



Statement of cash flows

Handbook

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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 classification for the many types of cash flows can be complex and regularly attracts SEC scrutiny, which is expected to continue.

In emphasizing the statement's importance, the SEC Chief Accountant in 2023 called for appropriate judgments around materiality, cash flow classification, and risk assessment, while also urging greater transparency around cash and noncash transactions. Also, in 2023, the FASB kicked off a project to make targeted improvements to the statement.

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 views 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.

[Valerie Boissou](#) and [Tim Phelps](#)

Department of Professional Practice, KPMG LLP

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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 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
- 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
- Reg G is SEC Regulation G, Conditions for Use of Non-GAAP Financial Measures
- 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
- AAG-BRD Ex 6-7 is Exhibit 6-7 of the AICPA's Audit and Accounting Guide for Brokers and Dealers in Securities

- 2006 AICPA Conf is the 2006 AICPA National Conference on Current SEC and PCAOB Developments
- CAQ 07/2008 is meeting minutes from the July 2008 Center for Audit Quality SEC Regulations Committee

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**'.

March 2026 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 **; guidance that has been significantly updated or revised is identified with #; guidance that has been moved to a new location is identified with a ^^ . The [Index of changes](#) identifies all significant changes and includes a section listing guidance that was moved to a new location.

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#

New item added in this edition: **

Item significantly updated in this edition: #

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.

| ASU | Title |
|---|---|
| 2018-12¹ | Financial Services-Insurance (Topic 944): Targeted improvements to the Accounting for Long Duration Contracts |
| 2023-06 | Disclosure Improvements: Codification Amendments in Response to the SEC's Disclosure Update and Simplification Initiative |
| 2023-08 | Accounting for and Disclosure of Crypto Assets |
| 2023-09 | Improvements to Income Tax Disclosures |
| 2025-10 | Accounting for Government Grants Received by Business Entities |
| Note: | |
| 1. Includes related ASUs effective concurrently, not individually listed. | |

ASU 2018-12: Long duration insurance contracts

Overview

In August 2018, the FASB issued ASU 2018-12, *Financial Services – Insurance (Topic 944): Targeted Improvements to the Accounting for Long Duration Contracts*, which makes targeted improvements to the existing recognition, measurement, presentation, and disclosure requirements for long-duration contracts issued by an insurance entity.

For more information about Topic 944, see Chapter 25 and KPMG Handbook, [Long-duration contracts](#).

Effective dates and transition

| | Public business entities | Other entities |
|------------------------|---|---|
| Effective date: | Annual and interim periods in fiscal years beginning after December 15, 2022. | <ul style="list-style-type: none"> — Annual periods in fiscal years beginning after December 15, 2024. — Interim periods in fiscal years beginning after December 15, 2025. |

| | Public business entities | Other entities |
|------------------------|---|----------------|
| Early adoption: | Permitted. If early adoption is elected, the transition date is either the beginning of the prior period presented or the beginning of the earliest period presented. | |
| Transition: | <ul style="list-style-type: none"> — For the liability for future policyholder benefits (for traditional and limited-payment contracts) and deferred acquisition costs, the ASU: <ul style="list-style-type: none"> – applies to contracts in force as of the beginning of the earliest period presented, on the basis of their existing carrying amounts, adjusted for the removal of any related amounts in accumulated other comprehensive income. – may be applied retrospectively. — For market risk benefits, the ASU applies retrospectively as of the beginning of the earliest period presented. <p>Accounting policy election available to exclude certain contracts from the ASU upon transition.</p> | |

ASU 2023-06: Disclosure improvements (in response to the SEC’s disclosure update and simplification initiative)

Overview

In October 2023, the FASB issued ASU 2023-06, *Disclosure improvements: Codification amendments in response to the SEC’s disclosure update and simplification initiative*, which incorporates into the Codification several disclosures and presentation requirements currently residing in SEC Regulations S-X and S-K. As a result, the ASU is not expected to significantly affect entities already subject to these SEC requirements. However, certain disclosures currently presented outside the financial statements as a result of Reg S-K may need to be relocated into the financial statements. Conversely, the ASU adds certain requirements for private and not-for-profit entities (as they were not previously subject to the requirements in Reg S-X and S-K).

Effective dates and transition

| | Entities subject to the SEC’s existing disclosure requirements ¹ | Other entities |
|--|---|-----------------|
| Each amendment will be effective: | As of the effective date to remove the related disclosure requirement from Reg S-X or S-K. | Two years later |
| | If by June 30, 2027, the SEC has not removed the existing disclosure requirement from Reg S-X or S-K, the corresponding | |

| | Entities subject to the SEC's existing disclosure requirements ¹ | Other entities |
|---|---|----------------|
| | pending requirement will be removed from the Codification and will not become effective for any entity. | |
| Early adoption: | Not permitted | |
| Note: | | |
| 1. Entities subject to the SEC's existing disclosure requirements and entities required to file or furnish financial statements with or to the SEC in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer. | | |

ASU 2023-08: Crypto assets

Overview

In December 2023, the FASB issued ASU 2023-08, *Accounting for and Disclosure of Crypto Assets*, which creates new Subtopic 350-60 (crypto assets) and specifies fair value measurement, separate presentation and new disclosures for in-scope crypto assets (e.g. bitcoin and ether).

