [230-10-45-21C, ASU 2016-15.BC25]

17.3.20 Settlement proceeds

Question 17.3.20

How are cash flows from a corporate-owned life insurance settlement classified?

Interpretive response: Topic 230 requires proceeds received from the settlement of a corporate-owned life insurance policy are cash inflows from **investing** activities. [230-10-45-21C]

This approach is based on the EITF's belief that most corporate-owned life insurance policies are purchased primarily as investment vehicles because their cash surrender value builds up tax-free. [ASU 2016-15.BC23]

18. Business combinations

Detailed contents

18.4.70 How are cash flows for liability-classified contingent payments not settled *soon after* the acquisition date classified?

18.4.80 What is the appropriate unit of account when a business combination involves more than one contingent consideration payment?

Examples

18.4.10 Contingent payments in a business combination settled *soon after* the acquisition date

18.4.20 Liability-classified contingent cash payments not settled *soon after* acquisition date

18.5 Settlement of liabilities assumed in a business combination

Questions

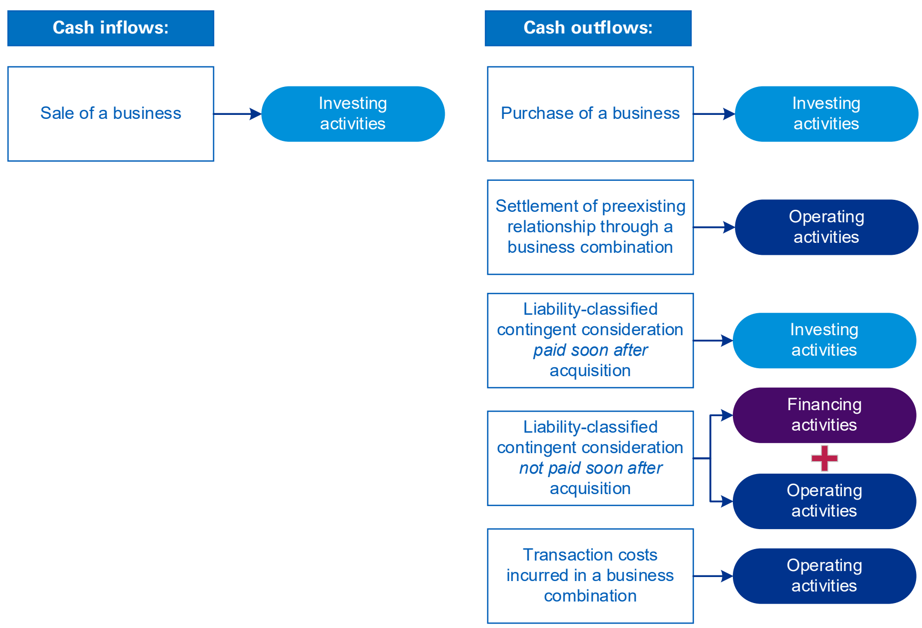
18.5.10 How are cash flows for settlement of liabilities assumed in a business combination classified?

18.5.20 How are cash flows for the extinguishment of debt paid in conjunction with a business combination classified?

18.1 How the standard works

A business combination in Topic 805 (business combinations) includes all transactions or events in which an acquirer obtains control of one or more businesses, regardless of whether the acquirer obtains control through the transfer of consideration, or without the transfer of consideration. Consideration transferred in a business combination may be cash or noncash and can be fixed and/or contingent on future events.

The following chart summarizes some of the classification issues encountered, which are explained in more detail in this chapter.



Any noncash consideration transferred in a business combination, including equity-classified contingent consideration, must be disclosed as a **noncash** investing and financing activity.

18.2 Acquisition or sale of a business

Consideration transferred in a business combination may take many forms, including cash, tangible and intangible assets, a business or subsidiary of the acquirer, securities of the acquirer (e.g. common stock, preferred stock, options, warrants, debt instruments) and/or other promised future payments of the acquirer, including contingent payments.

Question 18.2.10

How are cash flows for the acquisition or sale of a business classified?

Interpretive response: Cash flows for the purchase or sale of productive assets, including the acquisition or sale of a business, are classified as cash flows from **investing** activities. [230-10-45-12(c), 45-13(c)]

The statement of cash flows should reflect, as a single line item, cash paid to purchase a business (net of any cash acquired) or cash received from the sale of a business (net of any cash sold). The effects of a business combination on specific asset and liability accounts are excluded from the calculation of other amounts in the statement of cash flows. Subsequent to a business combination, the cash flows of the combined entity are presented in cash flows from **operating**, **investing** and **financing** activities as appropriate.

Any **noncash** investing and financing activities in relation to a business combination, including any noncash consideration included in the total purchase consideration, are required to be disclosed either in a narrative format or summarized in a schedule (see section 4.7.20). [230-10-50-3]

Example 18.2.10

Acquisition of a business for cash

On November 1, Year 1, Parent acquires all of the capital stock of Target for cash of $2 million. The acquisition is a business combination.

On the acquisition date, Target reported cash and cash equivalents of $100,000 on its closing balance sheet.

Because the acquisition of Target involves only cash consideration, Parent includes the full consideration transferred in cash flows from **investing** activities, net of the cash and cash equivalents acquired ($2 million - $100,000).

The following illustrates the effect of this transaction on Parent's Year 1 statement of cash flows, including the supplemental schedule of **noncash** investing and financing activities. [230-10-55-11, 55-15]

$'000s	
Cash flows from investing activities	
Acquisition of Target, net of cash acquired	$(1,900)
Net cash provided by (used in) investing activities	**$(1,900)**
Supplemental schedule of noncash investing and financing activities	
Fair value of Target assets acquired	$ 2,580
Cash paid for Target capital stock	(2,000)
Target liabilities assumed	**$ 580**

Example 18.2.20
Acquisition of a business for stock

Assume the same facts as Example 18.2.10, except that the consideration exchanged is 50,000 shares of Parent's common stock. On the acquisition date, the fair value of Parent's common stock is $40.

Because the acquisition of Target involves no cash consideration, Parent discloses the transaction as a **noncash** investing (acquisition of Target) and **noncash** financing (issuance of Parent's stock) transaction.

Additionally, Parent classifies the acquired cash and cash equivalents as an **investing** activity in its Year 1 statement of cash flows.

The following illustrates the effect of this transaction on Parent's Year 1 statement of cash flows, including the supplemental schedule of **noncash** investing and financing activities. [230-10-55-11, 55-15]

$'000s	
Cash flows from investing activities	
Net cash acquired in acquisition of Target	$ 100
Net cash provided by (used in) investing activities	**$ 100**
Supplemental schedule of noncash investing and financing activities	
Fair value of Target assets acquired	$2,580
50,000 shares of Parent common stock issued in exchange for Target capital stock	(2,000)
Target liabilities assumed	**$ 580**

Question 18.2.20

How are cash flows for settling a preexisting relationship through a business combination classified?

Background: Preexisting relationships between the acquirer and acquiree are either *contractual* (e.g. a supply purchase agreement or lease agreement) or *noncontractual* (e.g. a lawsuit relating to a noncontractual matter in which the two parties had a relationship as plaintiff and defendant). These relationships are identified and assessed to determine whether they have effectively been settled as a result of a business combination and should therefore be accounted for separately from the business combination (i.e. a gain or loss is recognized in the acquirer's income statement). [805-10-55-20]

The portion of the payment to settle a preexisting *contractual relationship* is measured at the lesser of: [805-10-55-21(b)]

- the amount by which the contract is favorable or unfavorable from the acquirer's perspective when compared with pricing for current market transactions for the same or similar items; and
- any stated settlement provisions in the contract available to the counterparty to which the contract is unfavorable.

The portion of the payment to settle a preexisting *noncontractual relationship* is measured at fair value. [805-10-55-21(a)]

Interpretive response: When the settlement of a preexisting relationship results from a business combination, we believe that the cash outflow for the settlement and acquired business should be bifurcated between **operating** activities and **investing** activities, respectively.

This classification appropriately aligns the nature of the cash flow with its statement of cash flows classification. It is also consistent with Topic 805, which requires an entity to separately account for components of a transaction relating to the entity's ongoing operations (e.g. the settlement of a preexisting contract) and the entity's investing activities (e.g. the acquisition of a business).

Question 18.2.30

How are cash flows for IPR&D acquired in a business combination classified?

Background: R&D projects that are underway but have not been completed are referred to as in-process research and development (IPR&D). IPR&D acquired in a business combination is recognized and measured at fair value at the acquisition date. [805-20-30-1]

After initial recognition, capitalized IPR&D is accounted for as indefinite-lived until the completion or abandonment of the associated R&D project. Subsequent R&D costs related to the IPR&D are generally expensed as incurred unless they represent costs of materials, equipment or facilities that have alternative future uses. [350-30-35-17A, 730-10-25-1]

See chapter 7 of KPMG Handbook, Business combinations, for additional guidance on accounting for IPR&D assets acquired in a business combination.

Question 8.2.15 discusses IPR&D acquired in an asset acquisition.

Interpretive response: The consideration paid to acquire IPR&D in a business combination is classified as cash flows from **investing** activities. This is because this payment is part of the overall consideration exchanged for the business (see Question 18.2.10). [230-10-45-13(c)]

Subsequent to the acquisition date, R&D costs expensed in relation to acquired IPR&D are classified as cash flows from **operating** activities. [230-10-45-17(b)]

Question 8.5.30 discusses the presentation of any amortization, depreciation or impairment.

18.3 Transaction costs incurred

When consummating a business combination, an acquirer frequently incurs acquisition-related costs such as fees for legal, consulting, accounting and valuation services. Acquisition-related costs incurred by an acquirer to effect a business combination are not part of the consideration transferred. Rather, they are recognized as expense in the period incurred, unless these costs are incurred to issue debt or equity securities, in which case they are recognized in accordance with other applicable US GAAP. [805-10-25-23]

Question 18.3.10

How are cash flows for transaction costs incurred in a business combination classified?

Interpretive response: We believe transaction costs incurred in connection with a business combination are cash outflows for **operating** activities.

This classification is consistent with the definition of **operating** activities, which 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." [230-10 Glossary]

Question 18.3.20

How are cash flows for (from) a break-up fee paid (received) in a failed merger transaction classified?

Interpretive response: A break-up fee that is paid (or received) in a failed merger transaction is an **operating** cash outflow (or inflow) because it does not result from a consummated investing or financing transaction. [230-10-45-17(f)]

18.4 Contingent consideration

18.4.10 Overview

Contingent consideration is usually an obligation to transfer additional consideration to the former owners of an acquiree as part of the business combination if specified future events occur or conditions are met. An acquirer's obligation to pay contingent consideration may be deemed to be either equity (equity-classified contingent consideration) or a liability (liability-classified contingent consideration). Contingent consideration may also give the acquirer the right to the return of previously transferred consideration if specified conditions are met (asset-classified contingent consideration). [805-10 Glossary, 805-30-25-6]

Regardless of its classification, contingent consideration is recognized and measured at fair value at the acquisition date and included in the consideration transferred. However, how contingent consideration is subsequently measured and presented in the statement of cash flows depends on its classification. [805-30-25-5]

18.4.20 Equity-classified contingent consideration

Equity-classified contingent consideration is measured at fair value at the acquisition date but is not remeasured after the acquisition date, and its ultimate settlement is accounted for within equity. [805-30-25-5, 35-1(a)]

Question 18.4.10

How is the grant of an equity-classified contingent consideration presented?

Interpretive response: The initial recognition of the equity-classified contingent consideration arrangement at the acquisition date (including measurement period adjustments) is a **noncash** investing activity. In contrast, the issuance of shares to settle the contingent consideration arrangement on the date the contingency is resolved is a **noncash** financing activity. These activities are either disclosed in a narrative format or summarized in a schedule (see section 4.7.20). [230-10-50-3]

18.4.30 Liability-classified contingent consideration

Initial recognition and changes in fair value

Liability-classified contingent consideration is measured at fair value at the acquisition date and is remeasured at fair value at each subsequent reporting date (with changes in fair value recognized in the income statement) until the contingency is resolved. [805-30-25-5, 35-1(b)]

Question 18.4.20

How is the initial recognition of liability-classified contingent consideration presented?

Interpretive response: The initial recognition of liability-classified contingent consideration at the acquisition date is reflected as a **noncash** investing activity because no cash consideration is transferred on the acquisition date. The arrangement is either disclosed in a narrative format or summarized in a schedule (see section 4.7.20). [230-10-50-3]

Question 18.4.30

How is the subsequent remeasurement of liability-classified contingent consideration presented?

Background: Contingent consideration is often settled at an amount different from its initial fair value measurement at the acquisition date. Changes in the fair value of liability-classified contingent consideration occur from (1) the passage of time (i.e. accretion expense) and (2) revisions to the amount or timing of the initial measurement of the contingent consideration.

These noncash changes in fair value are recognized in operating income unless the arrangement is a derivative designated as a cash flow hedge. In that case, Topic 815 (derivatives and hedging) requires the changes to be initially recognized in OCI. [805-30-35-1(b), 815-30-35-3]

Interpretive response: The remeasurement of liability-classified contingent consideration recognized in operating income is a noncash reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2).

Settlement soon after acquisition date

If the contingent consideration is satisfied in either cash or cash equivalents upon resolution of the contingency, the classification of the amount paid depends on the timing of the payment after the acquisition date.

Question 18.4.40

How are cash flows for liability-classified contingent payments settled *soon after* the acquisition date classified?

Interpretive response: Contingent cash payments made soon after the acquisition date are cash outflows for **investing** activities. [230-10-45-13(d)]

Question 18.4.50

How should 'soon after' be interpreted in classifying cash flows for liability-classified contingent payments?

Interpretive response: We believe three months or less is an appropriate interpretation for 'soon after'. Although Topic 230 does not include explicit guidance, the basis for conclusions explains that these payments should be made within a relatively short period of time after the acquisition date, such as three months or less. [ASU 2016-15.BC16]

Example 18.4.10

Contingent payments in a business combination settled *soon after* the acquisition date

Parent acquires Target in a business combination on December 15, Year 1.

In connection with the business combination, Parent enters into a liability-classified contingent consideration arrangement with the former owners of Target. On December 15, Year 1, Parent estimates the fair value of the contingent consideration as $100,000. Parent settles the contingent arrangement on March 1, Year 2, for $100,000.

Parent includes the $100,000 payment in its Year 2 cash flows from **investing** activities because the payment was made within three months after the acquisition date.

The following illustrates the effect of this transaction on Parent's Year 2 statement of cash flows.

