

Memo No. **Issue Summary No. 1***

Memo

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Project	EITF Issue No. 15-F, "Statement of Cash Flows: Classification of Certain Cash Receipts and Cash Payments"		
Project Stage	Initial Deliberations		
Dates previously discussed by EITF	None		
Previously distributed Memo Numbers	None		

Purpose of This Memo

1. The purpose of this memo is to assist the Task Force as it considers classification of certain cash receipts and payments in the statement of cash flows.
2. This memo is structured as follows:
 - a. Background Information
 - b. Issue 1 – Debt Prepayment or Debt Extinguishment Costs
 - c. Issue 2 – Settlement of Zero-Coupon Bonds

*** The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

- d. Issue 3 – Contingent Consideration Payments Made after a Business Combination
- e. Issue 4 – Restricted Cash
- f. Issue 5 – Proceeds from the Settlement of Insurance Claims
- g. Issue 6 – Proceeds from the Settlement of Corporate-Owned Life Insurance Policies
- h. Next Steps
- i. Appendix A – Information About the Prior FASB Project, Clarifying Certain Existing Principles on Statement of Cash Flows
- j. Appendix B – Definitions of Financing, Investing and Operating Activities from the Master Glossary of the Codification
- k. Appendix C – Summary of Alternatives and Staff Recommendations

Background Information

- 3. In April 2014, the Board decided to add a statement of cash flows project to the FASB's technical agenda. The project, Clarifying Certain Existing Principles on Statement of Cash Flows, was intended to reduce diversity in practice in financial reporting by clarifying certain existing principles in Topic 230, Statement of Cash Flows. Information about that project can be found in Appendix A of this Issue Summary.
- 4. At its April 1, 2015 meeting, the Board decided that clarifying certain existing principles within Topic 230 only would incrementally reduce diversity in practice about the classification of cash receipts and cash payments. Therefore, the Board decided to have the Task Force consider nine specific cash flow classification issues with the goal of reducing the existing diversity in practice on those issues on a timely basis. The Task Force will deliberate the first six issues at its June 18, 2015 meeting. The other three issues to be considered by the Task Force at its September 17, 2015 meeting are: (a) distributions received from equity method investees, (b) beneficial interests in securitization transactions, and (c) application of the predominance principle.

5. While there are other similar or interrelated issues pertaining to the six specific cash flow classification issues included herein, the objective of this Issue is to reduce the existing diversity on a timely basis for those nine issues added to the EITF's agenda. Therefore, while the staff considered certain similar or interrelated issues, the staff's analysis and recommendations are focused on the cash flow classification issues the Board selected to include in the scope of this Issue.
6. The guidance in Topic 230 applies to all entities, including both business entities and not-for-profit entities,¹ with specific exceptions noted in paragraph 230-10-15-4 and summarized below:
 - a. Defined benefit pension plans that present financial information in accordance with Topic 960, Plan Accounting—Defined Benefit Pension Plans and other employee benefit plans that present financial information similar to that required by Topic 960
 - b. Investment companies that meet certain conditions
 - c. 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 moneys.
7. The staff considered a number of factors in determining the most appropriate recommendation for each cash flow classification issue. However, the staff recommendations primarily are based on its interpretation of existing principles, definitions, and application guidance in Topic 230 and other Topics. The staff acknowledges that in some circumstances, there are multiple paragraphs in the Codification that could be used as a basis for classification and therefore would result in differing classifications.

¹ In April 2015, the Board issued a proposed Accounting Standards Update, *Presentation of Financial Statements of Not-for-Profit Entities* (proposal). The proposal includes, among other things, classifying certain cash flows differently than how they are classified under current guidance. Certain issues in the Issue Summary overlap with the classification of certain cash flows in the proposal. While the staff has considered the proposal, the recommendations in the Issue Summary were based on the interpretations of existing guidance because the outcome of whether or how GAAP will be amended by that proposal is not known at this time. The comment letter period for that proposal ends on August 20, 2015.

Issue 1: Debt Prepayment or Debt Extinguishment Costs

8. Debt prepayment or debt extinguishment costs are paid by a borrower to settle a debt financing arrangement prior to the maturity date. A lender often will include a prepayment penalty in the financing agreement that 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.
9. The absence of specific guidance has resulted in entities classifying cash payments for debt prepayment or extinguishment costs in either financing or operating activities.

Question for the Task Force – Debt Prepayment or Debt Extinguishment Costs

1. How should a cash payment for debt prepayment or debt extinguishment costs be classified in the statement of cash flows (that is, using Alternative A or Alternative B)?

Staff Analysis and Outreach – Issue 1

10. The staff has identified the following potential alternatives to address Issue 1:

Alternative A – Cash payments for debt prepayment or extinguishment costs should be classified as cash outflows for operating activities.

Alternative B – Cash payments for debt prepayment or extinguishment costs should be classified as cash outflows for financing activities.

Alternative A

11. Proponents of Alternative A believe that cash payments for debt prepayment or extinguishment costs largely represent payments of additional interest to a lender. Topic 230 states that cash payments to lenders for interest are cash outflows for operating activities, thus proponents of Alternative A claim that cash payments for debt prepayment or extinguishment costs also should be classified as operating activities. One of two public accounting firms in the staff's outreach agreed that the payment represents the payment of interest and not a repayment of future borrowings. Lenders in the staff's outreach confirmed the payment, at least in part, represents future interest costs.

12. Furthermore, proponents of Alternative A point out that part of the master glossary² definition of *operating activities* states that cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income. These costs, whether they represent an approximation of the interest foregone, a penalty, or other lender costs, all enter into the determination of net income.
13. Additionally, proponents of Alternative A believe that an entity's decision to extinguish its debt early usually implies that the net present value of future cash inflows and outflows is maximized by extinguishing the debt now rather than by holding it to maturity. For example, the savings may be in lower cash interest costs on a new debt issue or in some other form. Since settling a debt obligation prior to maturity is often driven by an entity's operating strategy, the nature of the transaction relates more directly to an operating activity rather than to a financing activity.

Alternative B

14. Proponents of Alternative B state that cash payments for debt prepayment or extinguishment costs are similar to debt issue costs, which under paragraph 230-45-15(e) are classified as cash outflows for financing activities. The classification of debt issue costs as cash outflows for financing activities was the result of EITF Issue No. 95-13, "Classification of Debt Issue Costs in the Statement of Cash Flows." During its deliberations of Issue 95-13, the Task Force acknowledged that debt issue costs have aspects of both an operating activity and a financing activity, and, therefore, considered both classifications.
15. Some proponents of Alternative B utilize the definition of *reacquisition price of debt* in conjunction with other guidance in GAAP as a basis for classifying cash outflows for debt prepayment or extinguishment costs as financing activities. That information includes:
 - a. The definition of *reacquisition price of debt* in the Master Glossary, which states, in part, that it is the "amount paid on extinguishment, including a call premium and miscellaneous costs of reacquisition."

² Included in Appendix B are the Master Glossary definitions of *financing*, *investing*, and *operating* activities.