For more information about ASU 2023-08, see KPMG Defining Issues, [FASB issues final ASU on crypto asset accounting](#) and KPMG Issues In-Depth, [Accounting and reporting for crypto intangible assets](#).

Effective dates and transition

| | All entities |
|------------------------|---|
| Effective date: | Annual and interim periods in fiscal years beginning after December 15, 2024. |
| Early adoption: | Permitted, in any interim or annual period for which an entity's financial statements have not been issued (or made available for issuance), as of the beginning of the entity's fiscal year. |
| Transition: | The ASU must be adopted on a modified retrospective basis, with a cumulative-effect adjustment to retained earnings (or other appropriate components of equity or net assets) as of the beginning of the fiscal year of adoption. |

ASU 2023-09: Income tax disclosures

Overview

In December 2023, the FASB issued ASU 2023-09, *Improvements to Income Tax Disclosures*, which enhances income tax disclosures for the effective tax rate reconciliation and income taxes paid. The ASU also includes other amendments, such as updating terminology and the removal of certain disclosures.

For more information about ASU 2023-09, see KPMG Hot Topic, [Income tax disclosures](#).

Effective dates and transition

| | Public business entities | Other entities |
|------------------------|--|--|
| Effective date: | Annual periods in fiscal years beginning after December 15, 2024 | Annual periods in fiscal years beginning after December 15, 2025 |
| Early adoption: | Permitted. | |
| Transition: | The ASU can be applied either prospectively or retrospectively. | |

ASU 2025-10: Accounting for government grants received by business entities**

Overview

In December 2025, the FASB issued ASU 2025-10, *Accounting for Government Grants Received by Business Entities*, which provides accounting guidance on the recognition, measurement and presentation of grants received by business entities from a government. The ASU also amends the disclosure requirements in Topic 832 for business entities to disclose information about government grants they receive.

For more information about ASU 2025-10, see KPMG Defining Issues, [FASB issues ASU on accounting for government grants](#).

Effective dates and transition

| | Public business entities | Other entities |
|------------------------|--|--|
| Effective date: | Annual periods in fiscal years beginning after December 15, 2028 | Annual periods in fiscal years beginning after December 15, 2029 |
| Early adoption: | Permitted. | |
| Transition: | The ASU can be applied either prospectively or retrospectively. | |

2. Objective and scope

Detailed contents

2.1 How the standard works

2.2 Objective

2.3 Scope

Questions

- 2.3.10 Is a statement of cash flows required if only a balance sheet or an income statement, but not both, is presented?
- 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?
- 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?
- 2.3.40 Is an investment company required to provide a statement of cash flows?

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.



Excerpt from SEC staff speech

"A clear and accurate depiction of the nature and quality of an issuer's cash flows can serve as an important tool for investors to make informed judgments regarding an issuer's ability to generate positive future net cash flows, meet its financial obligations, and pay dividends or otherwise return cash to investors."

Paul Munter, SEC Chief Accountant, Remarks before the 2024 AICPA & CIMA Conference on Current SEC and PCAOB Developments: Accounting Matters (December 9, 2024) – See [Appendix](#).

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]



Observation

The importance of the statement of cash flows

At the AICPA & CIMA Conference on Current SEC and PCAOB Developments in both 2023 and 2024, Paul Munter, SEC Chief Accountant, highlighted the importance of the statement of cash flows to investors. During his speech, he stressed the importance of preparers and auditors applying the same level of rigor and attention to the statement of cash flows as they do to other financial statements. See [Appendix](#) for full remarks.

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. For more guidance on the statement of cash flows of investment entities, see [Question 9.2.05](#). See also sections 9.2 and 9.3 in KPMG Handbook, [Investment companies](#).

3. Format of the statement

Detailed contents

New item added in this edition: **

Item significantly updated in this edition: #

Item has been moved in this edition: ^^

3.1 How the standard works

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

Questions

- 3.2.10 What is the starting point in the reconciliation of net income to net cash flows from operating activities?
- 3.2.20 What should be considered when reconciling net income to operating cash flows in the statement of cash flows? **

3.3 Direct vs indirect method

- 3.3.10 Overview
- 3.3.20 Direct method
- 3.3.30 Indirect method #
- 3.3.40 Change in the presentation method

Questions

- 3.3.05 How does bankruptcy affect the statement of cash flows?
- 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?
- 3.3.20 May an entity change its presentation method from the indirect method to the direct method?

3.4 Cash flow per share and other liquidity measures

Questions

- 3.4.10 May an entity disclose cash flow per share?
- 3.4.20 May an entity present subtotals within the categories in the statement of cash flows?
- 3.4.30 May an entity disclose free cash flows or adjusted free cash flows in its financial statements?

3.5 Gross vs net cash flows

Questions

- 3.5.05 When may cash flows be reported net? ^^
- 3.5.10 Should financial institutions present cash flows gross or net?