$'000s	
Cash flows from investing activities	
Payment of contingent consideration liability	$(100)
Net cash provided by (used in) investing activities	**$(100)**

Settlement not soon after acquisition date

Question 18.4.70

How are cash flows for liability-classified contingent payments not settled *soon after* the acquisition date classified?

Interpretive response: Contingent cash payments that are not made soon after (three months or less) the acquisition date are cash outflows for **financing** and **operating** activities.

Portion of contingent cash payment is ...	Classification
Up to acquisition-date fair value of the liability (including any measurement period adjustments)	**financing** activities [230-10-45-15(f)]
In excess of the acquisition-date fair value of the contingent consideration liability	**operating** activities [230-10-45-17(ee)]
Lower than the acquisition-date fair value of the contingent consideration liability	**financing** activities[1] [230-10-45-15(f)]

Note:

1. The difference between the amount paid and the acquisition-date fair value of the liability represents a noncash reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2). [230-10-45-28(b)]

When determining whether the liability is settled at an amount greater than the acquisition-date fair value, any amounts paid soon after the acquisition date should be deducted (see Questions 18.4.40 and 18.4.50, and Example 18.4.10).

The acquisition-date fair value of the contingent consideration liability is measured at the present value of the estimated payments. Therefore, a portion of these payments may be attributable to accretion. However, we believe no such amount should be bifurcated to be presented as interest paid.

Question 18.4.80

What is the appropriate unit of account when a business combination involves more than one contingent consideration payment?

Background: A contingent consideration arrangement entered into as part of a business combination may contain multiple contingent payment triggers. Topic 805 does not specify whether these payments should be viewed as multiple units of account or as one overall contingent consideration arrangement (i.e. one unit of account).

Interpretive response: We believe that payments with discrete risk exposures are separate units of account. However, if the payments are interrelated and not independent of each other, then it may be appropriate to conclude that the contingent consideration arrangement is one unit of account.

Judgment is needed to determine whether a business combination contains one or multiple units of account for contingent consideration arrangements.

See Examples 18.4.20 and 18.4.30 for an illustration of the statement of cash flows classification of multiple payments in a contingent consideration arrangement where each payment is a separate unit of account. Additionally, see paragraphs 6.054 to 6.056 of KPMG Handbook, Business combinations, for guidance on determining the units of account when a business combination potentially involves more than one contingent consideration arrangement.

Example 18.4.20

Liability-classified contingent cash payments not settled *soon after* acquisition date

The following 3 scenarios illustrate how liability-classified contingent cash payments not settled *soon after* acquisition date are classified in the statement of cash flows. In Scenario 1 and Scenario 2, each contingent consideration payment is a separate unit of account with different variations in multi-year payments. Scenario 3 builds on Scenario 2, except that the contingent consideration arrangement is considered a single unit of account. The 3 scenarios have the same basic fact pattern as follows.

Parent acquires Target in a business combination on January 1, Year 1.

The terms of the acquisition agreement provide for contingent consideration to be paid by Parent in cash on January 1 in each of the two years after the acquisition date.

Amounts are in 000s for simplicity.

Year 1

On January 1, Year 1, Parent estimates the fair value of the acquisition-date contingent consideration as $210, calculated based on the present value of estimated payments of $121 on January 1 on each of the following two years, discounted at 10%.

Payment date	Estimated payment	Present value as of January 1, Year 1
January 1, Year 2	$121	$110
January 1, Year 3	$121	$100
Acquisition-date fair value		**$210**

Scenario 1: Two payments representing two units of account; each payment below acquisition-date fair value

The contingent consideration is calculated according to an earnings-based formula for each of the following two years independently. The two contingent payments are considered separate units of account.

On December 31, Year 1, Parent updates its estimate of the fair value of the contingent consideration to $219. This is calculated as the present value of estimated payments of $115 on January 1 on each of the following two years, discounted as 11%.

Payment date	Estimated payment	Present value as of January 1, Year 1
January 1, Year 2	$115	$ 115
January 1, Year 3	$115	$ 104
Fair value at December 31, Year 1		**$ 219**

Year 1

The changes in Parent's contingent consideration liability during Year 1 are as follows.

Acquisition-date fair value	$ 210
Year 1 accretion[1]	21
Unadjusted December 31, Year 1 balance	**231**
Adjustment to fair value	(12)
Fair value at December 31, Year 1	**$ 219**

Note:

1. Acquisition-date fair value of $210 × 10%.

The following illustrates the effect of this transaction on Parent's Year 1 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)[1]	$ (9)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Noncash accretion of contingent consideration	21
Noncash adjustment to fair value of contingent consideration liability	(12)
Net cash provided by (used in) operating activities	**$ -**

Note:

1. Adjustment to fair value of $12 less accretion of $21.

Year 2

On January 1, Year 2, Parent pays $115 to the former owners of Target.

On December 31, Year 2, Parent updates its estimate of the fair value of the remaining contingent consideration to $125, based on an expected payment of $125 on January 1, Year 3.

The changes in Parent's contingent consideration liability during Year 2 are as follows.

Fair value at December 31, Year 1	$ 219
January 1, Year 2 payment	(115)
January 1, Year 2 balance	**104**
Year 2 accretion[1]	11
Unadjusted December 31, Year 2 balance	**115**
Adjustment to fair value	10
Fair value at December 31, Year 2	**$ 125**

Note:
1. January 1, Year 2 balance of $104 × 11%.

The following illustrates the effect of this transaction on Parent's Year 2 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)[1]	$ (21)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Noncash accretion of contingent consideration	11
Noncash adjustment to fair value of contingent consideration liability	10
Payment of contingent consideration liability in excess of acquisition-date fair value	(5)
Net cash provided by (used in) operating activities	**(5)**
Cash flows from financing activities	
Payment of contingent consideration liability up to acquisition-date fair value	(110)
Net cash provided by (used in) financing activities	**$(110)**

Note:
1. Adjustment to fair value of $(10) less accretion of $11.

Parent includes $110 of the payment in cash flows from **financing** activities because the payment of $115 is more than the acquisition-date fair value of $110 for the January 1, Year 2 payment. Parent presents the excess payment of $5 as cash flows from **operating** activities.

Year 3

On January 1, Year 3, Parent pays $125 to the former owners of Target.

The following illustrates the effect of this transaction on Parent's Year 3 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$ -
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Payment of contingent consideration liability in excess of acquisition-date fair value	(25)
Net cash provided by (used in) operating activities	**(25)**
Cash flows from financing activities	
Payment of contingent consideration liability up to acquisition-date fair value	(100)
Net cash provided by (used in) financing activities	**$(100)**

Parent includes $100 of the payment in cash flows from **financing** activities because the payment of $125 is more than the acquisition-date fair value of $100 for the January 1, Year 3 payment. Parent presents the excess payment of $25 as cash flows from **operating** activities.

Scenario 2: Two payments representing two units of account; first payment below acquisition-date fair value and second payment above

Similar to Scenario 1, the contingent consideration is calculated according to an earnings-based formula for each of the following two years independently. The two contingent payments are considered separate units of account.

On December 31, Year 1, Parent updates its estimate of the fair value of the contingent consideration to $200, calculated as the present value of estimated payments of $105 on January 1 on each of the following two years, discounted at 11%.

Payment date	Estimated payment	Present value as of December 31, Year 1
January 1, Year 2	$105	$ 105
January 1, Year 3	$105	$ 95
Fair value at December 31, Year 1		**$ 200**

The changes in Parent's contingent consideration liability during Year 1 are as follows.

Acquisition-date fair value	$ 210
Year 1 accretion[1]	21
Unadjusted December 31, Year 1 balance	**231**
Adjustment to fair value	(31)
Fair value at December 31, Year 1	**$ 200**

Note:
1. Acquisition-date fair value of $210 × 10%.

The following illustrates the effect of this transaction on Parent's Year 1 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)[1]	$ 10
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Noncash accretion of contingent consideration	21
Noncash adjustment to fair value of contingent consideration liability	(31)
Net cash provided by (used in) operating activities	**$ -**

Note:
1. Adjustment to fair value of $31 less accretion of $21.

Year 2

On January 1, Year 2, Parent pays $105 to the former owners of Target.

On December 31, Year 2, Parent updates its estimate of the fair value of the remaining contingent consideration to $125, based on an expected payment of $125 on January 1, Year 3.

The changes in Parent's contingent consideration liability during Year 2 are as follows.

Fair value at December 31, Year 1	$ 200
January 1, Year 2 payment	(105)
January 1, Year 2 balance	**95**
Year 2 accretion[1]	10
Unadjusted December 31, Year 2 balance	**105**
Adjustment to fair value	20
Fair value at December 31, Year 2	**$ 125**

Note:

1. January 1, Year 2 balance of $95 × 11%.

The following illustrates the effect of this transaction on Parent's Year 2 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)[1]	$ (30)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Noncash accretion of contingent consideration	10
Noncash adjustment to fair value of contingent consideration liability	20
Net cash provided by (used in) operating activities	**-**
Cash flows from financing activities	
Payment of contingent consideration liability up to acquisition-date fair value	(105)
Net cash provided by (used in) financing activities	**$(105)**

Note:

1. Adjustment to fair value of $(20) less accretion of $10.

Parent includes the entire payment of $105 in cash flows from **financing** activities. This is because the payment is not made soon after the acquisition and it is less than the acquisition-date fair value of $110 for the January 1, Year 2 payment.

Year 3

On January 1, Year 3, Parent pays $125 to the former owners of Target.

The following illustrates the effect of this transaction on Parent's Year 3 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$ -
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Payment of contingent consideration liability in excess of acquisition-date fair value	(25)
Net cash provided by (used in) operating activities	**(25)**
Cash flows from financing activities	
Payment of contingent consideration liability up to acquisition-date fair value	(100)
Net cash provided by (used in) financing activities	**$(100)**

Parent includes $100 of the payment in cash flows from **financing** activities because the payment of $125 is more than the acquisition-date fair value of $100 for the January 1, Year 3 payment. Parent presents the excess payment of $25 as cash flows from **operating** activities. This is because the two contingent consideration payments in this example are considered separate units of account.

Scenario 3: Two payments representing a single unit of account; first payment below acquisition-date fair value and second payment above

Assume the same facts as in Scenario 2, except the annual payments are interrelated; they are based on an earnings-based formula for the following two years combined and the first payment is subject to clawback if cumulative earnings are not met at the end of the second year. The contingent consideration arrangement has been assessed as one unit of account.

Year 1 and Year 2 are unchanged from Scenario 2 because the payment on January 1, Year 2 was still less than the acquisition date fair value of the single contingent consideration liability.

Year 3

On January 1, Year 3, Parent pays $125 to the former owners of Target, similar to Scenario 2.

The following illustrates the effect of this transaction on Parent's Year 3 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)	$ -
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Payment of contingent consideration liability in excess of acquisition-date fair value	(20)

Net cash provided by (used in) operating activities	**(20)**
Cash flows from financing activities	
Payment of contingent consideration liability up to acquisition-date fair value	(105)
Net cash provided by (used in) financing activities	**$(105)**

Because the contingent consideration arrangement is considered a single unit of account, Parent recognizes total payments up to the original aggregate liability recorded ($210) as cash flows from **financing** activities and the excess payment of $20 ($105 + $125 - $210) as cash flows from **operating** activities. This results in Year 3 classification of $105 ($125 - $20) in cash flows from **financing** activities.

18.5 Settlement of liabilities assumed in a business combination

Question 18.5.10

How are cash flows for settlement of liabilities assumed in a business combination classified?

Interpretive response: Payments to settle liabilities assumed in a business combination are classified as they normally would be outside of the business combination. This means the classifications should be consistent with how the liabilities would be settled in the normal course of operations.

Therefore, a payment could be an **operating**, **investing** or **financing** activity depending on the nature of the settled liability. The following are examples.

— If the payment is for inventory purchased on account, it is a cash outflow for **operating** activities (see section 7.3).

— If the payment is for PP&E and other productive assets purchased on account and the payment is made soon after its original purchase date, it is a cash outflow for **investing** activities (see section 8.2).

— If the payment relates to a debt obligation legally assumed in an acquisition that remained outstanding after the acquisition date, it is a cash outflow for **financing** activities (see section 12.2.40). However, as described in Question 18.5.20, if the payment is to extinguish debt at the time of the business combination, the acquirer considers certain facts and circumstances of the business combination to determine the payment's appropriate classification in the statement of cash flows.

Question 18.5.20

How are cash flows for the extinguishment of debt paid in conjunction with a business combination classified?

Interpretive response: It depends on whether the acquirer legally assumes the acquiree's debt as part of the business combination.

— If the acquirer legally assumes the acquiree's debt as part of the business combination, the acquirer generally presents the extinguishment as a **financing** activity. This is consistent with how it would present the repayment of a debt obligation outside of a business combination (see section 12.2.40). [230-10-45-15(b)]

— If the acquirer does not legally assume the acquiree's debt as part of the business combination and the debt is extinguished on the acquisition date, the acquirer presents the extinguishment as an **investing** activity. This is consistent with how it would present consideration paid in a business combination (see section 18.2). [230-10-45-13(c)]

Determining whether the acquirer legally assumes the acquiree's debt as part of the business combination requires an evaluation of the facts and circumstances of the arrangement. The acquirer should review the provisions of the related debt and purchase agreements, the method and timing of extinguishment and the substance of the transaction – e.g. why the debt is being repaid.

We believe consideration should be given to all relevant factors, including the following.

— Whether repayment of an acquiree's debt is required by the terms of the debt or purchase agreement. For example:

  — If repayment is required at closing under the change-in-control provisions of the debt agreement, this generally indicates that the acquirer has not legally assumed the debt.

  — If the lender is required to grant consent to allow the acquirer to assume the debt, the lender's consent generally indicates that the acquirer has legally assumed the debt. If the lender does not consent, triggering repayment on the change of control, this generally indicates that the acquirer has not legally assumed the debt.

  — If repayment is the acquirer's own financing decision (e.g. the acquirer has a more favorable interest rate with its bank) this generally indicates that the acquirer has legally assumed the debt.

— Whether the acquiree's debt is repaid after the acquisition date, which generally indicates that the debt was legally assumed by the acquirer in the acquisition. Exceptions may exist if the repayment occurs after the acquisition date as a matter of administrative convenience for transferring funds between multiple parties and it is clear that the acquirer is not substantially exposed to the risks inherent in the borrowing – e.g. changes in market interest rates.