- b. Paragraph 230-10-45-28(b), which states, in part, that a reconciliation of net income and net cash flow from operating activities 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).
16. Of those contacted in the staff's outreach effort, all of the lenders, one of two public accounting firms, and a majority of the FASB advisory group members supported Alternative B for the reasons noted above. Additionally, one advisory group member stated that cash flows from operating activities primarily represents recurring cash flows, and because debt prepayment or extinguishment costs are nonrecurring in nature, the associated cash payments should be classified as financing activities.

Staff Recommendation – Issue 1

17. While the staff acknowledges that there is existing guidance in Topic 230 that supports the classification of debt prepayment or extinguishment costs as either an operating activity or a financing activity, the staff recommends Alternative A primarily because the staff thinks that it most closely applies the specific application guidance in Topic 230. Debt prepayment or extinguishment costs represent prepayment penalties required by a lender to settle the obligation, which often includes an approximation of a portion of the interest foregone by the lender as well as other lender costs. Existing guidance in Topic 230 classifies both cash payments to lenders for interest and cash payments of penalties as cash outflows for operating activities.

Issue 2: Settlement of Zero-Coupon Bonds

18. Zero-coupon bonds are a type of high-yield debt security that may be issued or traded at significant discounts from their face amounts. Interest on zero-coupon bonds is not paid throughout the life of the bond, but, instead, is deferred and paid at maturity.

19. An entity that issues a zero-coupon bond classifies the cash proceeds received from the issuance of the bond as a financing inflow on the statement of cash flows. The bond is accreted to its redemption value through the recognition of interest expense. Under the indirect method of presenting the cash flow statement, the interest accrued is included as a reconciling item between net income and cash flows from operating activities. On the maturity date, the issuer repays the original proceeds and the interest that accrued from the date of issuance.
20. Diversity in practice exists in the classification of the cash payment made by the bond issuer at the settlement of a zero-coupon bond. Specifically, there is diversity in how the portion of the cash payment attributable to the accreted interest is classified.

Question for the Task Force – Settlement of Zero-Coupon Bonds

2. How should the cash payment for the settlement of a zero-coupon bond be classified in the statement of cash flows (that is, using Alternative A or Alternative B)?

Staff Analysis and Outreach – Issue 2

21. The staff conducted outreach with three public accounting firms, an FASB advisory group, and one academic. Those stakeholders indicated that there are two predominant views on how to classify the cash paid for the settlement of a zero-coupon bond. The three public accounting firms believe today that either view is acceptable given that there is no specific guidance in GAAP. The staff has identified those two views in the following potential alternatives to address Issue 2:

Alternative A – At settlement, the portion of the cash payment attributable to the accreted interest should be classified as a cash outflow for operating activities and the portion of the cash payment attributable to the principal (original proceeds) should be classified as a cash outflow for financing activities.

Alternative B – At settlement, the entire cash payment should be classified as a cash outflow for financing activities.

Alternative A

22. Proponents of Alternative A believe that it is consistent with paragraph 230-10-45-17(d), which states that cash outflows for operating activities include cash payments to lenders and other creditors for interest. Additionally, the definition of *operating activities* in the Master Glossary states, in part, that “cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income.” Thus, proponents of Alternative A argue that interest expense recognized during the life of the zero-coupon bond enters into the determination of net income.
23. The view that part of the cash payment for the settlement of a zero-coupon bond is for interest is supported by investor information provided by the Securities and Exchange Commission (SEC) in which a zero-coupon bond is described as a bond that does not pay interest during the life of the bond. Instead, investors buy zero-coupon bonds at a deep discount from their face value (the amount a bond will be worth when it matures or comes due). When a zero-coupon bond matures, the investor will receive one lump sum equal to the initial investment plus interest that has accrued.
24. Furthermore, Topic 946, Financial Services—Investment Companies, states that interest in high-yield debt securities is not paid currently and, instead, may be deferred and paid at maturity (zero-coupon bonds).
25. The majority of the FASB advisory group members who provided feedback, the academic, and one accounting firm indicated a preference for Alternative A because they believe that the amount paid in excess of the original proceeds represents interest.

Alternative B

26. Under Alternative B, the entire cash payment made to settle the zero-coupon bond should be classified as a cash outflow for financing activities. Under this approach, the accrued interest is added to the principal amount each period. That is, the interest is effectively refinanced, with additional principal due upon redemption of the bonds. Accordingly, the entire cash payment represents the repayment of amounts borrowed, which includes the original principal from the issuance of the bonds plus the additional principal resulting from the accrued interest that was refinanced.

27. The classification in Alternative B is consistent with paragraph 230-10-45-15(b), which states that cash outflows for financing activities includes repayments of amounts borrowed.

Staff Recommendation – Issue 2

28. The staff recommends Alternative A primarily because (a) the cash paid at the settlement of the zero-coupon bond represents both an interest and a principal component that should be classified separately; (b) the component representing interest most faithfully applies the guidance in Topic 230 that states that cash payments to lenders and other creditors for interest are cash outflows for operating activities; (c) the component representing principal most faithfully applies the guidance in Topic 230 that states that repayments of amounts borrowed are cash outflows for financing activities; and (d) it would not take significant effort or cost to apply.

Issue 3: Contingent Consideration Payments Made after a Business Combination

29. As defined in the Master Glossary, *contingent consideration* is usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.
30. Topic 805, Business Combinations, provides guidance on the initial and subsequent measurement of contingent consideration arrangements. An acquirer recognizes the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree. Any subsequent change in the fair value of contingent consideration classified as an asset or liability is recognized in earnings (unless it is a hedging instrument for which Topic 815 requires the changes to be initially recognized in other comprehensive income).
31. Topic 805 and Topic 230 do not provide specific guidance on the cash flow statement classification of contingent consideration payments made after the business combination. The lack of guidance has resulted in entities classifying cash payments made after a

business combination for the settlement of a contingent consideration liability in operating, investing, or financing activities, or in a combination thereof.

Question for the Task Force – Contingent Consideration Payments Made after a Business Combination

3. How should the cash payments made after a business combination for the settlement of a contingent consideration liability be classified in the statement of cash flows (that is, using Alternative A, Alternative B or Alternative C)?

Staff Analysis – Issue 3

32. The staff has identified the following potential alternatives to address Issue 3:

Alternative A – Cash payments made after a business combination for the settlement of a contingent consideration liability should be classified as cash outflows for investing activities.

Alternative B – Cash payments made after a business combination for the settlement of a contingent consideration liability should be classified as cash outflows for financing activities if the amount was not paid at the time of purchase or soon before or after the business combination occurred.

Alternative C – Cash payments made after a business combination for the settlement of a contingent consideration liability should be separated and classified as cash outflows for financing activities and operating activities. Specifically, the portion of the total cash payment not to exceed the amount of the contingent consideration liability recognized at acquisition-date fair value, including measurement period adjustments, should be classified as a cash outflow for financing activities, if the amount was not paid at the time of purchase or soon before or after the business combination occurred. Amounts paid in excess of the amount of the contingent consideration liability recognized at acquisition-date fair value, including measurement period adjustments, should be classified as a cash outflow for operating activities.

