What you need to know

- The FASB issued final amendments to clarify how entities should classify certain cash receipts and cash payments on the statement of cash flows.

- The new guidance also clarifies how the predominance principle should be applied when cash receipts and cash payments have aspects of more than one class of cash flows.

- The guidance will generally be applied retrospectively and is effective for public business entities for fiscal years beginning after 15 December 2017, and interim periods within those years. For all other entities, it is effective for fiscal years beginning after 15 December 2018, and interim periods within fiscal years beginning after 15 December 2019. Early adoption is permitted.

Overview

The Financial Accounting Standards Board (FASB) issued final guidance[^1] that may change how an entity classifies certain cash receipts and cash payments on its statement of cash flows.

The new guidance, which is based on a consensus of the Emerging Issues Task Force (EITF), addresses certain issues where diversity in practice was identified. It amends the guidance in Accounting Standards Codification (ASC) 230[^2], which is principles based and often requires judgment to determine the appropriate classification of cash flows as operating, investing or financing activities. The application of judgment has resulted in diversity in how certain cash receipts and cash payments are classified.

The FASB has separately proposed requiring restricted cash to be included with cash and cash equivalents in the statement of cash flows. That proposal is also based on an EITF consensus.
Key considerations

The new guidance addresses the classification of cash flows related to the following transactions:

- **Debt prepayment or extinguishment costs** – An entity will classify cash payments for debt prepayment or extinguishment costs as financing cash outflows.

- **Settlement of zero-coupon debt instruments or other debt instruments with coupon rates that are insignificant in relation to the effective interest rate of the borrowing** – An entity will classify the portion of the cash payment made to settle a zero-coupon bond or a bond with an insignificant cash coupon attributable to accreted interest related to the debt discount as a cash outflow for operating activities. It will classify the portion of the cash payment attributable to the principal as a cash outflow for financing activities.

- **Contingent consideration payments made after a business combination** – An entity will classify cash payments that are not made “soon after” (i.e., a relatively short period of time such as three months or less) the consummation of a business combination to settle a contingent consideration liability as cash outflows for financing and operating activities. The portion of the cash payment up to the acquisition date fair value of the contingent consideration liability (including any measurement-period adjustments) will be classified as a financing outflow, and amounts paid in excess of the acquisition date fair value of that liability will be classified as operating outflows. Cash payments made “soon after” the consummation of a business combination generally will be classified as cash outflows for investing activities.

- **Proceeds from the settlement of insurance claims** – An entity will classify insurance settlement proceeds (except as noted below) based on the related insurance coverage (i.e., the nature of the loss). The entity will allocate a lump-sum settlement that relates to more than one type of loss (e.g., loss of a building in a fire and business interruption costs) to each type of loss to determine how the proceeds should be classified.

- **Proceeds from the settlement of corporate-owned life insurance** – An entity will classify corporate-owned life insurance (COLI) settlement proceeds as cash inflows from investing activities and will be able to present COLI premiums as cash outflows for investing activities, operating activities or a combination of them both.

- **Distributions received from equity method investees** – An entity will elect either the cumulative earnings approach or the nature of the distribution approach to determine whether distributions received from equity method investees are returns on investment (operating cash inflows) or returns of investment (investing cash inflows).
  - Under the cumulative earnings approach, distributions up to the amount of cumulative equity in earnings recognized will be treated as returns on investment and those in excess of that amount will be treated as returns of investment.
  - Under the nature of the distribution approach, distributions will be classified based on the nature of the activity or activities that generated them. An entity that elects this approach but lacks the information to apply it for an individual equity method investee will apply the cumulative earnings approach for that investee as an accounting change (on a retrospective basis) and the nature of the distribution approach for all other equity method investees.

- **Beneficial interests in securitization transactions** – An entity will disclose any beneficial interests obtained in financial assets transferred to an unconsolidated securitization entity as a noncash investing activity. The entity will classify subsequent cash receipts received that are related to beneficial interests in previously transferred trade receivables as inflows from investing activities.
**Application of the predominance principle**

Certain cash receipts and cash payments may have aspects of more than one class of cash flows. The new guidance clarifies that an entity will first apply any relevant guidance in ASC 230 and in other applicable topics. If there is no guidance that addresses those cash receipts and cash payments, an entity will determine each separately identifiable source or use and classify the receipt or payment based on the nature of the cash flow. If a receipt or payment has aspects of more than one class of cash flows and cannot be separated, classification will depend on the predominant source or use.

**How we see it**

While the new guidance attempts to clarify how the predominance principle should be applied, judgment will still be required.

**Effective date and transition**

For public business entities, the guidance is effective for fiscal years beginning after 15 December 2017, and interim periods within those years. For all other entities, it is effective for fiscal years beginning after 15 December 2018, and interim periods within fiscal years beginning after 15 December 2019. Early adoption is permitted. An entity that elects early adoption must adopt all of the amendments in the same period. Early adoption in an interim period is permitted, but any adjustments must be reflected as of the beginning of the fiscal year that includes that interim period.

Entities will be required to apply the guidance retrospectively and provide the relevant disclosures in ASC 250, in the first interim and annual periods in which they adopt the guidance. If it is impracticable to apply the amendments retrospectively for an issue, the amendments related to that issue would be applied prospectively.

**Endnotes:**

3. The guidance will also apply to bank-owned life insurance.
4. The guidance won’t apply to equity method investments measured using the fair value option.
5. ASC 250, Accounting Changes and Error Corrections.