19. Transactions with shareholders

Detailed contents

19.6 Dividends paid to NCI holders

Question

19.6.10 How are cash flows for dividends paid to NCI holders classified?

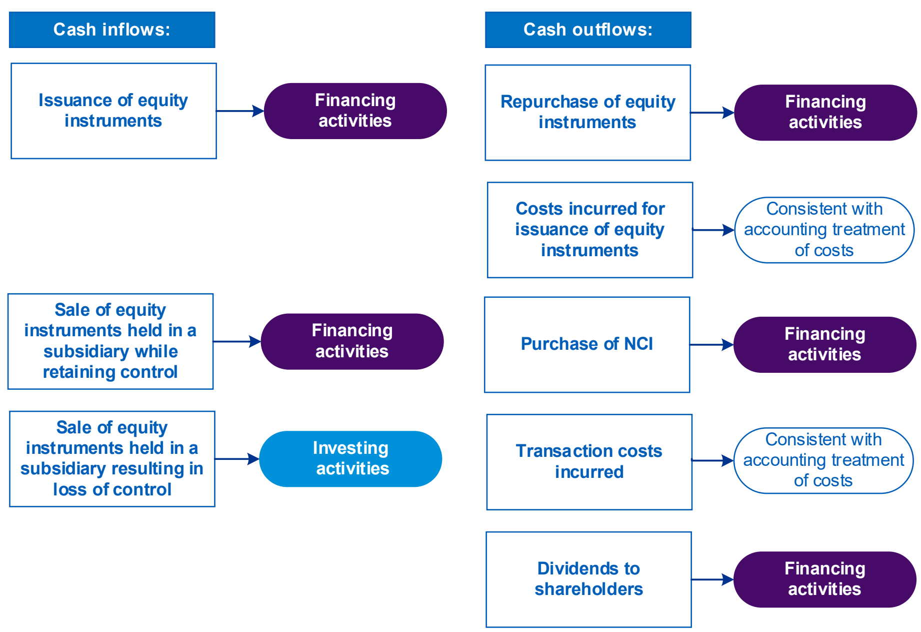
19.1 How the standard works

This chapter addresses the classification – in the stand-alone financial statements of an entity – of equity transactions with its shareholders, including owners (of the parent) and NCI holders (in subsidiaries). Equity transactions with shareholders in their capacity as employees are discussed in chapter 16. Financial instruments classified as liabilities are discussed in chapter 12.

— **Equity transactions with shareholders.** These transactions typically include the issuance or repurchase of an entity's own equity instruments and distributions to shareholders in the form of dividends. They generally represent cash flows from/for **financing** activities.

— **Transactions with NCI holders.** While Topic 230 does not provide specific guidance on how to classify transactions with NCI holders, we believe the classification of cash flows varies depending on whether the parent maintains or loses control of the subsidiary as a result of the transaction.

The following chart summarizes some of the classification issues that are explained in more detail in this chapter.



19.2 Issuance of equity instruments

Question 19.2.10

How are proceeds from the issuance of equity instruments classified?

Interpretive response: Proceeds from the issuance of equity instruments are cash inflows from **financing** activities. [230-10-45-14(a)]

The definition of **financing** activities includes "obtaining resources from owners and providing them with a return on, and a return of, their investment." [230-10 Glossary]

Example 19.2.10

Issuance of common stock for cash

On December 31, Year 1, ABC Corp. issues 10,000 shares of common stock for $15 per share. The par value of ABC common stock is $1.

The following illustrates the effect of this transaction on ABC's Year 1 statement of cash flows.

$'000s	
Cash flows from financing activities	
Proceeds from issuance of common stock	$150
Net cash provided by (used in) financing activities	**$150**

Question 19.2.20

How are cash flows for costs incurred in connection with a stock offering classified?

Background: Direct incremental costs of obtaining capital by issuing stock are deducted from the related proceeds, and the net amount is recorded as contributed stockholders' equity. [TQA 4110.01]

Such costs should be limited to the direct cost of issuing the security – e.g. direct, incremental fees charged by underwriters, attorneys and accountants. There should be no allocation of salaries, and any fees that would have been incurred in the absence of such issuance also should be excluded. [TQA 4110.01]

Direct incremental costs incurred before issuing stock may be deferred until the offering is complete, at which time the costs reduce the proceeds. [340-10-S99-1]

Interpretive response: The classification of costs incurred in connection with a stock offering depends on the accounting treatment for these costs.

— Direct incremental costs that reduce the amount recorded in equity are cash outflows for **financing** activities. This is consistent with the treatment of cash flows for equity transactions. [230-10-45-15(a)]

— Other issuance costs recorded as current period expenses are cash outflows for **operating** activities. This is based on the definition of **operating** activities, which states 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." [230-10 Glossary]

Additionally, careful consideration should be given to the gross versus net presentation of direct incremental costs, as follows.

— **Fees paid to third parties other than the investor.** We believe cash outflows for those fees should generally be presented gross in cash flows from **financing** activities, as a separate line item from inflows from the issuance of stock. This is because these costs are paid to parties unrelated to the investor and are not settled net.

— **Fees paid to the investor.** We believe cash outflows for those fees should be presented net in cash flows from **financing** activities, as a reduction of the cash inflows from the issuance of stock. This is because those costs reduce the amount paid by the investor.

— **Fees paid to third-party intermediary.** An issuance of stock may involve a third-party intermediary (e.g. investment bank) acting as an agent of the issuer and/or as a principal to the transaction (i.e. as an investor). Further consideration should be given to the gross versus net presentation of fees paid to such intermediaries; we believe the issues related to the presentation of such fees are similar to those in an issuance of debt (see Question 12.2.50).

19.3 Distributions to owners

The definition of **financing** activities includes "obtaining resources from owners and providing them with a return on, and a return of, their investment." [230-10 Glossary]

Question 19.3.10

How are cash flows for dividends paid to owners classified?

Interpretive response: Cash dividends paid to owners are a return on their investment. Cash outflows for **financing** activities include "payments of dividends or other distributions to owners, including outlays to reacquire the entity's equity instruments." Therefore, cash dividends paid to owners are cash outflows for **financing** activities. [230-10-45-15(a)]

We believe this guidance also applies to payments to owners that are in substance dividends and accounted for as such. See an illustration in Question 19.3.40.

Question 19.3.20

How should a parent entity classify the reduction of cash resulting from a spinoff?

Background: A spinoff involves the transfer of assets that constitute a business by an entity (the spinnor) into a new legal spun-off entity (the spinnee). This transfer of assets is followed by a distribution of the shares of the spinnee to the spinnor's shareholders, without the surrender by the shareholders of any stock of the spinnor. [505-60 Glossary]

A spinoff transaction is recorded at the historical carrying amount of the net assets similar to a distribution of nonmonetary assets to the owners of the spinnor under Subtopics 845-10 (nonmonetary transactions) and 505-60 (spinoffs and reverse spinoffs). The assets and liabilities of the business spun off are derecognized, including any cash, cash equivalents and restricted cash (collectively referred to as cash).

Interpretive response: We believe a parent entity should classify the reduction of cash as a cash flow from **financing** activities. This is because the cash included in the spinoff transaction is considered a distribution to the owners of the spun-off entity.

This classification is consistent with the definition of **financing** activities, which indicates that it includes "obtaining resources from owners and providing them with a return on, and a return of, their investment." [230-10 Glossary]

Further, classification as a **financing** activity is consistent with the accounting for a spinoff transaction, which is recorded directly to equity.

Question 19.3.30

How are payments made to repurchase equity instruments classified?

Interpretive response: Cash payments to owners to repurchase outstanding stock are a return of their investment. Cash outflows for **financing** activities include "payments of dividends or other distributions to owners, including outlays to reacquire the entity's equity instruments." Therefore, payments to owners by an entity to repurchase its own outstanding stock are cash outflows for **financing** activities. [230-10-45-15(a)]

Further, **financing** cash inflows and outflows are reported separately in the statement of cash flows. As such, payments to reacquire the entity's stock should be reported separately from proceeds from issuing stock and cash dividends paid to owners. [230-10-45-26]

Question 19.3.40

How are cash flows for income tax paid to a parent under a tax-sharing agreement classified?

Background: A parent and its subsidiaries (consolidated tax group) may file a consolidated tax return whereby the parent is generally responsible for paying the income tax liabilities for the group and receives any income tax refunds. In many cases, the consolidated tax group enters into a tax-sharing agreement that states how payments to and reimbursements from the parent will be calculated.

The consolidated amount of current and deferred tax expense for a consolidated tax group is allocated among the members of the group when those members issue stand-alone financial statements. Although Topic 740 does not require a single allocation method, any method adopted must be systematic, rational and consistent with the broad principles established by Topic 740. [740-10-30-27]

In some situations, the sum of income tax expense or benefit separately reported by the individual members may not equal either the consolidated amount or the amount of cash exchanged as required by the tax-sharing agreement. This frequently occurs when the members use the separate return method to compute their income tax expense or benefit for their stand-alone financial statements. The separate return method applies Topic 740 to the stand-alone financial statements of each member of the consolidated tax group as if the member were a separate taxpayer. For example, Subsidiary A may report $90 of income tax expense under the separate return method but pays $50 to its parent as a result of the tax sharing agreement. Similarly, Subsidiary B may report $100 but pays $120.

In other situations, a member of a consolidated tax group may report no income tax expense or benefit, although it does participate in the tax-sharing agreement. For example, consolidated income tax expense or benefit is not required to be allocated to a legal entity that is not subject to tax and is disregarded by the taxing authority. This often affects members that are single-member LLCs. For example, Subsidiary C (single-member LLC) does not report any income tax but pays $30 to its parent as a result of the tax-sharing agreement.

For more guidance on accounting for income tax in consolidated tax returns, see paragraph 3.012 of KPMG Handbook, Accounting for income taxes.

Interpretive response: We believe income tax paid to the parent under a tax-sharing agreement should be classified as cash flows from:

— **operating** activities, up to the amount of income tax reported in the subsidiary's financial statements. This is because, when part of a tax consolidated group, the parent is considered the taxing authority;

— **financing** activities, for the amount paid in excess of the income tax reported in the subsidiary's financial statements. This excess amount paid is considered a distribution to the parent (see Question 19.3.10).

In the background examples, Subsidiary A classifies $50 as cash flows from **operating** activities. Subsidiary B classifies $100 as cash flows from **operating** activities and $20 as cash flows from **financing** activities. Subsidiary C classifies $30 as cash flows from **financing** activities.

We believe the 'amount of income tax reported' in the subsidiary's financial statements is either total income tax expense including current and deferred tax, or limited to the amount of current tax. We believe it is acceptable to apply this approach as an accounting policy election that should be disclosed and applied consistently.

19.4 Transactions with NCI holders when control is retained

A parent's ownership interest in a subsidiary could change while the parent retains its controlling financial interest in the subsidiary. For example, the parent could purchase an additional ownership interest or sell some of its ownership interest in its subsidiary and retain control after each transaction.

Changes in a parent's ownership interest while the parent retains control are accounted for as equity transactions. Therefore, no gain or loss is recognized in consolidated net income or comprehensive income. [810-10-45-23]

Question 19.4.10

How are cash flows for purchases of NCI or from sales of equity interests in a subsidiary while retaining control classified?

Interpretive response: We believe cash flows for purchases of NCI or from sales of equity interests in a subsidiary by the parent while retaining control of the subsidiary are **financing** cash flows. This is because these transactions are accounted for as equity transactions among owners. [810-10-45-23]

The definition of **financing** activities includes "obtaining resources from owners and providing them with a return on, and a return of, their investment." [230-10 Glossary]

Example 19.4.10

Sale by parent of a portion of its ownership interest in a subsidiary – control retained

On October 31, Year 1, Subsidiary has 10,000 shares of common stock outstanding, all of which are owned by Parent.

On November 1, Year 1, Parent sells 2,000 of its shares in Subsidiary to an unrelated entity for $500,000 in cash, reducing its ownership interest from 100% to 80%.

Parent has control of Subsidiary both before and after the transaction. As such, Parent classifies the consideration received as cash flows from **financing** activities.

The following illustrates the effect of this transaction on Parent's Year 1 statement of cash flows.

$'000s	
Cash flows from financing activities	
Sale of shares in Subsidiary	$500
Net cash provided by (used in) financing activities	**$500**

Question 19.4.20

How are cash flows for transaction costs incurred in connection with purchases of NCI and sales of equity interests in a subsidiary while retaining control classified?

Background: When the parent purchases an additional ownership interest or sells some of its ownership interest in its subsidiary while retaining control, the parent may incur transaction costs, such as fees for legal, consulting, accounting and valuation services.

These costs may be accounted for as either equity transactions or expensed as incurred based on an entity's accounting policy election. See Question 7.5.170 of KPMG Handbook, Consolidation, for additional guidance related to the accounting treatment for these transaction costs.

Interpretive response: The classification of transaction costs for transactions with NCI holders while retaining control depends on the accounting treatment for these costs.

If an entity's accounting policy is to:

— expense the transaction costs as incurred, the related payments are cash outflows for **operating** activities. This is based on the definition of **operating** activities, which states 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." [230-10 Glossary]

— include the transaction costs in equity, the related cash flows are classified as cash flows from **financing** activities. This is consistent with the treatment of cash flows for equity transactions. [230-10-45-15(a)]

19.5 Transactions with NCI holders resulting in the loss of control

Transactions with NCI holders resulting in a loss of control by the parent require the parent to deconsolidate the subsidiary as of the date control is lost and recognize a gain or loss on both the interest sold and the interest retained. [810-10-40-4]

Question 19.5.10

How are cash flows from transactions with NCI holders resulting in the loss of control classified?

Interpretive response: Just as cash flows related to the acquisition of a business (i.e. upon obtaining control) are classified as cash flows from investing activities (see Question 18.2.10), we believe the cash flows received from the sale of a controlling financial interest in a subsidiary (i.e. upon losing control) are cash inflows from **investing** activities, net of the cash and cash equivalents deconsolidated.

The remeasurement of the retained interest in the former subsidiary to fair value is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2).

19.6 Dividends paid to NCI holders

Question 19.6.10

How are cash flows for dividends paid to NCI holders classified?

Interpretive response: NCIs are accounted for as an element of equity in the consolidated financial statements (see Question 19.4.10). Cash outflows for **financing** activities include "[p]ayments of dividends or other distributions to owners, including outlays to reacquire the entity's equity instruments." Therefore, dividends paid to NCI holders are cash outflows for **financing** activities. [230-10-45-15(a)]

20. Discontinued operations

Detailed contents

20.1 How the standard works

The approaches for presenting cash flows from discontinued operations are limited and separate cash flows must continue to be presented until they are no longer material. Therefore, an entity should consider the future financial reporting implications when selecting its policy for presenting and disclosing cash flows for discontinued operations.

In addition, another accounting policy election must be made when presenting cash flows from the sale of a discontinued operation in cash flows from **investing** activities (e.g. present proceeds as cash flows from continuing versus discontinued operations).