Alternative A

33. Proponents of Alternative A state that the cash payment made to settle the contingent consideration liability should be classified in the same class of cash flows as the cash paid for the acquisition of the business, an investing activity, regardless of (a) the timing of when the cash payment is made and (b) the financial statement impact resulting from the accounting treatment of the initial and subsequent measurement.
34. Proponents of Alternative A note that an investing activity classification is appropriate regardless of the timing of when the cash payment is made because amounts paid to settle the contingent consideration liability represent a transfer of consideration for the acquisition of a business, which is an investing activity. The majority of the FASB advisory group members who provided feedback agreed with this view.
35. Furthermore, proponents of Alternative A note that the classification of a cash payment for a contingent consideration liability should not depend on how the recognition of the liability was treated from an accounting perspective. In other words, recognizing some or all of the liability in the accounting for the business combination or recognizing some or all of the liability in the income statement should not affect the classification of the cash payment in the statement of cash flows.

Alternative B

36. Proponents of Alternative B state that the cash payment made to settle the contingent consideration liability should be classified as a financing activity, if the cash payment was not made at the time of purchase or soon before or after the business combination occurred. They believe that this view is appropriate regardless of the financial statement impact resulting from the accounting treatment of the initial and subsequent measurement.
37. This view is consistent with paragraph 230-10-45-13(c), which states that cash outflows for *investing activities* include 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 and subsequent payments of principal on that debt are financing cash outflows.

38. In addition, paragraph 230-10-45-15(c) states that cash outflows for financing activities include other principal payments to creditors who have extended long-term credit.
39. Proponents of Alternative B note that because contingent consideration reflected in the accounting for the business combination is more similar to the buyer incurring debt to acquire the business than it is to an amount the buyer will pay soon after the acquisition date to acquire the business, the cash payment for the contingent consideration liability represents a subsequent payment of principal on the borrowing.
40. Furthermore, proponents believe that the classification of a cash payment for a contingent consideration liability should not depend on how the recognition of the liability was treated from an accounting perspective. In other words, the recognition of some or all of the liability in either the accounting for the business combination or in the income statement should not affect the classification of the cash payment in the statement of cash flows. Rather, proponents believe that the nature of the entire amount paid to the seller to settle the contingent consideration liability is a financing activity.

Alternative C

41. Proponents of Alternative C state that cash payments made from cash and cash equivalents after a business combination for the settlement of a contingent consideration liability should be separated and classified as cash outflows for financing activities and operating activities, by analogizing to existing guidance in Topic 230 as described further below. This view presumes that the amount is not paid at the time of purchase or soon before or after the business combination.
42. Proponents of Alternative C have similar views to proponents of Alternative B. However, proponents of Alternative C believe that amounts paid in excess of the amount of the contingent consideration liability recognized at acquisition-date fair value should be classified as cash outflows for operating activities because the fair value adjustments were recognized in earnings. Proponents of Alternative C believe that classifying a portion of the payment as an operating activity is consistent with part of the definition of *operating*

activities, which states that cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income. Five public accounting firms, a regulator, and one member of an FASB advisory group agreed with this view.

Staff Recommendation – Issue 3

43. The staff recommends Alternative C primarily because it most closely applies the existing guidance in Topic 230. Although Alternative B is consistent with certain existing cash flow classification guidance, it does not consider the part of the definition of *operating activities* that states that cash flows from operating activities are generally the cash effects of transactions that enter into the determination of net income. In Alternative B, the amounts paid in excess of the amount of contingent consideration liability recognized at acquisition-date fair value would be classified as cash outflows for financing activities even though the fair value adjustments were recognized in earnings. In Alternative C, that same portion of the cash payment would be classified as cash outflows for operating activities. Additionally, Alternative C is consistent with the views of a majority of the stakeholders with whom the staff performed outreach and would not take significant effort or cost to apply.

Issue 4: Restricted Cash

44. Significant diversity in practice exists in the classification and presentation of changes in restricted cash on the statement of cash flows. Entities classify the changes in operating, investing, or financing activities, or in a combination thereof.
45. Stakeholders have raised two primary issues:
- a. Classification of cash flows resulting from changes in restricted cash, including whether classification should be based on the nature of or the purpose for the restricted cash. (Subissue 4a)
 - b. Presentation of changes in restricted cash when cash payments are made directly from restricted cash and cash is deposited directly into restricted cash. (Subissue 4b)

46. Those issues arise partially because there is no Master Glossary definition of restricted cash. However, restricted cash does not meet the Master Glossary definitions of *cash* and *cash equivalents*:

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 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).

47. Topic 210, Balance Sheet, also contains limited guidance related to items that are restricted as to withdrawal or use. Paragraph 210-10-45-4 states that “the concept of the nature of current assets contemplates the exclusion from that classification of such resources as the following: cash and claims to cash that are restricted as to withdrawal or use for other than current operations, are designated for expenditure in the acquisition or construction of noncurrent assets, or are segregated for the liquidation of long-term debts.”

48. SEC Regulation S-X, Reg. § 210.5-02 states, in part, that separate disclosure shall be made of the cash and cash items that 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.
49. The staff describes restricted cash as cash that is legally or contractually restricted by agreements with third parties for special purposes and is restricted as to withdrawal or usage. The following are examples of general types of restrictions placed on cash: bankruptcy reorganizations, financing obligations, insurance claims, litigation purposes, and operational obligations.
50. The staff believes that because restricted cash cannot be withdrawn without prior notice or penalty, it should not be presented as part of cash and cash equivalents.

Subissue 4a – Classification of Changes in Restricted Cash

51. Changes in restricted cash typically occur when restricted cash is established (transfer of cash from unrestricted cash to restricted cash) and when the restrictions are released (transfer of cash from restricted cash to unrestricted cash). For purposes of the staff analysis, unrestricted cash is synonymous with cash and cash equivalents.
52. Sometimes, restricted cash is set aside in a separate bank account and other times, restricted cash is maintained in the same bank account along with unrestricted cash. The fact that a separate bank account is not established for restricted cash does not mean that the cash is without restrictions. When entities commingle restricted and unrestricted cash in the same bank account, cash receipts and payments are tracked separately for financial reporting purposes. Regardless of whether the transfers occur between separate bank accounts or whether the restricted and unrestricted cash is maintained in the same bank account and tracked separately for financial reporting purposes, the movement of cash between restricted and unrestricted cash results in cash flows that should be classified in the statement of cash flows.

53. Entities presently classify the changes in restricted cash in operating, investing, or financing activities, or in a combination thereof. Stakeholders indicated that it is unclear whether the classification should be based on the nature of the cash flows or the purpose of the restriction.

Question for the Task Force – Restricted Cash

4. How should the changes of the principal balances in restricted cash be classified in the statement of cash flows when cash and cash equivalents have been affected (that is, using Alternative A or Alternative B)?

Staff Analysis – Subissue 4a

54. The staff has identified the following potential alternatives to address Subissue 4a:

Alternative A – Changes of the principal balances in restricted cash that affect cash and cash equivalents should be based on the nature of the cash flows and, therefore, classified as investing activities on the statement of cash flows.

Alternative B – Changes of the principal balances in restricted cash that affect cash and cash equivalents should be classified based on the purpose of the restricted cash.

Alternative A

55. Under Alternative A, the classification of changes of the principal balances in restricted cash that affect cash and cash equivalents would be based on the nature of the cash flows. Proponents of Alternative A believe it is inherent in Topic 230 that classification should be based on the nature of the cash flows. That is, inherent in the definitions of financing, investing, and operating activities, classification is based on the nature of the cash flow without regard to whether it stems from another item such as a transaction. In other words, the term “nature” in this context can be described as the characteristics or features that a cash receipt or payment exhibits without regard to whether the cash receipt or payment is linked to other transactions. For example, proceeds from a debt borrowing are considered a financing activity although the proceeds will be used to construct a building, which is an investing activity.

56. In evaluating the nature of the cash flows related to restricted cash, the staff considered the descriptions of financing, operating, and investing activities in Topic 230:

Financing Activities - The definition of *financing activities* includes, in part, obtaining resources from owners and providing them with a return and borrowing money and repaying amounts borrowed. The cash flows associated with both the establishment of and the release of the principal balances in restricted cash that are simply transfers between unrestricted and restricted cash are not representative of these activities. Therefore, the staff thinks that the nature of the cash flows do not fit within financing activities.

Operating Activities - While the definition of *operating activities* is a residual category, meaning operating activities include all transactions and other events that are not defined as investing or financing, Topic 230 does state that operating activities generally involve producing and delivering goods and providing services. The cash flows associated with both the establishment of and the release of the principal balances in restricted cash do not directly relate to producing and delivering goods and providing services. Furthermore, cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income. The cash flows associated with both the establishment and release of restricted cash do not enter into the determination of net income. For those reasons, the staff thinks that the nature of the cash flows do not fit within operating activities.

Investing Activities – Cash flows from *investing activities* include the purchase and sales of equity securities, debt securities, and property, plant and equipment. Restricted cash generally results from a contractual requirement to commit money or to invest cash balances for a particular purpose. The owner of a restricted cash account contractually limits its ability to withdraw funds at any time.

57. Based on its review of the descriptions of operating, investing, and financing, the staff believes that a balance on deposit in a restricted cash account is most analogous to an investment whose return of principal requires the satisfaction of conditions rather than a mere withdrawal demand. Accordingly, deposits and withdrawals of principal balances in restricted cash accounts represent the creation or return of investment. Therefore, the nature of the cash flows associated with both the establishment and the release of the principal balances in restricted cash most closely fits within the definition of investing activities.
58. Proponents of Alternative A also observe that determining the classification of cash receipts and payments based on the nature of the restriction results in a consistent cash flow classification and provides more decision useful information to financial statement users.

59. Furthermore, FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises* (CON 5), paragraph 24(c), states that statements of cash flows commonly show a great deal about an entity's current cash receipts and payments, but a cash flow statement provides an incomplete basis for assessing prospects for future cash flows because it cannot show interperiod relationships. Statements of earnings and comprehensive income, especially if used in conjunction with statements of financial position, usually provide a better basis for assessing future cash flow prospects of an entity than do cash flow statements alone.
60. Generally, cash is restricted for a future purpose (for example, future cash flows for the payment of litigation claims, self-insurance and workers' compensation obligations, and financing obligations). Because the cash flow statement provides an incomplete basis for assessing prospects for future cash flows and cannot show interperiod relationships, classifying the changes in restricted cash based on the purpose of the restriction is contrary to the information that CON 5 intends the statement of cash flows to provide.
61. Proponents of Alternative A also highlighted that classifying changes in restricted cash based on the purpose of the restricted cash could result in reflecting a duplicate cash flow classification, which some people may believe is inappropriate.
62. For those reasons, Alternative A was supported by the five public accounting firms in the staff's outreach, the majority of the FASB Advisory Group members who provided feedback, and a preparer representing a large multi-national public business entity.

Alternative B

63. Proponents of Alternative B observe that classifying the changes of the principal balances in restricted cash based on the purpose for restriction is more understandable to a financial statement user. Those proponents believe that classifying changes of the principal balances in restricted cash in investing activities does not provide the user with information about the purpose of the restriction.
64. One member of an FASB advisory group indicated that he believes that Alternative B is more appropriate because classifying the changes of the principal balances in restricted cash based on its purpose is a logical approach to presenting information on the statement

of cash flows. In addition, an academic research report³ indicated that classification of changes in restricted cash should be based on the purpose of the cash restriction.

65. Proponents of Alternative B also have indicated that because changes of the principal balances in restricted cash do not precisely fall into the definitions of financing, investing, and operating activities, the most reasonable way to classify these changes is based on the purpose of the restriction.

Comparison of Classifications – Alternative A versus Alternative B

66. As noted above, Alternative A would result in a consistent cash flow classification of changes of the principal balances in restricted cash, while under Alternative B, the cash flow classification would vary based on the purpose of the restriction. The following two examples illustrate those differences:

Example 1:

An entity is required by its insurer to establish a restricted cash account for future payment of workers' compensation claims. The restricted cash is to be invested in an interest-bearing account until the restriction is released and cash payments are made for workers' compensation claims.

	Classification Based on:	
	Nature of the Cash Flows	Purpose of the Restriction
Cash Flow #1: Set up the restricted cash account (transfer of cash from unrestricted cash to restricted cash)	Investing outflow	Operating outflow
Cash Flow #2: Release from restriction occurs (transfer of cash from restricted cash to unrestricted cash)	Investing inflow	Operating inflow
Cash Flow #3: Payment of workers' compensation claims from unrestricted cash	Operating outflow	Operating outflow

Nature of the cash flows: Cash flows #1 and #2 are classified as an investing activity because the cash flows are similar to the purchase and sale of an investment.

Purpose of the restriction: Cash flows #1 and #2 are classified as an operating activity because the cash flows are being linked to the future payment of workers' compensation claims, an operating activity. However, an operating activities classification for cash flows #1 and #2 is contrary to the Master Glossary definition of *operating activities*, which states, in part, cash flows from operating activities generally are the cash effects of transactions and other events that enter into the determination of net income. Cash flows #1 and #2 do not enter into the determination of net income.

³ The academic research report, *Accounting and Reporting Practices for Restricted Cash*, is available for download by clicking [here](#).

Example 2:

An entity is required by its lender to establish a restricted cash account for the future payment of debt. The restricted cash is required to be invested in an interest-bearing account until the restriction is released and a cash payment is made to pay down debt.

	Classification Based on:	
	Nature of the Cash Flows	Purpose of the Restriction
Cash Flow #1: Set up the restricted cash account (transfer of cash from unrestricted cash to restricted cash)	Investing outflow	Financing outflow
Cash Flow #2: Release from restriction occurs (transfer of cash from restricted cash to unrestricted cash)	Investing inflow	Financing inflow
Cash Flow #3: Payment of debt from the unrestricted cash account	Financing outflow	Financing outflow

Nature of the cash flows: Cash flows #1 and #2 are classified as an investing activity because the cash flows are similar to the purchase and sale of an investment.