20.2 Cash flows from discontinued operations

20.2.10 Overview

A disposal of a component or group of components of an entity is reported in discontinued operations if the disposal meets the criteria in Subtopic 205-20. [205-20-45-1B(c)]

For more guidance on discontinued operations, see KPMG Handbook, Discontinued operations and held-for-sale disposal groups.

Question 6.4.60 addresses the presentation of cash balances held by discontinued operations (or disposal groups held-for-sale).

20.2.20 Presentation of cash flows from discontinued operations

Question 20.2.10

How are cash flows from discontinued operations presented?

Interpretive response: We believe an entity's presentation of cash flows from discontinued operations should follow one of three approaches. These approaches are consistent with SEC staff views. [2005 AICPA Conf]

Approach 1: No separate identification

Cash flows from a discontinued operation and the continuing business are presented together without separate identification within cash flows from **operating**, **investing** and **financing** activities.

Statement of cash flows category	Approach 1
operating activities	Combined (Continuing + Discontinued)
investing activities	Combined (Continuing + Discontinued)
financing activities	Combined (Continuing + Discontinued)

If Approach 1 is used, an entity discloses in a note (see section 20.2.40): [205-20-50-5B(c)]

— total **operating** and **investing** cash flows for discontinued operations; or
— depreciation, amortization, capital expenditures and significant operating and investing noncash items related to discontinued operations.

Approach 2: By category, continuing then discontinued

The net total *or* detailed line items of discontinued operation cash flows are separately presented within cash flows from **operating**, **investing** and **financing** activities.

Statement of cash flows category	Approach 2	
	(net total)	(in detail)
operating activities	Continuing Discontinued (net) Total	Continuing Discontinued (detail) Total
investing activities	Continuing Discontinued (net) Total	Continuing Discontinued (detail) Total
financing activities	Continuing Discontinued (net) Total	Continuing Discontinued (detail) Total

Approach 3: Continuing first (all categories), followed by discontinued (all categories)

Operating, **investing** and **financing** activities of the continuing business are presented, and then discontinued operation cash flows are presented below **financing** activities of the continuing operation. Like Approach 2, the discontinued operation shows the net total amount of activities *or* detailed line items comprising **operating**, **investing** and **financing** cash flows.

Statement of cash flows category	Approach 3	
	(net total)	(in detail)
operating activities	Continuing	Continuing
investing activities	Continuing	Continuing
financing activities	Continuing	Continuing
Discontinued:	**operating** activities (net) **investing** activities (net) **financing** activities (net)	**operating** activities (detail) **investing** activities (detail) **financing** activities (detail)

Under this approach, the combined total for each of the three categories (i.e. **operating**, **investing**, **financing**) is not provided. In addition, the captions related to any totals presented must clearly reflect the related category total (i.e. continuing versus discontinued).

Approaches that are not acceptable

The following approaches are *not* appropriate: [2005 AICPA Conf]

— aggregating operating, investing and financing cash flows from discontinued operations into a single, net line item; or
— presenting operating, investing and financing cash flows from discontinued operations all as operating cash flows.

Question 20.2.20
What periods are affected by discontinued operations in the statement of cash flows?

Interpretive response: The separate cash flows of the discontinued operation are presented for all periods affected (current and prior periods) and continue to be presented until there are no longer material cash flows related to the discontinued operation. Due to the nature of the cash flows related to discontinued operations (e.g. earnouts, severance pay, postretirement healthcare benefits), those cash flows may continue for many periods after the sale or liquidation of the operation.

This means that an entity should consider the future financial reporting implications when selecting its policy for presenting and disclosing cash flows from discontinued operations (see Question 20.2.10).

Question 20.2.30
What is the starting point in reconciling net income to net cash flows from operating activities?

Interpretive response: The reconciliation of net income to net cash flows from operating activities should begin with 'net income (loss)' – not 'net income (loss) from continuing operations'. [230-10-45-29, 2005 AICPA Conf]

20.2.30 Sale of a discontinued operation

Question 20.2.40
How are cash flows from the sale of a discontinued operation classified?

Interpretive response: The net cash received from the sale of a discontinued operation (i.e. proceeds from sale less any cash sold) is a cash inflow from **investing** activities. Any gain or loss recorded, both when the assets are classified as held-for-sale and at the time of sale, is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2). [230-10-45-2]

However, there is a further issue about whether the **investing** cash flows should be classified as part of cash flows from continuing operations or cash flows from discontinued operations. While we believe the more logical presentation is investing cash flows from discontinued operations, we believe it is acceptable to apply either approach as an accounting policy election that should be disclosed and consistently applied.

The policy election is relevant to the presentation approaches discussed in Question 20.2.10 as follows.

- **Approach 1.** It does not affect the statement of cash flows itself (because discontinued operations are not separately identified), but it does affect the disclosure of cash flows from continuing versus discontinued operations in the notes to the financial statements.
- **Approaches 2 and 3.** It affects presentation in the statement of cash flows.

Question 20.2.50

How are cash flows for income taxes paid on the sale of a discontinued operation classified?

Interpretive response: Cash payments to taxing authorities for income taxes are **operating** cash flows. Therefore, even though the cash proceeds from the sale of a discontinued operation are cash inflows from investing activities, any related income tax payments are cash outflows for **operating** activities within discontinued operations. [230-10-45-17(c)]

20.2.40 Disclosure of cash flows from discontinued operations

Excerpt from ASC 205-20

> Disclosures Required for a Discontinued Operation Comprising a Component or Group of Components of an Entity

50-5B An entity shall disclose, to the extent not presented on the face of the financial statements as part of discontinued operations, all of the following in the notes to financial statements: …

c. Either of the following:
   1. The total operating and investing cash flows of the discontinued operation for the periods in which the results of operations of the discontinued operation are presented in the statement where net income is reported (or statement of activities for a not-for-profit entity)
   2. The depreciation, amortization, capital expenditures, and significant operating and investing noncash items of the discontinued operation for the periods in which the results of operations of the discontinued operation are presented in the statement where net income is reported (or statement of activities for a not-for-profit entity).

To the extent not separately presented in the statement of cash flows (i.e. Approach 1 in Question 20.2.10), an entity with discontinued operations discloses either:

— the total **operating** and **investing** cash flows of the discontinued operation; or
— the depreciation, amortization, capital expenditures and significant **noncash** operating and investing activities of the discontinued operation.

These amounts are disclosed in the notes to the financial statements for all periods in which the entity has reported discontinued operations in its income statement. [205-20-50-5B(c)]

When an entity retains significant continuing involvement in a discontinued operation after the disposal date, cash inflows and outflows from the discontinued operation after the disposal date should also be disclosed. [205-20-50-4B(c)(1)]

For additional guidance on disclosure requirements, see chapter 7 in KPMG Handbook, Discontinued operations and held-for-sale disposal groups.

Question 20.2.60

Can an entity disclose additional voluntary cash flow information about discontinued operations?

Interpretive response: Yes. We believe an entity is permitted to provide information about **operating** or **investing** activities for discontinued operations that is incremental to the requirements in Subtopic 205-20. However, this incremental information should support US GAAP financial measures, and should not be based on non-GAAP financial measures.

In addition, although Subtopic 205-20 does not require presentation or disclosure of cash flow information from discontinued operations related to **financing** activities, we believe an entity is not precluded from presenting or disclosing such information. [ASU 2014-08.BC38]

Question 20.2.70

Are there additional cash flow-related disclosure requirements relating to discontinued operations?

Interpretive response: Yes. An entity that has significant continuing involvement with a discontinued operation after the disposal date discloses the amount of any cash flows from/for the discontinued operation after the disposal date.

Examples of continuing involvement include a supply and distribution agreement, a financial guarantee, an option to repurchase a discontinued operation, and an equity method investment in the discontinued operation. [205-20-50-4A, 50-4B(c)(1)]

Question 20.2.80

Should an SEC registrant's Form 10-K disclose cash flows from discontinued operations in MD&A?

Interpretive response: Yes. The SEC staff has emphasized the importance of considering disclosures concerning the cash flows from discontinued operations in the liquidity and capital resources section of MD&A in Form 10-K. [2005 AICPA Conf]

The SEC staff highlighted that these disclosures include the following:

— a description of how cash flows from discontinued operations are reported in the statement of cash flows;

— a quantification, where material, of the cash flows from discontinued operations if not separately disclosed in the statement of cash flows; and

— a description of how the absence of cash flows from discontinued operations, whether positive or negative, is expected to affect future liquidity and capital resources.

21. Foreign currency matters

Detailed contents

21.1 How the standard works

This chapter addresses the guidance in Subtopic 830-230 on reporting foreign currency matters in the statement of cash flows.

The following chart provides an overview of the foreign currency matters explained in more detail in this chapter.

Foreign currency transactions	**Foreign currency translation**
Effect of exchange rate changes on cash, cash equivalents and restricted cash	**Highly inflationary economies**

21.2 Transactions denominated in a foreign currency

Excerpt from ASC 830-230

45-1 A statement of cash flows of an entity with **foreign currency transactions** or foreign operations shall report the **reporting currency** equivalent of **foreign currency** cash flows using the exchange rates in effect at the time of the cash flows. An appropriately weighted average **exchange rate** for the period may be used for **translation** if the result is substantially the same as if the rates at the dates of the cash flows were used. (That is, paragraph 830-30-45-3 applies to cash receipts and cash payments.) The statement of cash flows shall report the effect of exchange rate changes on cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents held in foreign currencies as a separate part of the reconciliation of the change in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents during the period. See Example 1 (paragraph 830-230-55-1) for an illustration of this guidance.

Foreign currency transactions are transactions whose terms are denominated in a currency other than the entity's functional currency (i.e. the currency of the primary economic environment in which the entity operates). Foreign currency transactions should be accounted for as follows. [830-20 Glossary, 830-20-25-1, 35-2]

— At the date the transaction is recognized, each asset, liability, revenue, expense, gain or loss arising from the transaction should be measured and recorded in the entity's functional currency using the exchange rate at which the transaction could be settled at the transaction date.

— At each balance sheet date, recognized monetary assets and liabilities that are denominated in a currency other than the entity's functional currency should be adjusted to reflect the exchange rate at which the related monetary item could be settled at that date.

Changes in the exchange rate increase or decrease the expected functional currency cash flows on settlement of a transaction. These changes are reflected in the remeasurement of monetary assets and liabilities at each balance sheet date and on settlement. The corresponding effects of those remeasurements are recognized as foreign currency transaction gains or losses in the income statement. [830-20-35-1 – 35-2]

Examples of monetary assets and liabilities denominated in a foreign currency include the following for an entity whose functional currency is the US dollar or any currency other than the Japanese yen:

— a loan payable in Japanese yen
— cash balances denominated in Japanese yen
— accounts receivable denominated in Japanese yen
— investments in debt securities classified as held-to-maturity denominated in Japanese yen.

Question 21.2.10

How are the cash flow effects of transactions denominated in a foreign currency measured?

Interpretive response: An entity should report the cash flow effects of transactions denominated in a foreign currency by using the exchange rates in effect on the date of the related cash flows. However, if the exchange rates are relatively consistent throughout the reporting period, an entity may use an appropriate weighted average exchange rate for the period for remeasuring the foreign currency cash flows (i.e. the result should be substantially the same as using the exchange rates on the date of the individual cash flows). [830-230-45-1]

Question 21.2.20

How are unrealized foreign currency transaction gains and losses presented?

Interpretive response: If at the balance sheet date the foreign currency transaction gains and losses are unrealized, the gains and losses are presented as reconciling items in the reconciliation of net income to net cash flows from operating activities (see section 3.2). [230-10-45-2, 45-28(b)]

Question 21.2.30

How are cash flows resulting from the settlement of a foreign-currency denominated monetary asset or liability classified?

Interpretive response: Any cash flows resulting from the settlement of a foreign-currency denominated monetary asset or liability are classified as cash flows from **operating**, **investing**, or **financing** activities on the basis of the nature of such cash flows. See other chapters of this publication for a comprehensive view of classification considerations.

If a realized foreign currency transaction gain or loss relates to an **investing** or **financing** activity (e.g. repayment of a foreign-currency denominated debt), the realized gain or loss is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2). [230-10-45-2, 45-28(b)]

Example 21.2.10

Foreign currency transaction – sale of goods

ABC Corp.'s functional currency is the US dollar (USD). On November 15, Year 1, ABC sells equipment to a customer in Mexico with terms requiring payment on January 31, Year 2.

The following additional facts are relevant.

— Transaction denominated in:	Mexico peso (MXN)
— Sales price of equipment:	200,000 MXN
— Exchange rates:	
– November 15, Year 1	1 USD to 20 MXN
– December 31, Year 1	1 USD to 25 MXN
– January 31, Year 2	1 USD to 25 MXN

Year 1

ABC records the following journal entry on November 15, Year 1.

USD	*Debit*	*Credit*
Accounts receivable[1]	10,000	
Revenue		10,000
To recognize revenue in USD based on exchange rate on date of transaction.		

Note:
1. 200,000 MXN / 20.

On December 31, Year 1, the receivable remains unsettled and ABC records the following journal entry.

USD	*Debit*	*Credit*
Unrealized foreign exchange loss[1]	2,000	
Accounts receivable		2,000
To recognize change in exchange rate as of end of period.		

Note:
1. (200,000 MXN / 25) - (200,000 MXN / 20).

The following illustrates the effect of this transaction on ABC's Year 1 statement of cash flows, which is prepared using the indirect method.

$'000s	
Cash flows from operating activities	
Net income (loss)[1]	$ 8
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Unrealized foreign exchange (gain) loss, net	2
Change in assets and liabilities:	
Increase in accounts receivable[2]	(10)
Net cash provided by (used in) operating activities	**$ -**

Notes:

1. Revenue of $10 less foreign exchange loss of $2.
2. Equal to amount recognized on date of transaction that remains unsettled.

Year 2

On January 31, Year 2 settlement occurs and ABC records the following journal entry. The exchange rate has not changed and therefore no gain or loss on remeasurement arises.

USD	*Debit*	*Credit*
Cash	8,000	
Accounts receivable		8,000
To record settlement of transaction.		

The following illustrates the effect of this transaction on ABC's Year 2 statement of cash flows, which is prepared using the indirect method. This assumes that the cash received is immediately converted into USD.

$'000s	
Cash flows from operating activities	
Net income (loss)	$ -
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities	
Change in assets and liabilities:	
Decrease in accounts receivable[1]	8
Net cash provided by (used in) operating activities	**$8**

Note:

1. The $10 increase in accounts receivable in Year 1 is offset by the $2 foreign exchange loss that is realized in Year 2 upon collection, to arrive at a decrease in accounts receivable of $8 in Year 2.