Purpose of the restriction: Cash flows #1 and #2 are classified as a financing activity because the cash flows are being linked to the future payment of debt, a financing activity. However, the nature of cash flows #1 and #2 do not fit into the Master Glossary definition of *financing activities*, which includes, in part, obtaining resources from owners and providing them with a return and borrowing money and repaying amounts borrowed.

Staff Recommendation – Subissue 4a

67. The staff recommends Alternative A primarily because (a) inherent in the definitions of financing, investing, and operating activities, Topic 230 describes the classification principle as being based on the nature of the cash flows without regard to whether it stems from another item, (b) the nature of the changes of the principal balances in restricted cash that affect cash and cash equivalents most closely fits within the definition of investing activities, and (c) it would not take significant effort or cost to apply.

Subissue 4b – Cash Payments and Cash Receipts That Directly Affect Restricted Cash

68. Sometimes, cash payments are made directly from restricted cash and cash receipts are deposited directly into restricted cash from a source outside the entity (for example, an investor or lender). However, because restricted cash does not meet the definitions of *cash* and *cash equivalents*, it is not included in the reconciliation of cash and cash equivalents on the statement of cash flows. Therefore, some entities present direct payments made from restricted cash or direct deposits received into restricted cash as line items on the

statement of cash flows (that is, those entities gross up the cash flows) and some entities provide a noncash disclosure.

69. The staff performed outreach with two public accounting firms and an FASB advisory group. The outreach indicated that application of existing guidance results in a noncash disclosure because direct cash payments from and direct deposits into restricted cash are not changes in cash and cash equivalents. However, those stakeholders expressed concerns that existing guidance about noncash disclosures is lacking because it does not address disclosures of noncash operating activities.

Examples of Cash Payments Made Directly from Restricted Cash

70. Cash payments made directly from restricted cash could relate to operating, investing, or financing activities (for example, workers compensation claims, litigation claims, property and equipment, and repayment of debt).

Example of Cash Deposited Directly into Restricted Cash

71. During the establishment of restricted cash, cash is sometimes directly deposited into restricted cash. For example, an entity issues debt in a bond offering and according to the bond agreement, the proceeds are deposited into an escrow account that is restricted for a specified purpose. A portion of the proceeds are restricted for the immediate payment of existing debt and the remaining portion is restricted for future construction expenditures. The entity never received the funds from the bond offering in its unrestricted cash account; rather, the proceeds were sent directly from the investor to the trustee-controlled escrow (restricted) account. In addition, the payment for the existing debt was made directly from restricted cash.
72. A common noncash investing and financing transaction involves capital expenditures that are financed. Often times, capital expenditures are financed directly by the vendor or by a financial institution that sends the proceeds of the borrowing directly to the seller. Therefore, the cash proceeds from the financing are never received by the borrower, which is different from the cash flows described in the previous paragraph in which the cash proceeds from the issuance of debt are received by the borrower through a direct deposit into a restricted cash account.

Question for the Task Force – Restricted Cash

5. How should the changes in restricted cash be presented in the statement of cash flows when cash payments are made directly from restricted cash and cash receipts are deposited directly into restricted cash (that is, using Alternative A or Alternative B)?

Staff Analysis – Subissue 4b

73. The staff has identified the following potential alternatives to address Subissue 4b:

Alternative A – Require noncash disclosures.

Alternative B – Present cash payments made directly from restricted cash and cash receipts directly deposited into restricted cash in the body of the statement of cash flows.

Alternative A

74. Alternative A would provide explicit guidance that cash payments made directly from restricted cash and cash receipts directly deposited into restricted cash should be disclosed as noncash activities, including noncash financing, investing, and operating activities.
75. Proponents note that Topic 230 states that a statement of cash flows should explain the change during the period in cash and cash equivalents (as defined), and 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 should be disclosed. Therefore, because restricted cash does not meet the definitions of cash and cash equivalents, direct changes in restricted cash that do not affect cash and cash equivalents should not be presented in the body of the statement of cash flows. Rather, the information should be disclosed.
76. Furthermore, proponents of Alternative A observe that presenting the direct changes in restricted cash as a gross up in the statement of cash flows when, by definition, they are not a change in cash and cash equivalents, could set a precedent that similar types of transactions also should be presented as a gross up in the statement of cash flows.

Alternative B

77. Alternative B would require that cash payments made directly from restricted cash and cash receipts directly deposited into restricted cash be presented in the body of the statement of cash flows.
78. Proponents of Alternative B believe that the cash payments made directly from restricted cash are actual cash outflows of an entity and are different from the types of transactions described in the noncash investing and financing activities guidance because those noncash investing and financing transactions result in no cash receipts or cash payments. Therefore, the cash payments made directly from restricted cash should be grossed up and presented as a transfer to unrestricted cash (cash inflow) and then as a cash outflow for the payments made directly from the restricted cash account.
79. Proponents of Alternative B stated that disclosure of direct cash payments and receipts as a noncash activity could give the connotation that the transactions did not result in actual cash receipts or payments. Proponents also noted that Alternative B would provide better information to financial statement users about an entity's cash transactions.
80. Proponents of Alternative B also highlight that Topic 230 includes guidance that states that information shall be disclosed about all investing and financing activities of an entity during a period that affect recognized assets and liabilities but do not result in cash receipts or payments. However, Topic 230 does not include disclosure guidance for noncash operating activities, and, therefore, it is unclear how to present cash payments made directly from restricted cash for operating activities.
81. Some stakeholders have highlighted that, if Alternative B is selected for Subissue 4a (classifying changes of the principal balances in restricted cash based on the purpose of the restricted cash), gross presentation of cash flows made directly from restricted cash could result in reflecting a duplicate cash flow classification, which some people may believe is inappropriate. An example of this fact pattern is illustrated below:

Changes in Restricted Cash Account—Cash Payments Directly from Restricted Cash

Fact Pattern: On January 1, 20X5, an entity is required to set up a restricted cash account (held in escrow) as a result of a court proceeding related to a class action lawsuit. The restricted cash account is restricted for the potential future cash payments to the plaintiffs of the class action lawsuit. The restricted cash account is established by transferring \$10 million from the entity's general cash account (unrestricted cash). On June 15, 20X5, the court-appointed trustee of the escrow account makes cash payments to plaintiffs directly from the restricted cash account in the amount of \$10 million. The fact pattern also assumes that the entity previously recorded a litigation accrual and an expense, prior to cash payments made to the plaintiffs.