Example 21.2.20
Foreign currency transaction – borrowing

ABC Corp.'s functional currency is USD. On November 15, Year 1, ABC borrows 100 million Japanese yen (JPY) from a bank. The loan is repayable in JPY. The cash received is immediately converted and held in USD; interest is not considered for simplicity.

The following additional facts are relevant.

— Exchange rates:

– November 15, Year 1	1 USD to 100 JPY
– December 31, Year 1	1 USD to 125 JPY

ABC records the following journal entry on November 15, Year 1.

USD	*Debit*	*Credit*
Cash[1]	1,000,000	
Loan payable		1,000,000
To record borrowing in USD based on exchange rate at date of transaction.		

Note:
1. 100,000,000 JPY / 100.

On December 31, Year 1, the borrowing remains unsettled, and ABC records the following journal entry.

USD	*Debit*	*Credit*
Loan payable[1]	200,000	
Unrealized foreign exchange gain		200,000
To recognize change in exchange rate as of end of period.		

Note:
1. (100,000,000 JPY / 100) - (100,000,000 JPY / 125).

The following illustrates the effect of this transaction on ABC's Year 1 statement of cash flows, which is prepared using the indirect method.

$'000s	
Cash flows from operating activities	
Net income	$ 200
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:	
Unrealized foreign exchange (gain) loss, net	(200)
Net cash provided by (used in) operating activities	**-**
Cash flows from financing activities	
Proceeds from borrowings	1,000
Net cash provided by (used in) financing activities	**$1,000**

Note:
1. For classification guidance on cash flows from the issuance of debt, see Question 12.2.10.

Question 21.2.40

How is the effect of exchange rate changes on foreign-currency denominated cash, cash equivalents and restricted cash presented?

Interpretive response: When an entity holds cash, cash equivalents and restricted cash in a currency other than its functional currency, those balances are measured in the functional currency at each reporting date. The resulting remeasurement gains and losses are not cash flows. Instead, these amounts are reported in a separate line item as part of the reconciliation of the change in cash, cash equivalents and restricted cash during the period. [830-230-45-1]

This separate line item also includes the effect of exchange rate changes on cash, cash equivalents and restricted cash held by a foreign operation (see Question 21.3.20).

Net cash provided by operating activities	$ XXX
Net cash used in investing activities	(XXX)
Net cash provided by financing activities	XXX
Effect of exchange rate changes on cash, cash equivalents and restricted cash	XXX
Net change in cash, cash equivalents and restricted cash	**XXX**
Cash, cash equivalents and restricted cash at beginning of period	XXX
Cash, cash equivalents and restricted cash at end of period	**$XXX**

21.3 Operations in a foreign currency environment

21.3.10 Foreign currency translation

To prepare a set of consolidated financial statements, an entity translates all functional currency financial statements into a single reporting currency. The same applies if an entity uses a different reporting currency than its functional currency. The effects of translation are not included in the determination of net income but are instead recognized in OCI. [830-30-45-12]

Question 21.3.10

How are translation gains or losses presented?

Interpretive response: Translation effects are recognized in OCI and do not represent cash receipts or payments. Therefore, they are not presented in the statement of cash flows. [830-30-45-12]

21.3.20 Preparing and translating a statement of cash flows for an entity with foreign operations

When preparing the statement of cash flows for an entity with foreign operations, the following process should be used (which is illustrated further in Example 21.3.10).

Identify the functional currency for each foreign operation. The functional currency might be the currency of the country in which the foreign operation is located (i.e. the local currency), the reporting currency of the parent, or the currency of another country.

↓

Prepare a separate statement of cash flows for each foreign operation using the operation's functional currency.

↓

Translate the separate statements of cash flows into the reporting currency of the reporting entity. [830-230-45-1]

↓

Consolidate the separate translated statements of cash flows.

Question 21.3.20

How does an entity calculate and present the effect of exchange rate changes on cash, cash equivalents and restricted cash for each foreign operation?

Interpretive response: The effect of exchange rate changes on cash, cash equivalents and restricted cash is presented separately in the statement of cash flows (see Question 21.2.40) and is calculated for each foreign operation using the following formula.

The net cash flow activity for the period measured in the functional currency of the foreign operation **multiplied by** the difference between the exchange rates used in translating functional currency cash flows (see note below) and the exchange rate at period-end.	+	The change in exchange rate from the beginning of the period to the end of the period **multiplied by** the beginning cash balance denominated in currencies other than the reporting currency.

Note: The exchange rates used in translating functional currency cash flows are the exchange rates in effect on the date of the related cash flows. However, if the exchange rates are relatively consistent throughout the reporting period, an appropriate weighted average exchange rate for the period may be used for translation (i.e. the result should be substantially the same as using the exchange rates on the date of the individual cash flows). [830-230-45-1]

Example 21.3.10
Foreign currency translation – comprehensive example

Foreign Sub is established and begins business on June 30, Year 1. Foreign Sub is wholly owned by a US company (Parent), and Foreign Sub's functional currency is the local currency (LC).

The following additional facts are relevant.

— Reporting currency of Parent:	USD
— Year 2 opening net assets of Foreign Sub	120 LC
— Exchange rates:	
– June 30, Year 1	.95 USD to 1 LC
– December 31, Year 1	.85 USD to 1 LC
– Year 1 (average exchange rate)	.90 USD to 1 LC
– December 31, Year 2	.80 USD to 1 LC
– Year 2 (average exchange rate)	.825 USD to 1 LC
— Other Year 2 activity for Foreign Subsidiary and related exchange rates:	
– Issued long-term debt of 120 LC on January 15, Year 2	.775 USD to 1 LC
– Acquired fixed assets of 100 LC on March 15, Year 2	.875 USD to 1 LC
– Repaid 20 LC of debt ratably throughout Year 2	

Translation of Foreign Sub financial statements – December 31, Year 2

$'000s	**LC**	**Rate**	**USD**
Balance sheet			
Cash	40	.80	$ 32
Receivables, net	115	.80	92
Inventory	400	.80	320
Fixed assets, net	678	.80	542
Total assets	**1,233**		**$986**

$'000s	**LC**	**Rate**	**USD**
Current liabilities	279	.80	$223
Long-term debt	800	.80	640
Stockholders' equity:			
Common stock	100		95[1]
Retained earnings	54		46[2]
Accumulated other comprehensive income	-		(18)[3]
Total liabilities and stockholder's equity	**1,233**		**$986**

$'000s	**LC**	**Rate**	**USD**
Income statement			
Revenue	195	.825	$161
Cost of goods sold	(90)	.825	(74)
Depreciation	(22)	.825	(18)
Other expenses, net	(15)	.825	(13)
Income before taxes	**68**		**56**
Income taxes	(34)	.825	(28)
Net income	**34**		**$ 28**

$'000s	**LC**	**Rate**	**USD**
Statement of comprehensive income			
Net income			$ 28
Other comprehensive income:			
Current year translation adjustment			(7)[3]
Comprehensive income			$ 21

$'000s	**LC**	**Rate**	**USD**
Statement of cash flows			
Cash flows from operating activities			
Net income	34	.825	$ 28
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation	22	.825	18
Change in assets and liabilities:			
Increase in accounts receivable	(35)	.825	(29)
Increase in inventory	(100)	.825	(82)
Increase in current liabilities	99	.825	82
Net cash provided by (used in) operating activities	**20**		**17**

$'000s	LC	Rate	USD
Cash flows from investing activities			
Capital expenditures	(100)	.875	(88)
Net cash provided by (used in) investing activities	**(100)**		**(88)**
Cash flows from financing activities			
Proceeds from issuance of long-term debt	120	.775	93
Principal payments of long-term debt	(20)	.825	(17)
Net cash provided by (used in) operating activities	**100**		**76**
Effect of exchange rate changes on cash			10[4]
Net increase in cash	**20**		**15**
Cash at beginning of year	20	.85	17
Cash at end of year	**40**		**$ 32**

Notes:

1. Common stock was issued on June 30, Year 1 when exchange rate was 1 LC to .95 USD.
2. Retained earnings represent accumulated net income. Therefore, it is translated at the same rate as (accumulated) net income.
3. The cumulative translation adjustment includes:

Translation difference on opening net assets (i.e. opening equity)	120 LC × (.80 - .85)	$ (6)
Translation difference on net income	34 LC × (.80 - .825)	(1)
Current year translation adjustment		**(7)**
Translation adjustment in Year 1		(11)
Cumulative translation adjustment		**$ (18)**

4. The effect of exchange rate changes on cash is calculated as follows.

Effect on cash at beginning of year:			
Beginning cash balance at Year 2 year-end rate	20 LC × .80	$ 16	
Beginning cash balance at Year 1 year-end rate	20 LC × .85	$ 17	**$ (1)**
Effect from operating activities:			
Operating cash flows at year-end rate	20 LC × .80	$ 16	
Operating cash flows in statement of cash flows		$ 17	**(1)**
Effect from investing activities:			
Investing cash flows at year-end rate	(100) LC × .80	$(80)	
Investing cash flows in statement of cash flows		$(88)	**8**
Effect from financing activities:			
Financing cash flows at year-end rate	100 LC × .80	$ 80	
Financing cash flows in statement of cash flows		$ 76	**4**
Effect of exchange rate changes on cash			**$ 10**

Consolidation of Foreign Sub and Parent – December 31, Year 2

$'000s	Parent (assumed)	Foreign Sub	Eliminations	Consolidated
Balance sheet				
Cash	$ 40	$ 32		$ 72
Receivables, net	75	92		167
Inventory	350	320		670
Fixed assets, net	1,295	542		1,837
Investment in subsidiary, 100%	95	-	$ (95)	-
Total assets	**$1,855**	**$986**	**$(95)**	**$2,746**
Current liabilities	$ 192	$223		$ 415
Long-term debt	315	640		955
Stockholders' equity:				
Common stock	800	95	$ (95)	800
Retained earnings	548	46		594
Accumulated other comprehensive income	-	(18)		(18)
Total liabilities and stockholder's equity	**$1,855**	**$986**	**$(95)**	**$2,746**

$'000s	Parent (assumed)	Foreign Sub	Eliminations	Consolidated
Income statement				
Revenue	$ 500	$161		$ 661
Cost of goods sold	(250)	(74)		(324)
Depreciation	(55)	(18)		(73)
Other expenses, net	(55)	(13)		(68)
Income before taxes	**140**	**56**		**196**
Income taxes	(77)	(28)		(105)
Net income	**$ 63**	**$ 28**		**$ 91**

$'000s	Parent (assumed)	Foreign Sub	Eliminations	Consolidated
Statement of comprehensive income				
Net income	$ 63	$ 28		$ 91
Other comprehensive income:				
Current year translation adjustment	-	(7)		(7)
Comprehensive income	**$ 63**	**$ 21**		**$ 84**

$'000s	Parent (assumed)	Foreign Sub	Consolidated
Statement of cash flows			
Cash flows from operating activities			
Net income	$ 63	$ 28	$ 91
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation	55	18	73
Accrued interest on long-term debt	15		15
Change in assets and liabilities:			
(Increase) decrease in accounts receivable	30	(29)	1
Increase in inventory	(100)	(82)	(182)
Increase in current liabilities	27	82	109
Net cash provided by (used in) operating activities	**90**	**17**	**107**
Cash flows from investing activities			
Capital expenditures	(100)	(88)	(188)
Net cash provided by (used in) investing activities	**(100)**	**(88)**	**(188)**
Cash flows from financing activities			
Proceeds from issuance of long-term debt	-	93	93
Principal payments of long-term debt	-	(17)	(17)
Net cash provided by (used in) operating activities	**-**	**76**	**76**
Effect of exchange rate changes on cash	-	10	10
Net increase (decrease) in cash	**(10)**	**15**	**5**
Cash at beginning of year	50	17	67
Cash at end of year	**$ 40**	**$ 32**	**$ 72**

21.4 Highly inflationary economies

21.4.10 Overview

A highly inflationary economy is one that has a cumulative inflation rate of approximately 100% or more over a three-year period. [830-10-45-11]

This section addresses two common situations in which the entity located in a highly inflationary economy is either:

— a foreign operation that reports to a parent in US GAAP; or
— an entity that files US GAAP stand-alone financial statements with the SEC (issuer).

21.4.20 Foreign operations in highly inflationary economies

Question 21.4.10

How would a highly inflationary economy affect a foreign operation that reports to its parent in US GAAP?

Interpretive response: The financial statements of a foreign operation in a highly inflationary economy are remeasured as if the functional currency were the reporting currency of the entity's parent in accordance with Subtopic 830-20 (foreign currency transactions). As such, a US parent's subsidiary in a highly inflationary economy would typically use the US dollar as its functional currency. See section 21.2 for guidance on transactions denominated in a foreign currency. [830-10-45-11, 45-17]

21.4.30 Issuers in highly inflationary economies

An issuer whose primary economic environment is highly inflationary has two options to prepare financial statements in accordance with US GAAP: either select a stable currency as its reporting currency, or prepare price-level adjusted financial statements in the local, highly inflationary currency. [FRM 6710.3]

Stable currency reporting

If the stable currency approach is used, the remeasurement principles of Topic 830 apply (see section 21.2).

Price-level adjusted financial statements

Question 21.4.20

How does an issuer that prepares price-level adjusted financial statements present its statement of cash flows?

Interpretive response: Including the effects of inflation in the line items within the three major categories of the statement of cash flows (i.e. operating, investing and financing) may make the presentation less meaningful and possibly misleading. For example, the financing activities section may depict reductions of foreign-currency denominated debt because of the recasting of prior balance sheet amounts for inflation, even though no cash repayment has occurred. In some cases, these effects may permeate the statement of cash flows. Therefore, issuers are required to prepare a price-level adjusted statement of cash flows in a manner that comprehensively segregates in a *fourth caption* the effects of inflation from cash flows from **operating**, **investing** and **financing** activities. This approach is consistent with the approach adopted in several countries. [FRM 6720.4]

22. NFP entities

Detailed contents

New item added in this edition: **

Examples

22.5 Investments

Question

22.6 Agency transactions

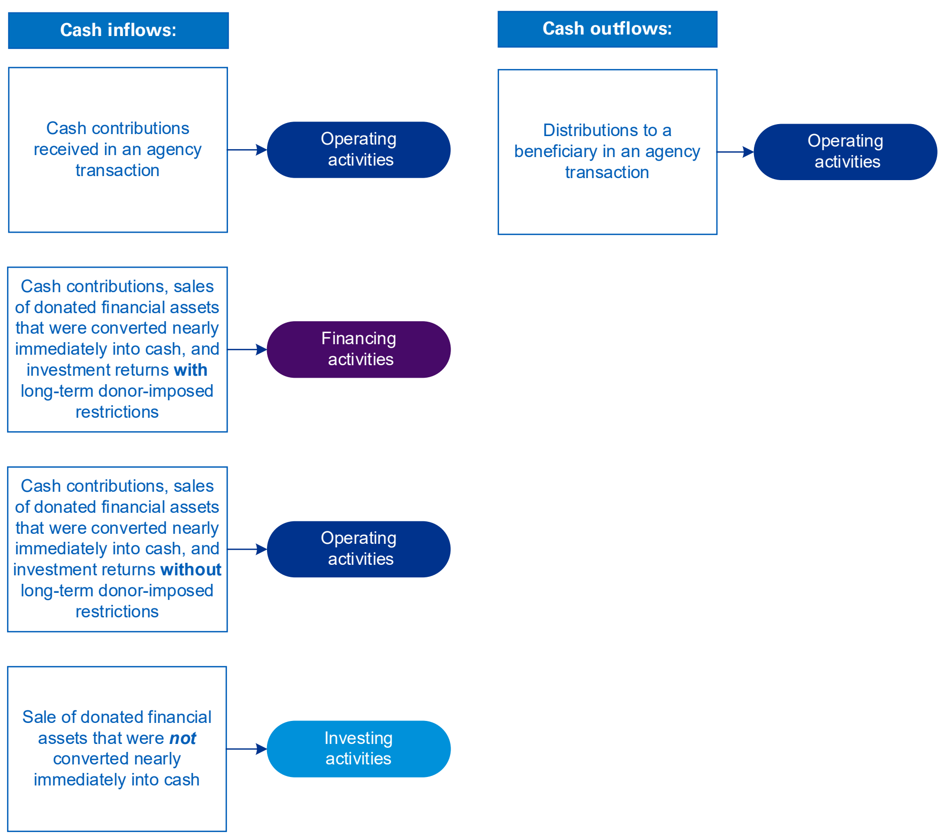
Question

22.1 How the standard works

When preparing a statement of cash flows, NFPs follow the guidance in:

- Topic 230, unless the specific provision explicitly exempts NFPs or the subject matter is not applicable to an NFP; and
- Subtopic 958-230, which provides industry-specific incremental guidance to Topic 230.

This chapter focuses on the incremental presentation and classification issues in Topic 230 and Subtopic 958-230 relating to an NFP's statement of cash flows. An NFP should refer to other chapters of this Handbook for the general presentation and classification issues in Topic 230. The following chart summarizes some of the industry-specific classification issues encountered, which are explained in more detail in this chapter.



22.2 Format of the statement

22.2.10 Direct vs indirect method

Like a business entity, an NFP can prepare its statement of cash flows under either the direct or indirect method. Although Topic 230 encourages all entities to use the direct method, most NFPs (like most business entities) apply the indirect method.

An NFP using the indirect method starts with the change in net assets to reconcile to cash flows from operating activities. In contrast, a business entity starts with net income. This difference is illustrated in Example 22.2.10, with the change in pension liability. [230-10-45-28]

Examples of an NFP's direct and indirect method statement of cash flows are in Subtopic 958-205. [958-205-55-18 – 55-20]

Example 22.2.10**

NFP - Change in pension liability

NFP provides a noncontributory defined benefit pension plan to certain employees. See Example 15.2.10 for supporting details about the changes in NFP's net pension liability (projected benefit obligation, net of plan assets) and the components of other changes recognized in OCI (i.e. other changes in net assets) during Year 2.

The following illustrates one approach to presenting the effect of the change in the net pension liability on NFP's Year 2 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Change in net assets	$ (100)
Adjustments to reconcile change in net assets to net cash used in operating activities:	
Net periodic pension cost	700
Components of the change in net pension liability recognized in other changes in net assets	(600)
Change in assets and liabilities:	
Contributions to pension plan	(900)
Net cash used in operating activities	**$ (900)**

In our experience, some NFP entities may alternatively combine the net periodic pension cost with the contributions to pension plan within the operating activities section of the statement of cash flows, particularly when net periodic pension cost is not material.

22.2.20 Reconciliation of change in net assets to net cash flows from operating activities

Question 22.2.10

Is an NFP required to reconcile the change in net assets to net cash flows from operating activities?

Interpretive response: It depends on the format of the statement of cash flows.

Indirect method

If an NFP prepares its statement of cash flows under the indirect method, it is required to provide a reconciliation of the change in net assets to net cash flows from operating activities. [230-10-45-29]

Direct method

An NFP that prepares its statement of cash flows under the direct method is not required to provide a reconciliation. [230-10-45-29]

Question 22.2.20

Are 'cash flows from operating activities' derived from 'income (loss) from operations' in the NFP's statement of activities/operations?

Background: 'Income (loss) from operations', as used in an NFP's statement of activities/operations, is currently self-defined by an NFP. Subject to certain limitations imposed by other Topics, it can be any intermediate measure that the NFP's management and board believes reflects their view of the NFP's operations for the year. When an NFP uses an intermediate measure of operations in its statement of activities/operations, certain amounts are required to be included within operations. [350-20-45-2, 350-30-45-2, 954-220-45-6, 958-220-45-9 – 45-12]

Interpretive response: No. Although an NFP has significant flexibility in self-defining the nature of operations for the statement of activities/operations, this is not the case for the statement of cash flows. Therefore, errors in the classification among the categories in the statement of cash flows can occur if an NFP prepares the statement of cash flows to correlate directly with the definition of 'income (loss) from operations' as used in the statement of activities/operations. The cash flows from operating activities subtotal is required to capture those activities explicitly defined as operating in Topic 230, as well as all cash inflows and outflows that are not explicitly defined in Topic 230 or Subtopic 958-230 as investing or financing activities. [230-10-45-16 – 45-17]

22.3 Cash, cash equivalents and restricted cash

Excerpt from ASC 958-210

> Classification of Assets and Liabilities

45-5A As illustrated in paragraph 958-205-55-7, cash and cash equivalents of permanent endowment funds held temporarily until suitable long-term investment opportunities are identified may be included in the classification long-term investments. Likewise, cash held temporarily by a custodian for investment purposes may be included as part of investments in a statement of financial position rather than as cash.

45-6 Assets may be restricted by donors. For example, land could be restricted to use as a public park. Generally, however, restrictions apply to net assets, not to specific assets. Assets need not be disaggregated on the basis of the presence of donor-imposed restrictions on their use; for example, cash available for current use and without donor restrictions need not be reported separately from cash received with donor-imposed restrictions that is also available for current use. However, cash or other assets received with a donor-imposed restriction that limits their use to long-term purposes shall not be classified with cash or other assets that are without donor restrictions and are available for current use. The kind of asset whose use is limited either by a donor-imposed restriction or by governing board designations shall be described in the notes to the financial statements if the nature of the restriction or designation (that is, amount and purpose) is not clear from the description on the face of the statement of financial position.

Excerpt from ASC 958-230

> Implementation Guidance

>> Cash and Cash Equivalents

55-2 Not all assets of NFPs that meet the definition of **cash equivalents** are cash equivalents for purposes of preparing statements of financial position and cash flows. Restrictions can prevent them from being included as cash equivalents even if they otherwise qualify. For example, short-term highly liquid investments are not cash equivalents if they are purchased with resources that have donor-imposed restrictions that limit their use to long-term investment.

Following the adoption of ASU 2018-16 (see chapter 1), NFPs apply the below requirements.

Cash

All cash (see section 6.2) is included in the total of cash and cash equivalents and amounts generally described as restricted cash or restricted cash equivalents in the statement of cash flows, irrespective of its classification on the balance sheet and irrespective of its restrictions. [230-10-45-4, 958-210-45-6]

Cash equivalents

NFPs may establish a policy or be required to exclude certain short-term, highly liquid investments that would otherwise meet the definition of cash equivalents (see section 6.3) from the cash equivalents line item in both the balance sheet and in the statement of cash flows. [230-10-45-6, 958-230-55-2]

The reconciliation requirements described in section 6.3 also apply to NFPs.

Question 22.3.10

Does an NFP report all cash balances in the beginning and ending totals of cash and cash equivalents in the statement of cash flows?

Background: An NFP may have cash amounts presented outside of the cash and cash equivalents balance sheet caption – e.g. included in investments, other long-term assets, or assets limited as to use. This may be the case when [958-210-45-5A, 45-6]:

- restrictions or designations preclude the cash amounts from being classified with cash that is without donor restrictions and available for current use. Common examples include cash received with a donor-imposed restriction that limits its use to long-term purposes, cash designated by the governing board to be held for long-term purposes, and cash restricted by law or contract for noncurrent purposes; or
- the entity has elected to include in investments cash held temporarily by a custodian for investment purposes.

Interpretative response: Yes. Regardless of the reason why the cash amount is excluded from the cash and cash equivalents balance sheet caption, the amount is included in the total of cash, cash equivalents and amounts generally described as restricted cash or restricted cash equivalents in the statement of cash flows, and disclosed as a reconciling item between the two cash and cash equivalents totals (see section 6.3). [230-10-45-4, 50-8]

Question 22.3.20

Does an NFP report in cash equivalents all investments that qualify as cash equivalents?

Interpretative response: Not necessarily. Certain short-term highly liquid investments of NFPs do not qualify as cash equivalents. For those that qualify, an NFP may have a policy to not treat them as cash equivalents when preparing the balance sheet and statement of cash flows.

An NFP first considers whether the short-term highly liquid investment was purchased with resources that have donor-imposed restrictions that prevent them from being included in cash equivalents on the balance sheet and in the statement of cash flows. For example, short-term highly liquid investments are not cash equivalents if purchased with resources from a donor-restricted endowment fund or other resources limited to long-term investment by donor-imposed restrictions. [958-230-55-2]

Then, like a business entity, an NFP establishes (and discloses) a policy for which other short-term highly liquid investments that meet the cash equivalent definition will be treated as cash equivalents. Only those assets treated as cash equivalents may be 'restricted' cash equivalents. [230-10-45-6, 50-1]

— If the NFP chooses not to treat any of these short-term highly liquid investments as cash equivalents, it does not include them in total cash and cash equivalents and amounts generally described as restricted cash or restricted cash equivalents in the statement of cash flows.

— Alternatively, if the short-term highly liquid investment meets the definition of a cash equivalent and is treated as such (either with or without restrictions), it is included in the total cash, cash equivalents and amounts generally described as restricted cash or restricted cash equivalents in the statement of cash flows (see Question 6.4.15).

An NFP needs to review the composition of assets outside of the cash and cash equivalents caption on the balance sheet. This is to determine whether any of those assets are generally described as restricted cash equivalents and therefore need to be included with other cash, cash equivalents and amounts generally described as restricted cash or restricted cash equivalents in the statement of cash flows.

The following table summarizes the approach.

Does the asset meet the definition of a cash equivalent?	Does the asset contain long-term donor-imposed restrictions that prevent it from being included in cash equivalents?	Is the asset treated as a cash equivalent under the entity's accounting policy?	Include in the total statement of cash flows cash and cash equivalents?
Yes	No	Yes	Yes
Yes	No	No	No
Yes	Yes	N/A	No
No	N/A	N/A	No

Question 22.3.30

What are some example balance sheet captions that may include amounts of cash and cash equivalents?

Interpretative response: We believe that cash, cash equivalents, or amounts generally described as restricted cash or restricted cash equivalents may exist in the following balance sheet line items of an NFP.

— Investments
— Assets restricted to investment in land, buildings and equipment
— Deposits held by bond trustees or bond sinking funds *
— Insurance reserves established under a contractual agreement with an insurer *
— Escrows for maintenance or other purposes under a lease *
— Collateral set aside for a line of credit, other debt arrangement, or swap *
— Assets limited or restricted as to use.

* Might be included in 'other long-term assets' or similar line item.

22.4 Contributions received

22.4.10 Overview

Contributions (or donations or grants accounted for as contributions) may be received in cash or in kind. An NFP classifies contributions received (and related investment income) as follows.

	Classification	
Transaction	**Donor-imposed restriction that limits use to certain long-term purposes**	**No long-term donor-imposed restriction**
Cash contributions	**financing** activities [230-10-45-14(c)]	**operating** activities [230-10-45-16(c)]
Cash receipts from sale of donated financial assets that were converted nearly immediately into cash	**financing** activities [230-10-45-21A]	**operating** activities [230-10-45-21A]
Cash receipts from sale of donated financial assets that were *not* converted nearly immediately into cash	**investing** activities [230-10-45-12(a), 45-12(b)]	**investing** activities [230-10-45-12(a), 45-12(b)]
Investment return	**financing** activities [230-10-45-14(c)]	**operating** activities [230-10-45-16(b)]
In-kind contribution (e.g. nonmonetary donation)	Adjustment needed to exclude the noncash contribution amount from the total change in net assets to arrive at net cash flows from **operating** activities under the indirect method. [230-10-45-28] Disclosure of a **noncash** investing activity (e.g. contributed PP&E). [230-10-50-3 - 50-6]	

22.4.20 Cash contributions received with donor-imposed restrictions

Excerpt from ASC 958-230

> Implementation Guidance

>> Cash Received with a Donor-Imposed Restriction That Limits Its Use to Long-Term Purposes

55-3 When an NFP reports cash received (or cash receipts from the sale of donated **financial assets** that upon receipt were directed without any NFP-imposed limitations for sale and were converted nearly immediately into cash as discussed in paragraph 230-10-45-21A) with a **donor-imposed restriction** that limits its use to long-term purposes in conformity with paragraph 958-210-45-6, an adjustment to the change in net assets to reconcile to net cash flows from operating activities is necessary when using the indirect method of reporting cash flows in order to present those cash receipts as cash inflows from financing activities as required by paragraph 230-10-45-14(c).

Question 22.4.10

How are cash flows from contributions that are restricted for certain long-term purposes classified?

Interpretative response: NFPs are required to classify the receipts of contributions and investment income as cash flows from **financing** activities if they are restricted by donor stipulation to: [230-10-45-14(c)]

— acquiring, constructing or improving PP&E or other long-lived assets; or

— establishing or increasing a donor-restricted endowment fund.

Under the indirect method, these types of restricted contributions are presented as a reconciling item in the reconciliation of changes in net assets to net cash flows from operating activities (see section 3.2). [230-10-45-14(c), 958-230-55-3]

The use of those funds by an NFP is an **investing** activity. For example, this classification applies whether the funds represent cash contributions collected for the purchase of equipment or investment return designated by the donor to be used for the purchase of equipment. [230-10-45-14(c), 958-230-55-3]

Example 22.4.10

Restricted contribution received for the construction of a building

On December 1, Year 1, NFP receives an unconditional promise to give $10 million that is restricted for the construction of a new building.