	<u>Cash Flow Classification</u>		(in millions)	
			Debit	Credit
Cash Flow #1: On January 1, 20X5, the restricted cash account is established (move money from the unrestricted account to the restricted cash account) in the amount of \$10m	Cash used in operating activities	Journal Entry:		
		Restricted Cash	\$ 10	
		Unrestricted Cash		\$ 10
Cash Flow #2: On June 15, 20X5, cash payments are made to plaintiffs in the class action lawsuit, directly from restricted cash account in the amount of \$10m	Cash provided by operating activities	(1) Journal Entries:		
		Unrestricted Cash	\$ 10	
		Restricted Cash		\$ 10
	Cash used in operating activities	Liability	\$ 10	
		Unrestricted Cash		\$ 10

(1) The journal entries are provided in this example to assist the Task Force members in their analysis of this issue and are not meant to suggest that entities need to record journal entries in order to present a gross up of the cash flows.

Staff Recommendation – Subissue 4b

82. The staff recommends Alternative A primarily because it most closely applies existing guidance in Topic 230 that states that (a) a statement of cash flows explains the changes during the period in cash and cash equivalents (as defined in the Master Glossary) and (b) information about all investing and financing activities of an entity during a period that affect recognized assets and liabilities but that do not result in cash receipts or cash payments in the period shall be disclosed. The staff recognizes that there is a lack of existing guidance about disclosures of noncash operating activities. However, this alternative would provide explicit guidance that cash flows that directly affect restricted cash should be disclosed as noncash activities, including noncash financing, investing, and operating activities. The staff also is concerned that requiring a “gross up” of this cash activity could set a precedent and result in entities reaching conclusions that other noncash transactions should be “grossed up” in the cash flow statement.

Issue 5: Proceeds from the Settlement of Insurance Claims

83. Diversity in practice exists with the classification of proceeds received from the settlement of insurance claims. Existing guidance states in part that cash inflows from operating activities include proceeds of insurance settlements except for those that are directly related to investing or financing activities, such as from destruction of a building.
84. Stakeholders have indicated that it is unclear what “directly related to investing or financing activities” means and whether it was meant to relate to the insurance coverage or the planned use of the insurance proceeds.

Question for the Task Force - Proceeds from the Settlement of Insurance Claims

6. How should proceeds from the settlement of insurance claims be classified in the statement of cash flows (that is, using Alternative A or Alternative B)?

Staff Analysis – Issue 5

85. The staff has identified the following potential alternatives to address Issue 5:

Alternative A – Proceeds received from the settlement of insurance claims should be classified based on the insurance coverage (that is, the nature of the loss), including those proceeds that are received in a lump-sum settlement for which reasonable judgment is required to determine the classification based on the nature of each loss.

Alternative B – Proceeds received from the settlement of insurance claims should be classified as cash inflows from operating activities.

Alternative Considered but Rejected

86. The staff considered an alternative that would classify the proceeds received from the settlement of insurance claims based on the planned use of the funds. For example, insurance proceeds are received by an entity for the loss of inventory. However, if the entity plans to use the proceeds to construct a manufacturing facility, the proceeds would be classified as cash flows from investing activities. Similarly, if the entity plans to use the

funds to pay down its existing debt, the proceeds would be classified as cash flows from financing activities.

87. The staff rejected that alternative because classification based on how the proceeds are spent or will be spent in a different transaction does not provide relevant information about the current cash inflow and is contrary to the primary objective of a statement of cash flows, which is to provide relevant information about the cash receipts and payments of an entity during a period. For example, proceeds received from the issuance of debt are classified as cash inflows from financing activities. The classification is not based on how an entity intends to use the proceeds from the borrowing.

Alternative A

88. Alternative A would require proceeds received from the settlement of insurance claims to be classified based on the nature of each loss, including proceeds that are received in a lump-sum settlement. The application of this Alternative may result in classifying the insurance proceeds into more than one class of cash flows. For example:

<u>Nature of Loss</u>	<u>Classification in the Statement of Cash Flows</u>
Building	Investing activities
Manufacturing equipment	Investing activities
Inventory	Operating activities
Business interruption	Operating activities

89. Proponents of Alternative A believe that this approach follows GAAP as it was intended to be applied. Paragraph 230-10-45-16(c) states, in part, that cash flows from operating activities include proceeds of insurance settlements except for those that are directly related to investing or financing activities, such as from destruction of a building.
90. Proponents also refer to paragraph 230-10-45-12, which states, in part, that receipts from disposing of 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, are cash flows from investing activities.
91. Furthermore, proponents of Alternative A observe that the classification of insurance proceeds should be based on the nature of the loss because the primary objective of the

statement of cash flows is to provide relevant information about the cash receipts and payments of an entity during a period.

- 92. For those reasons, Alternative A was supported by the four public accounting firms in the staff's outreach, one academic, and some members of an FASB advisory group.
- 93. Some opponents of Alternative A indicate that classifying the insurance proceeds based on the nature of each loss could be costly and complex when a lump-sum settlement is received because it would require an entity to estimate and allocate those proceeds to more than one class of cash flows. Such an allocation could result in potential inconsistencies in financial reporting.

Alternative B

- 94. Proponents of Alternative B note that maintaining an insurance policy is integral to the operations of a business and, therefore, proceeds received from the settlement of an insurance claim should be classified as cash flows from operating activities, regardless of the nature of the loss. These proponents also note that classifying the proceeds received as operating activities would be consistent with the typical classification of premiums paid as operating activities.
- 95. Proponents of Alternative B also apply a part of the definition of operating activities as a basis to support an operating activities classification. The definition states, in part, that cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income. The settlement of insurance claims enter into the determination of net income. For example, the insurance proceeds may result in a gain in the income statement (for example, for business interruption claims) or may offset a loss from writing off the damaged building or equipment.
- 96. Additionally, proponents of Alternative B observe that presenting the entire cash receipt from the insurance proceeds in one cash flow classification reduces the costs necessary for users to analyze the information compared to a user analyzing components of the proceeds that are presented in multiple classifications.

Staff Recommendation – Issue 5

97. The staff recommends Alternative A primarily because the staff thinks that it is a clarification of how existing GAAP was intended to be applied and would provide more decision-useful information to financial statements users. Additionally, Alternative A is consistent with the views of a majority of the stakeholders with whom the staff performed outreach.

Issue 6: Proceeds from the Settlement of Corporate-Owned Life Insurance Policies

98. Existing guidance states that life insurance policies are purchased by entities for a variety of purposes, including funding the cost of providing employee benefits and protecting against the loss of key persons. These types of policies have generally been known as corporate-owned life insurance (COLI) or bank-owned life insurance. One of the primary benefits to using an insurance policy as a funding mechanism is the ability for an entity to receive the death benefits tax-free. Investment income is accumulated tax-free through the internal build-up of the cash surrender value.
99. The lack of specific cash flow guidance has resulted in entities classifying insurance proceeds received from the settlement of COLI policies in operating or investing activities, or in a combination thereof. However, stakeholders have indicated that there is guidance in Topic 230 and other Topics that is used as a basis for each of those classifications.
100. Some entities analogize to paragraph 230-10-45-16(c), which states, in part, that cash inflows from operating activities include proceeds of insurance settlements except for those that are directly related to investing or financing activities, such as from destruction of a building.
101. Other entities analogize to Subtopic 325-30, Investments—Other, which states that an investor shall classify cash receipts and cash payments related to life settlement contracts in accordance with Topic 230, based on the nature and purpose for which the life settlements were acquired.