The $10 million will be paid in equal installments of $2 million each year over the next five years. By the end of Year 1 (December 31), NFP has collected the first installment of $2 million. NFP also incurred capital expenditures of $2 million for the construction of the building during Year 1.

The following illustrates the effect of this transaction on NFP's Year 1 statement of cash flows, which is prepared under the indirect method.

$'000s	
Cash flows from operating activities	
Change in net assets	$10,000
Adjustments to reconcile change in net assets to net cash provided by operating activities:	
Contributions restricted for capital purposes	(2,000)
Increase in contributions receivable	(8,000)
Net cash provided by (used in) operating activities	**-**
Cash flows from investing activities	
Purchases of property, plant and equipment	(2,000)
Net cash provided by (used in) investing activities	**(2,000)**
Cash flows from financing activities	
Contributions restricted for capital purposes[1]	2,000
Net cash provided by (used in) financing activities	**$ 2,000**

Note:

1. Represents the actual cash received, and not the total contribution (promise) received.

22.4.30 Debt and equity investments donated to NFPs

Excerpt from ASC 230-10

> Classification

>> Acquisitions and Sales of Certain Securities and Loans

45-21A Cash receipts resulting from the sale of donated **financial assets** (for example, donated debt or equity instruments) by NFPs that upon receipt were directed without any NFP-imposed limitations for sale and were converted nearly immediately into cash shall be classified as operating cash flows. If, however, the donor restricted the use of the contributed resource to a long-term purpose of the nature of those described in paragraph 230-10-45-14(c), then those cash receipts meeting all the conditions in this paragraph shall be classified as a financing activity.

Many NFPs receive donations in the form of financial assets. Typically, they accept donated securities to accommodate donors' objectives, rather than to meet strategic investment decisions. Therefore, they often have policies in place to convert those securities into cash nearly immediately if there are no sale restrictions.

Cash inflows from the sale of donated financial assets are either **operating**, **financing** or **investing** cash flows depending on the existence and nature of donor-imposed restrictions on the sale and the timing of the sale. [230-10-45-12, 45-14(c), 45-21A]

These are cash inflows from **operating** activities if the sale occurs nearly immediately after contribution and the use of the proceeds is not restricted to a long-term purpose of: [230-10-45-21A]

- acquiring, constructing or improving PP&E or other long-lived assets; or
- establishing or increasing a donor-restricted endowment fund.

Question 22.4.20

How should 'nearly immediately' be interpreted?

Interpretive response: Although 'nearly immediately' is not defined in Topic 230, the conversion to cash should be within days rather than months. [230-10-45-21A, ASU 2012-05.BC8]

Question 22.4.30

How are cash flows from the sale of donated financial assets without long-term donor restrictions classified when converted nearly immediately into cash?

Interpretive response: The proceeds from the sale of donated financial assets without long-term donor restrictions and converted nearly immediately into cash are cash inflows from **operating** activities. [230-10-45-21A]

Although near-immediate disposal is economically similar to receiving a cash donation, we believe the sale proceeds would not be presented as cash donations. Instead, the sale proceeds would typically be included in 'proceeds from sale of investments'.

If the NFP prepares its statement of cash flows under the indirect method, this would be achieved by presenting the contribution revenue recognized from the donated assets in the NFP's change in net assets as a noncash reconciling item in the reconciliation of change in net assets to net cash flows from operating activities (see section 3.2).

Question 22.4.40

How are cash flows from the sale of donated financial assets without long-term donor restrictions classified when *not* converted nearly immediately into cash?

Interpretive response: The proceeds from the sale of donated financial assets are cash inflows from **investing** activities if: [230-10-45-12(b)]

— the financial assets are not sold nearly immediately after the contribution; and

— the donor has not restricted the use of the sale proceeds to a long-term purpose of the nature of those described in paragraph 230-10-45-14(c) (relating to expenditures for PP&E or for donor-restricted endowment funds).

This fact pattern could occur because of restrictions over the timing of the sale of the donated financial assets.

If the NFP prepares its statement of cash flows under the indirect method, the contribution revenue recognized from the donated assets is presented as a noncash reconciling item in the reconciliation of change in net assets to net cash flows from operating activities (see section 3.2). Additionally, it is disclosed as a **noncash** investing activity regardless of whether the NFP uses the direct or indirect method (see section 4.7.20). [230-10-45-28, 50-3]

Example 22.4.20

Sale of donated financial assets

On June 1, Year 1, NFP receives a donation of common stock with a fair value of $30,000.

The donor specified that $20,000 of the common stock is to be used in NFP's construction of a new medical office building; the use of the remaining $10,000 of common stock is not restricted by the donor. NFP liquidates all the contributed securities the following day (June 2) for $30,000.

On August 15, Year 1, NFP receives another donation of common stock with a fair value of $40,000 from a separate donor with no restrictions on use of the stock gift. NFP liquidates these contributed securities on December 15, Year 1, for $45,000.

The following illustrates the effect of these transactions on NFP's Year 1 statement of cash flows, which is prepared under the indirect method.

$’000s	
Cash flows from operating activities	
Change in net assets[1]	$75
Adjustments to reconcile change in net assets to net cash provided by operating activities:	
Contributed securities[2]	(70)
Proceeds from sale of contributed securities[3]	10
Gain on sale of contributed securities[4]	(5)
Net cash provided by (used in) operating activities	**10**
Cash flows from investing activities	
Proceeds from sale of contributed securities[5]	45
Net cash provided by (used in) investing activities	**45**
Cash flows from financing activities	
Proceeds from sale of contributed securities[6]	20
Net cash provided by (used in) financing activities	**$20**
Supplemental disclosure of noncash investing and financing activities	
Contributed securities[7]	$60

Notes:

1. Contributions received ($30 + $40) and gain on sale of securities ($5).
2. Donations of common stock ($30 + $40).
3. Immediate liquidation of the $10 of common stock donated on June 1, Year 1 that is not restricted for long-term purposes.
4. Proceeds from sale of $45 less fair value of investment at date of donation of $40.
5. Liquidation of the $45 of common stock donated on August 15, Year 1 that is not restricted for long-term purposes and was not converted nearly immediately into cash.
6. Immediate liquidation of the $20 of common stock donated on June 1, Year 1 that is restricted for construction of the building.
7. Donation of the $20 common stock on June 1, Year 1 that is restricted for construction of the building (financing activity) and donation of $40 common stock on August 15, Year 1 that was without restrictions and not converted nearly immediately into cash.

22.5 Investments

This section addresses only cash flows from investments that are not donated securities. For donated securities see section 22.4.30.

Topic 320 (debt securities) applies to NFP business-oriented healthcare entities but scopes out other NFPs. [320-10-15-4, 35-17]

— NFP business-oriented healthcare entities account for debt securities as either trading, available-for-sale or held-to-maturity under Topic 320. The investment category affects the appropriate classification of cash flows (see section 9.2.10). [954-220-45-8 – 45-9]

— Other NFPs measure debt securities at fair value under Subtopic 958-320, and do not need to categorize them as trading, available-for-sale or held-to-maturity. [958-320-35-1]

Topic 321 (equity securities) applies to all NFPs. Cash flows from/for purchases and sales of equity securities are classified based on the nature and purpose for which they were acquired (see section 9.2.20).

Question 22.5.10

How are cash flows from/for debt securities classified by NFPs that are not business-oriented healthcare entities?

Interpretive response: NFPs are not required to categorize debt securities as trading, available-for-sale or held-to-maturity. Therefore, we believe NFPs would classify cash flows from/for purchases, sales and maturities of debt securities as **investing** activities. [320-10-15-4, 230-10-45-12, 45-13]

22.6 Agency transactions

Excerpt from ASC 958-230

> Implementation Guidance

>> Agency Transactions

55-4 Cash received and paid in **agency transactions** shall be reported as cash flows from operating activities in a statement of cash flows. If the statement of cash flows is presented using the indirect method, cash received and paid in such transactions is permitted to be reported either gross or net.

An agency transaction is a type of exchange transaction in which the reporting entity acts as an agent, trustee or intermediary for another party that may be a donor or donee. [958-230 Glossary]

An example of such a transaction includes a circumstance in which a donor provides an asset to an organization (recipient entity) and specifies a beneficiary. In this situation, the recipient entity is not a donee and does not recognize a contribution unless: [958-605-25-24 – 25-27]

— the recipient entity and the beneficiary are financially interrelated; or
— the recipient entity is granted variance power, which is the unilateral power to redirect the use of the transferred assets to another beneficiary.

Question 22.6.10

How are cash flows in agency transactions classified?

Interpretive response: The cash received by the recipient entity or the 'agent', and subsequently disbursed to the beneficiary at the donor's direction, is an **operating** activity for the recipient entity and may be presented either gross or net in a statement of cash flows prepared under the indirect method. [958-230-55-4]

23. Other cash flow presentation matters

Detailed contents

New item added in this edition: **

23.1 How the standard works

This chapter addresses miscellaneous statement of cash flows classification and presentation issues, including those arising from:

— litigation
— government grants.

Recent ASU reflected in this chapter

This chapter reflects the amendments of ASU 2021-10, Disclosures by Business Entities about Government Assistance (Topic 832). See chapter 1 for an overview of the ASU and transition requirements.

23.2 Litigation

Question 23.2.10

How are cash flows from/for settling a lawsuit classified?

Interpretive response: An entity should classify cash received or paid to settle a lawsuit as cash flows from **operating** activities. [230-10-45-16(c), 45-17(f)]

23.3 Government grants received by for-profit entities

An entity may receive a grant or subsidy from a government agency subject to complying with certain eligible expenditures or activities – e.g. opening a manufacturing facility or maintaining employment over a specific period or at a specific location.

Topic 832 (government assistance) created by ASU 2021-10 (see chapter 1) is a disclosure only topic. Therefore, there is currently limited explicit US GAAP guidance about how a for-profit entity should account for government grants. This section addresses considerations for for-profit entities, referred to throughout as 'entities'. For NFPs, see chapter 22.

If explicit accounting guidance does not exist in other Topics for the transaction, the entity next determines if Topic 606 (revenue) applies by assessing if either the government agency or another party is a customer in the transaction. If Topic 606 does not apply, the entity should consider the most appropriate guidance to apply by analogy given its specific facts and circumstances.

Some entities account for grants not in the scope of Topic 606 by analogizing to IFRS® Standards for guidance on the accounting for government grants and disclosure of government assistance in IAS 20. IAS 20 requires government grants to be recognized in profit or loss on a systematic basis over the periods in which the entity recognizes as expenses the related costs the grant is intended to defray. It also distinguishes between government grants related to assets and those related to income for presentation purposes.

Other entities may analogize to Subtopic 958-605 for guidance on grants (contributions) received by NFPs. Although the guidance on contributions in Subtopic 958-605 excludes transfers of assets from governmental entities to for-profit entities, the FASB staff has indicated that for-profit entities are not prohibited from analogizing to that guidance.

Entities may also apply by analogy the gain contingency approach in Subtopic 450-30, or the recognition and measurement guidance in Topic 606. Under the latter approach, the subsidy is not classified as revenue from contracts with customers. [606-10-15-2]

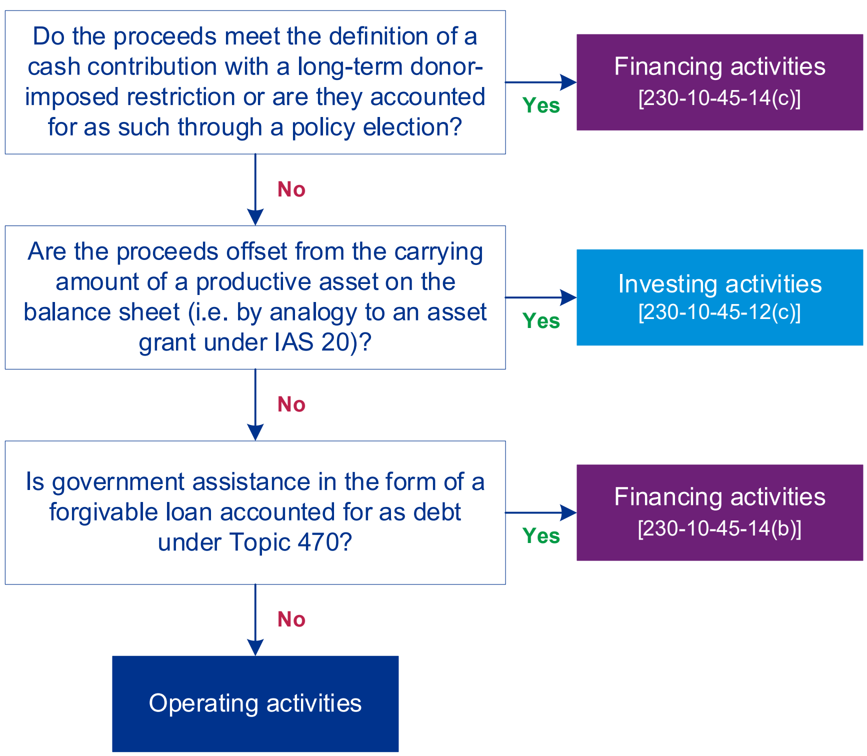
Entities will sometimes receive grants that are structured as forgivable loans. In these circumstances, entities may apply debt accounting under Topic 470. For example, a loan obtained under the CARES Act Paycheck Protection Program (PPP) is, in legal form, debt. Alternatively, if there is reasonable assurance that the entity will comply with the loan forgiveness conditions, it may also be acceptable to treat the loan as an in-substance government grant by applying IAS 20 by analogy.

For additional guidance on government grants, subsidies and contributions, see Questions 2.3.100 and 2.3.110 in KPMG Handbook, Revenue recognition.

Question 23.3.10

How are proceeds from government grants classified?

Interpretive response: Topic 230 provides no guidance on how to classify proceeds from government grants. Therefore, judgement should be applied taking into consideration the accounting approach selected, the conditions of the grant and the timing of receipt, as illustrated in the following decision tree. The presentation approach followed should be disclosed and consistently applied.



We believe it is generally appropriate to classify grant proceeds consistent with the accounting treatment of the grant. This may or may not align with the classification of the costs that the grant is intended to defray. For example, if a grant is received in the form of a forgivable loan to maintain employment (e.g. PPP loan under the CARES Act) and the entity elects to account for the loan as debt under Topic 470, we believe the proceeds should be classified as cash flows from **financing** activities while the payroll costs will be classified as cash flows from **operating** activities.

The guidance on contributions in Subtopic 958-605 may be relevant in assessing whether the grant is subject to long-term donor-imposed restrictions under paragraph 230-10-45-14(c, although Subtopic 958-605 does not scope in for-profit entities. That guidance distinguishes donor-imposed conditions (barriers the entity must overcome to be entitled to the grant) from donor-imposed restrictions (e.g. the funds can only be used after a certain date or for a specified purpose). [958 Glossary]

Example 23.3.10
CARES Act – PPP loan accounted for as a grant

ABC Corp. is a for-profit entity eligible to receive a PPP loan under the CARES Act. In April Year 1, ABC applies and receives $2 million in funds. ABC accounts for the forgivable loan as an in-substance government grant under a grant model by analogy to IAS 20 (see Question 23.3.10).

ABC uses the proceeds in April and May for payroll expenses; at that point ABC determines that it is reasonably certain that the loan will be forgiven and records the grant income of $2 million. In December, the loan is forgiven.

In preparing its statement of cash flows, ABC classifies the PPP proceeds of $2 million as cash flows from **operating** activities, to be consistent with the accounting approach for the loan.

Question 23.3.20
Are grant proceeds netted against the cash outflows they are intended to offset?

Interpretive response: No. We believe grant proceeds should generally be reported on a gross basis – i.e. on a separate line from the cash outflows they are intended to offset. However, gross reporting is not required when the statement of cash flows is prepared under the indirect method and the grant proceeds and cash outflows are both classified as cash flows from **operating** activities.

Example 23.3.20
CARES Act – PPP loan accounted for as debt

ABC Corp. is a for-profit entity eligible to receive a PPP loan under the CARES Act. In April Year 1, ABC applies and receives $2 million in funds. ABC accounts for the forgivable loan as debt under Topic 470 (see Question 23.3.10).

ABC uses the proceeds in April and May for payroll expenses. In December, the loan is forgiven; the corresponding debt is extinguished and ABC records the gain on extinguishment of debt of $2 million.

In preparing its statement of cash flows, ABC classifies the PPP proceeds of $2 million as cash flows from **financing** activities, to be consistent with the accounting approach for the loan. ABC also discloses the forgiveness of the PPP as a **noncash** financing activity.

Question 23.3.30

Are grant refund payments netted against the grant proceeds?

Background: An entity may face a situation where it returns some or all of the grant proceeds to the government. This may happen if the entity inadvertently or involuntarily received funds under a government assistance program and elects to turn down the assistance, if a forgivable loan is not forgiven, or if grant proceeds were received in advance of meeting the grant conditions but the conditions are ultimately not met.

Interpretive response: No. Grants proceeds and refund payments are presented gross unless they qualify for net reporting (see section 3.5), or when the statement of cash flows is prepared under the indirect method and the grant proceeds and refund payments are both classified as cash flows from **operating** activities. [230-10-45-8]

Items qualify for net reporting if their original maturity is three months or less. Forgivable loans and grants are typically provided for longer term purposes, and do not have a short maturity. Therefore, they usually do not qualify for net reporting, even if the amount of time that has lapsed between receipt and repayment of the funds is very short.

Example 23.3.30

CARES Act – voluntary repayment of PPP loan

ABC Corp. is a for-profit entity eligible to receive a PPP loan under the CARES Act. On April 1, ABC applies for the loan. On April 10, ABC receives $2 million in funds. On April 14, ABC returns the funds over reputation concerns for the company.

In preparing its statement of cash flows, ABC classifies the PPP proceeds and repayment as cash flows from **financing** activities. The $2 million of funds received is reported on a separate line item from the $2 million of funds repaid.

Note: Although ABC repaid the loan within 90 days, the loan itself has a maturity longer than three months and does not qualify for net reporting. Because ABC applied for the loan and voluntarily repaid it early, the financing obtained under the PPP in this example is similar to a revolving credit arrangement. As noted in Question 12.4.20, borrowings and repayments that are not payable on demand or that are subject to a note with an underlying maturity longer than three months are reported in the statement of cash flows on a gross basis.

Question 23.3.40

Are grant proceeds reclassified if the grant is repaid?

Interpretive response: No. When a grant is repaid, we believe the grant proceeds should not be reclassified, even if repayment was not expected at the time the proceeds were received. Further, we believe that grant refund payments should generally be classified in the same category as the grant proceeds.

Because classification is determined based on the facts and circumstances available when proceeds are received, we believe it is not appropriate to subsequently change the classification of the grant proceeds, unless the initial classification was the result of an error, or the entity adopts a new classification principle (see Question 4.6.10).

Question 23.3.50

Is cash received under a government grant presented as restricted cash?

Background: Government grants are often conditional and proceeds may be received before all conditions are met for the entity to be entitled to the grant. US GAAP does not define restricted cash. However, S-X Rule 5-02(1) provides some relevant guidance (see Question 6.4.10).

Interpretive response: Generally, no. We believe conditions do not necessarily represent legal restrictions on use. Although it does not scope in business entities, the guidance on contributions in Subtopic 958-605 distinguishes donor-imposed conditions (barriers the entity must overcome to be entitled to the contribution) from donor-imposed restrictions (e.g. the funds can only be used after a certain date or for a specified purpose). [958 Glossary]

An entity should carefully analyze all grant terms and conditions. Further, we believe the entity should disclose the conditions attached to the grant (see Question 23.3.40).

Question 23.3.60

What are the required disclosures for government grants received by for-profit entities?

Interpretive response:

Transactions accounted for as grants or contributions

ASU 2021-10 (see chapter 1) requires all entities other than NFPs and EBPs to disclose information about certain government assistance they receive. Transactions with a government are in scope of these requirements if accounted for as grants (e.g. using IAS 20) or contributions (e.g. using Subtopic 958-605) by analogy. [832-10-15-2 – 15-5]

The following is required to be disclosed [832-10-50-1 – 50-4]:

- nature of the assistance – e.g. general description of the transactions and form of the assistance received (i.e. cash or other assets);
- accounting policies used to account for the transactions;
- effect on financial statements – i.e. balance sheet and income statement line items affected by the grant and amounts applicable to each financial statement line item in the current reporting period; and
- significant terms and conditions – e.g. duration or period of agreement, commitments made by both parties, other contingencies, and any other provisions that would allow the government entity to recapture the amounts.

In rare circumstances, when the agreement legally prohibits specific information from being disclosed, the entity must disclose the general nature of the information and what items are legally prohibited from disclosure. [832-10-50-5}

Transactions not accounted for as grants or contributions

The requirements in ASU 2021-01 do not apply to transactions accounted for under other authoritative guidance – e.g. Topics 740 (income taxes), 470 (debt), 450 (contingencies), 606 (revenue). However, entities should consider the disclosure requirements in those other Topics. [BC17.ASU 2021-01]

23.4 Crypto assets**

For purposes of this section, the term 'crypto asset' is used in the same manner as in the AICPA Practice Aid, Accounting for and auditing of digital assets (the AICPA guide). The AICPA guide defines a 'crypto asset' as a type of digital asset that functions as a medium of exchange, and is not any of the following:

- issued by a governmental authority;
- a contract between the asset holder and another entity; or
- a security under either the Securities Act of 1933 or the Securities Exchange Act of 1934.

Common examples of crypto assets that meet this definition include bitcoin, ether and litecoin. In general, central bank digital currencies (CBDCs), as well as many non-fungible tokens (NFTs) and many stablecoins, do not meet this definition.

By contrast, the broader term 'digital asset' refers to any asset that is issued and transferred using distributed ledger or blockchain technology, which includes CBDCs, NFTs and stablecoins.

Most crypto assets get classified, and accounted for, as intangible assets. This, in effect, happens by default because: [ASC Master Glossary]

- they do not meet the definitions of 'cash' or 'cash equivalents', 'financial assets' or 'financial instruments', or 'inventory'; and
- the definition of an 'intangible asset' is broad.

Two KPMG Executive Summaries provide a high-level overview of the accounting for crypto assets classified and accounted for as intangible assets under US GAAP (crypto intangible assets):

— Accounting for crypto assets – entities that are not broker-dealers or investment companies; and

— Accounting for crypto assets – investment companies.

Question 23.4.10**

Why do crypto intangible assets generally not meet the definition of cash or cash equivalents?

Background: Sections 6.2 and 6.3 provide guidance on cash and cash equivalents, respectively.

Interpretive response: A crypto intangible asset such as bitcoin or ether generally does not meet the definition of cash because it is not legal tender issued by a government. It also generally does not meet the definition of a cash equivalent because it has no maturity date at which it is readily convertible to a known amount of cash. [ASC Master Glossary]

This question does not address whether crypto or digital assets not considered intangible assets (e.g. a stablecoin that meets the definition of a financial asset) could meet one or both of those definitions. We believe that would depend on the facts and circumstances. We encourage entities to discuss their specific facts and circumstances with their auditors or other accounting advisors.

Question 23.4.20**

How do crypto intangible assets used as a means of payment affect the statement of cash flows?

Interpretive response: As explained in Question 23.4.10, crypto intangible assets do not qualify as cash or cash equivalents. Therefore, purchases of goods and services paid for with crypto intangible assets are noncash transactions. Their effect on the determination of net income is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2). [230-10-45-28]

Purchases of PP&E and productive assets (see chapter 8) paid with crypto intangible assets are disclosed as a **noncash** investing activity (see section 4.7.20).

Question 23.4.30**

How are cash flows from sales / for purchases of crypto intangible assets classified?

Interpretive response: US GAAP does not explicitly address the classification of cash payments to acquire, or cash proceeds from the sale of, crypto intangible assets. US GAAP provides cash flow classification guidance for productive assets (see section 8.2), and intangible assets are frequently treated as 'productive assets'. However, US GAAP does not define that term or whether crypto intangible assets are productive assets. [230-10-45-12(c), 45-13(c)]

Therefore, judgment is required, considering all relevant facts and circumstances, in classifying cash flows from sales / for purchases of crypto intangible assets. In the absence of explicit guidance, we believe it is generally appropriate to consider the nature of the activity that gives rise to the cash flows. As examples, we believe that cash flows from sales / for purchases of crypto intangible assets should generally be classified as cash flows from (not exhaustive):

— **operating** activities when the crypto intangible assets are acquired for sale to customers, consistent with the classification of cash receipts from sales of goods and payments to acquire goods for resale; [230-10-45-16, 45-17]

— **operating** activities (cash proceeds only) when the crypto intangible assets are received as noncash consideration in the ordinary course of business (e.g. in exchange for goods and services transferred to a customer) and converted *nearly immediately* (see Question 22.4.20) into cash;

— **operating** activities when the crypto intangible assets are held with the intended purpose of generating trading profits in the short term – i.e. with a holding period generally measured in hours and days, consistent with the definition of 'trading' in Topic 320; or [320-10 Glossary]

— **investing** activities when the entity's investment objective and strategy is not to engage in trading activities.

Future developments

The FASB has an active project on its Technical Agenda on Accounting for and Disclosure of Crypto Assets. As of February 2023, the FASB has tentatively decided to propose guidance in US GAAP (in a proposed ASU expected in March 2023) that would be consistent with the second example above, but not to provide any other guidance on crypto intangible asset classification or presentation in the statement of cash flows as part of this project.

Question 23.4.40**

How does a SAB 121 digital asset safeguarding liability and corresponding asset affect the statement of cash flows?

Background: SAB 121 requires entities subject to the SEC's rules and regulations that have an obligation to 'safeguard' digital assets held for others to record on their balance sheet: [SAB Topic 5.FF]

— a 'safeguarding obligation liability', measured initially and subsequently at the Topic 820 fair value of the safeguarded digital assets; and
— a corresponding 'safeguarding asset', measured like the safeguarding obligation liability, except that its carrying amount reflects any actual or potential safeguarding loss events, such as those resulting from fraud or theft, including hacks.

See KPMG Hot Topic, SEC staff guidance on accounting for digital asset safeguarding obligations, (SAB 121 Hot Topic) for an in-depth discussion on SAB 121 requirements.

Interpretive response: The initial recognition of the safeguarding obligation liability and safeguarding asset is a noncash transaction that we believe is generally operating in nature for the entity. Therefore, it is neither presented in the statement of cash flows, nor separately disclosed under Topic 230.

In subsequent periods, we believe it is acceptable to present any difference between the remeasurement of (1) the safeguarding obligation liability and (2) the safeguarding asset during the period – e.g. from a loss (or potential loss) event (see Question 130 of the SAB 121 Hot Topic) on a net basis. This net difference should be presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2).

Question 23.4.50**

How does a lender reflect the initial transfer of a loaned crypto intangible asset in the statement of cash flows?

Background: US GAAP does not specifically address the accounting for crypto intangible asset lending. KPMG Hot Topic, Lenders' accounting for crypto intangible asset loans, discusses this matter, including SEC staff views on the subject.

In crypto lending transactions that meet the conditions outlined in the Hot Topic, the lender derecognizes the loaned crypto assets and recognizes a right to receive back in the future the loaned crypto assets (crypto asset loan receivable) in their place. The crypto asset loan receivable is initially measured at the fair value of the loaned crypto assets. This exchange may give rise to an income statement gain.

In addition, at loan commencement and throughout the loan period, the lender should consider and account for the borrower's credit risk (i.e. the risk the borrower will not return the loaned crypto assets), using the principles in Topic 326 (financial instruments—credit losses) to measure any credit impairment.

Interpretive response: We believe the exchange of the loaned crypto assets for the crypto asset loan receivable at loan commencement should be disclosed as a **noncash** investing activity (see section 4.7.20). Any gain on the exchange and effects of recording or adjusting (increasing or decreasing) any credit loss allowance should be presented as noncash reconciling items in the reconciliation of net income to net cash flows from operating activities (see section 3.2).

Question 23.4.60**

How does a lender reflect crypto intangible asset loan fees paid in crypto intangible assets in the statement of cash flows?

Background: Throughout the period a crypto intangible asset loan is outstanding, the lender typically earns loan fees. These are commonly paid in the form of crypto intangible assets. For example, the borrower may be required to pay one unit of crypto asset ABC for each month the loan of 100 units of crypto asset ABC is outstanding.

Interpretive response: Loan fees earned in the form of crypto intangible assets reflect noncash income that we believe should be presented as a noncash reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2). See Question 23.4.30 for guidance on how to determine the appropriate cash flow classification of cash proceeds from the sale of crypto intangible assets earned as loan fees.

Index of changes

This index lists the significant additions and changes made in this edition to assist you in locating recently added or updated content. New Questions and Examples added in this edition are identified throughout the Handbook with ** and items that have been significantly updated or revised are identified with #.

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- Service concession arrangements
- Share-based payment
- Statement of cash flows
- Transfers and servicing of financial assets

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