102. The intersection between the analogized guidance and the variety of purposes for which COLI policies are purchased can also result in inconsistent cash flow classifications of the insurance proceeds received.

Question for the Task Force – Proceeds from the Settlement of Corporate-Owned Life Insurance Policies

7. How should insurance proceeds received from the settlement of a COLI policy be classified in the statement of cash flows (that is, using Alternative A, Alternative B, or Alternative C)?

Staff Outreach and Analysis – Issue 6

103. The staff conducted outreach with members of two FASB advisory groups. The advisory group comprises financial statement users, preparers, and auditors. The advisory group members indicated that there are three predominant views on how to classify the proceeds received from the settlement of COLI policies. There was no majority support for any particular view; rather, the feedback received was evenly split between all three of the views, which are as follows:

Alternative A – Cash proceeds received from the settlement of COLI policies should be classified as cash inflows from operating activities.

Alternative B – Cash proceeds received from the settlement of COLI policies should be classified as cash inflows from investing activities.

Alternative C – Cash proceeds received from the settlement of COLI policies should be separated and classified as cash inflows from operating and investing activities.

Specifically, the portion of the total proceeds received equal to the amount of the insurance premiums attributable to the buildup of the cash surrender value should be classified as a cash inflow from investing activities and proceeds received in excess of the insurance premiums attributable to the buildup of the cash surrender value should be classified as a cash inflow from operating activities.

Alternative A

104. Proponents of Alternative A believe that the proceeds received from the settlement of a COLI policy should be classified as cash flows from operating activities. This classification presumes that the nature and purpose of the COLI policy is primarily used to fund the cost of providing employee benefits. Proponents further note that employing a workforce is a central operating activity and that entities are protecting against the loss of key employees.
105. Proponents of Alternative A also note that even though there is a buildup of a cash surrender value (which some view as an investing activity, as described in Alternative B), all cash receipts and payments related to a COLI policy should be classified as cash flows from operating activities because maintaining an insurance policy is integral to the operations of a business.
106. Proponents of Alternative A refer to paragraph 230-10-45-17(b), which states, in part, that cash outflows for operating activities include cash payments to other suppliers for other goods and services. Furthermore, paragraph 230-10-45-25(d), states that those entities that prepare the statement of cash flows using a direct method should separately report classes of operating cash receipts and payments, including cash paid to suppliers of insurance. Because proponents of Alternative A apply this guidance, and they view both the premium payments and the proceeds as having similar characteristics, the associated proceeds received should also be classified as operating activities.
107. Additionally, proponents of Alternative A observe that presenting the entire cash receipt from the insurance proceeds in one cash flow classification reduces the costs necessary for users to analyze the information compared to a user analyzing components of the proceeds that are presented in multiple classifications.

Alternative B

108. Proponents of Alternative B believe that while entities may purchase COLI policies to fund the cost of providing employee benefits and protect against the loss of key persons, the nature of the contract and its cash flows are an investment because COLI policies are used as a funding mechanism to receive death benefits tax-free and for the accumulation of tax-

free investment income on the cash surrender value. Therefore, the proceeds from the settlement of COLI policies should be consistent with the existing guidance in Topic 230 that states, in part, that receipts from sales of investments shall be classified as cash flows from investing activities and reported gross in the statement of cash flows.

109. Furthermore, Topic 325 states that an investment in a life insurance contract shall be reported as an asset and the asset shall be measured subsequently at the amount that could be realized under the insurance contract as of the date of the statement of financial position. A change in the cash surrender value or contract value during the period is an adjustment of premiums paid in determining the expense or income to be recognized under the contract for the period.
110. Proponents believe that based on the existing guidance in Topic 325, the asset (cash surrender value) recognized in a COLI policy is an investment and, therefore, the nature of the cash receipts and cash payments represents investing activities.
111. Additionally, proponents of Alternative B observe that presenting the entire cash receipt from the insurance proceeds in one cash flow classification reduces the costs necessary for users to analyze the information compared to a user analyzing components of the proceeds that are presented in multiple classifications.

Alternative C

112. Proponents of Alternative C note that cash receipts from COLI policies include characteristics of both investing and operating activities. Proponents analogize to the guidance in Topic 230 about the classification of cash receipts for a return *on* an investment and a return *of* an investment. Insurance proceeds received that do not exceed the insurance premiums attributable to the buildup of the cash surrender value are viewed as a return *of* investment and classified as cash flows from investing activities similar to the classification of cash receipts from returns *of* investment in debt and equity instruments of other entities. Insurance proceeds received that exceed the insurance premiums attributable to the buildup of the cash surrender value are viewed as a return *on* investment and classified as cash flows from operating activities similar to the classification of cash receipts from interest on debt instruments and dividends on equity securities.

113. Proponents also note that the definition of operating activities states, in part, that cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income. For example, when a gain is recorded in the income statement for a portion of the insurance proceeds received, that amount should be classified in the statement of cash flows as an operating activity.

Example

114. Entity A holds a COLI policy on its Chief Executive Officer (CEO). On January 1, 20X1, the CEO dies and Entity A receives \$1 million of insurance proceeds from the insurer. At the time the insurance proceeds are received, the cash surrender value recorded in the statement of financial position was \$600,000, of which \$570,000 represents insurance premiums attributable to the buildup of the cash surrender value and \$30,000 represents reinvested interest. Entity A records the following journal entry:

Account	Debit	Credit
Cash	1,000,000	
Cash surrender value		600,000
Gain on settlement of COLI policy		400,000

115. Application of the alternatives would result in the classification of the insurance proceeds received, as follows:
- a. Under Alternative A, the entire \$1 million of insurance proceeds received should be classified as a cash inflow from operating activities.
 - b. Under Alternative B, the entire \$1 million of insurance proceeds received should be classified as a cash inflow from investing activities.
 - c. Under Alternative C, \$570,000 should be classified as a cash inflow from investing activities and \$430,000 should be classified as a cash inflow from operating activities.

Staff Recommendation – Issue 6

116. The staff recommends Alternative B primarily because the staff views the COLI policy as an investment. Therefore, the proceeds received should be classified as an investing

activity, consistent with the classification of proceeds received in the sales of equity instruments of other entities and from returns of investment in those instruments. While the decision to fund employee benefits is primarily operating in nature, the staff agrees with the view that an entity's decision to fund those benefits using a COLI policy is an investment decision.

Next Steps

117. At the September 17, 2015 meeting, the staff will bring the following for the Task Force's consideration:

- a. Analyses of the other three issues: (i) distributions received from equity method investees, (ii) beneficial interests in securitization transactions, and (iii) application of the predominance principle
- b. Transition alternatives for all nine cash flow classification issues.

118. A proposed Accounting Standards Update will be issued for public comment after the Task Force has deliberated and reached a consensus-for-exposure on all nine cash flow classification issues.

Appendix A: Information about the Prior FASB Project, Clarifying Certain Existing Principles on Statement of Cash Flows

1. As mentioned in the background information, the prior FASB project, Clarifying Certain Existing Principles on Statement of Cash Flows, was a principles-based approach to reducing the diversity in practice in the application of Topic 230.
2. Topic 230 recognizes that the most appropriate classification will not always be clear, particularly in situations in which cash receipts and payments have aspects of more than one class of cash flows. In those situations, existing guidance suggests that the appropriate classification depends on the activity that is likely to be the predominant source or use of cash flows for the item. The staff refers to this guidance as the predominance principle.
3. Stakeholders indicated that Topic 230, specifically paragraph 230-10-45-22, is unclear about when a cash receipt or payment should be classified into more than one class of cash flows and when the predominant source of cash flows for the item should be used as a basis for determining the classification of cash flows.
4. To clarify the predominance principle and certain existing principles in Topic 230, the project was intended to address the following:
 - a. Classifying cash flows based on their nature
 - b. Determining when a cash flow should be bifurcated and classified into more than one class of cash flows and when the predominant source of cash flows should be used to determine classification
 - c. Whether it is appropriate to use estimation to quantify the amounts to be classified into more than one class of cash flows
 - d. Factors that could be used to identify the predominant cash flow
 - e. Clarifying that the predominance principle should be applied in situations in which there is no specific cash flow guidance
 - f. Disclosures when classification is based on predominance.
5. Because the existing guidance is unclear, the staff believes that the predominance principle is sometimes applied in a manner in which it was not intended and, therefore,

resulting in incorrect classification of certain cash receipts and payments. The staff believes that the predominance principle, as it exists currently, would not be applied when: (a) there is specific application guidance on the cash flow in question, (b) the cash flow is described by the definitions of financing, investing, or operating activities when there is a lack of specific application guidance, and (c) each separately identifiable source or use within the cash receipt or payment is determinable (for example, the principal and interest component for the cash payment for the settlement of a zero-coupon bond can be separately identified).

6. Rather, the staff believes that the predominance principle should be applied when the entire cash receipt or cash payment has characteristics of more than one class of cash flows and those characteristics cannot be separately identified. For example, a rent-to-own entity offers household electronics to its customers. The entity rents the household electronics for a period of time and then subsequently sells the used electronics. The cash payment made by the entity to acquire the electronics exhibits aspects of both investing (productive assets) and operating activities (inventory). Accordingly, the entity would apply the predominance principle to determine the classification of the cash outflow.
7. Of the nine specific cash flow issues being addressed by the Task Force, the following issues potentially may have been resolved through clarification of the predominance principle and other certain existing principles:
 - a. Settlement of zero-coupon bonds
 - b. Proceeds from the settlement of insurance claims
 - c. Contingent consideration payments made after a business combination
 - d. Application of the predominance principle.
8. Stakeholders with whom the staff performed outreach indicated that while the clarified principles may help to reduce the diversity, illustrative examples of these specific cash flow issues would be necessary to understand and apply the clarified principles, which the staff believes would have resulted in providing a “rule” for these issues indirectly (rather than truly relying on the clarified principle).

9. The FASB project was in the initial deliberations phase when the Board decided that clarifying existing principles within Topic 230 would only incrementally reduce diversity in practice. Therefore, the Board decided to have the Task Force consider nine specific cash flow classification issues. No other Board decisions were made about the project. Therefore, formalized feedback was not received on the applicability of the items being addressed in the project.

Appendix B: Definitions of Financing, Investing, and Operating Activities from the Master Glossary of the Codification

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.

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.

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.

Appendix C: Summary of Alternatives and Staff Recommendations

Issue Name	Alternatives	Staff Recommendation
Issue 1 —Debt Prepayment or Extinguishment Costs	Alternative A – Cash payments for debt prepayment or extinguishment costs should be classified as cash outflows for operating activities. Alternative B – Cash payments for debt prepayment or extinguishment costs should be classified as cash outflows for financing activities.	Alternative A
Issue 2 —Settlement of Zero-Coupon Bonds	Alternative A – At settlement, the portion of the cash payment attributable to the accreted interest should be classified as a cash outflow for operating activities and the portion of the cash payment attributable to the principal (original proceeds) should be classified as a cash outflow for financing activities. Alternative B – At settlement, the entire cash payment should be classified as a cash outflow for financing activities.	Alternative A
Issue 3 —Contingent Consideration Payments Made after a Business Combination	Alternative A – Cash payments made after a business combination for the settlement of a contingent consideration liability should be classified as cash outflows for investing activities. Alternative B – Cash payments made after a business combination for the settlement of a contingent consideration liability should be classified as cash outflows for financing activities if the amount was not paid at the time of purchase or soon before or after the business combination occurred. Alternative C – Cash payments made after a business combination for the settlement of a contingent consideration liability should be separated and classified as cash outflows for financing activities and operating activities. Specifically, the portion of the total cash payment not to exceed the amount of the contingent consideration liability recognized at acquisition-date fair value, including measurement period adjustments, should be classified as a cash outflow for financing activities, if the amount was not paid at the time of purchase or soon before or after the business combination occurred. Amounts paid in excess of the amount of the contingent consideration liability recognized at acquisition-date fair value, including measurement period adjustments, should be classified as a cash outflow for operating activities.	Alternative C

Issue	Alternatives	Staff Recommendation
Issue 4—Restricted Cash Subissue 4a—Classification of Changes in Restricted Cash	Alternative A – Changes of the principal balances in restricted cash that affect cash and cash equivalents should be based on the nature of the cash flows and, therefore, classified as investing activities on the statement of cash flows. Alternative B – Changes of the principal balances in restricted cash that affect cash and cash equivalents should be classified based on the purpose of the restricted cash.	Alternative A
Subissue 4b—Cash Payments and Cash Receipts that Directly Affect Restricted Cash	Alternative A – Require noncash disclosures. Alternative B – Present cash payments made directly from restricted cash and cash receipts directly deposited into restricted cash in the body of the statement of cash flows.	Alternative A
Issue 5—Proceeds from the Settlement of Insurance Claims	Alternative A – Proceeds received from the settlement of insurance claims should be classified based on the insurance coverage (that is, the nature of the loss), including those proceeds that are received in a lump sum settlement for which reasonable judgment is required to determine the classification based on the nature of each loss. Alternative B – Proceeds received from the settlement of insurance claims should be classified as cash inflows from operating activities.	Alternative A
Issue 6—Proceeds from the Settlement of Corporate Owned Life Insurance	Alternative A – Cash proceeds received from the settlement of COLI policies should be classified as cash inflows from operating activities. Alternative B – Cash proceeds received from the settlement of COLI policies should be classified as cash inflows from investing activities. Alternative C – Cash proceeds received from the settlement of COLI policies should be separated and classified as cash inflows from operating and investing activities. Specifically, the portion of the total proceeds received equal to the amount of the insurance premiums attributable to the buildup of the cash surrender value should be classified as a cash inflow from investing activities and proceeds received in excess of the insurance premiums attributable to the buildup of the cash surrender value should be classified as a cash inflow from operating activities.	Alternative B