3.6 Other presentation considerations

Question

3.6.10 How are related-party transactions presented?

3.7 Disclosures

Questions

3.7.10 What accounting policy disclosures are required for the statement of cash flows?

3.7.20 What other disclosures beyond accounting policies are required by Topic 230? #

3.7.30 What disclosures of income taxes paid are required after adoption of ASU 2023-09? **

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 affecting this chapter

This chapter reflects the amendments of ASU 2023-06, *Disclosures improvements: Codification amendments in response to the SEC's disclosure update and simplification initiative*, and ASU 2023-09, *Improvements to Income Tax Disclosures*. See [chapter 1](#) for an overview of these ASUs and transition requirements.

Excerpts from the Codification included in this chapter reflect these amendments as pending content.

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: <ul style="list-style-type: none"> — Inventory — Contract liabilities |
| Accruals of expected future operating cash receipts and payments | Changes during the period in: <ul style="list-style-type: none"> — Receivables — Payables |
| Noncash items reflected in net income (including items whose cash effects are related to investing or financing cash flows) | <ul style="list-style-type: none"> — Depreciation of PP&E — Amortization of finite lived intangible assets — Amortization of premiums and discounts on debt (including debt issuance costs) — Amortization of discounts on financial assets — Impairment losses — Allowance for credit losses — 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 and accretion of the ARO liability |

| Type of adjustment | Common examples |
|--------------------|---|
| | <ul style="list-style-type: none"> — 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]



Question 3.2.20**
What should be considered when reconciling net income to operating cash flows in the statement of cash flows?

Interpretive response: At the 2025 AICPA & CIMA Conference on Current SEC and PCAOB Developments, the SEC Staff encouraged issuers to ensure that the statement of cash flows is sufficiently detailed and clearly breaks out any material components. For example, operating activities at a minimum should reflect separate line items for changes in receivables, inventory and payables. The staff has issued comments where amounts are aggregated that should be presented separately. This can occur when items are incorrectly presented on a net basis rather than a gross basis, or when dissimilar items, such as ‘other assets’ and ‘other liabilities’, are combined. [2025 AICPA Conf]

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.



Observation

Direct vs indirect method

At the 2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments, Paul Munter, SEC Chief Accountant, commented that investors and academic studies have highlighted the importance of providing disaggregated cash flow information through the direct method. Despite the encouragement from US GAAP to use the direct method, most issuers still use the indirect method.

In response to investor requests for more transparency, the Chief Accountant encouraged issuers to evaluate whether using the direct method would better serve investor needs. Issuers using the indirect method can supplement their cash flow information by disclosing major classes of gross cash receipts and payments. Audit committees should discuss the potential use of the direct method or additional disclosures with management and independent auditors, focusing on meeting investor needs. Independent auditors can facilitate this dialogue through their communications with the audit committee on alternative accounting treatments. See [Appendix](#) for full remarks.

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.

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, specific amounts are required to be disclosed:

- interest paid (net of amounts capitalized – see [section 12.2.40](#)); and
- income taxes paid. Prior to adoption of ASU 2023-09, these amounts are disclosed either on the face of the statement of cash flows or in the notes to the financial statements. See [Question 3.7.30](#) for disclosures of income taxes paid after adoption of ASU 2023-09. [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 |
| 55-14 The following table illustrates the supplemental disclosures of cash flow information. | | |
| Cash paid during the year for: | | |
| Interest (net of amount capitalized) | \$220 | |
| Income taxes | 325 | |

Pending Content

Transition Date: (P) December 16, 2024; (N) December 16, 2025 |
Transition Guidance: 740-10-65-9

55-14 ...

Note: This Example does not illustrate the disclosures of income taxes paid required by paragraphs 740-10-50-22 through 50-23, for the year ended December 31, 19X1.



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 from the indirect method to the direct method?

Interpretive response: Yes. Because 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, this method is preferable. [230-10-45-25]

If an entity changes its presentation method from the indirect method to the direct method, it should consider the requirements in Topic 250 and 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. [250-10-45-5, 50-1, TQA 1300.20]

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. [\[230-10-45-3\]](#)



Question 3.4.30

May an entity disclose free cash flows or adjusted free cash flows in its financial statements?

Interpretive response: No. Many entities choose to disclose free cash flows or similar measures in their annual reports. The SEC generally prohibits the presentation of non-GAAP financial measures on the face of a registrant's financial statements or in the accompanying notes. This includes free cash flows or adjusted free cash flows.

However, registrants may disclose these measures in other sections of a filing that includes non-GAAP financial measures if they comply with SEC rules and regulations governing disclosure of non-GAAP measures. This includes reconciling the non-GAAP financial measure to the most directly comparable financial measure calculated and presented in accordance with GAAP. The SEC staff has commented that cash flows from operating activities are generally the most comparable GAAP measure to free cash flows or adjusted free cash flows. [\[S-K Item 10\(e\), Reg G\]](#)

However, the SEC prohibits free cash flows from being disclosed on a per share basis. [\[C&DI 102.07\]](#)

See section 4.3 in KPMG Issues In-Depth, [Non-GAAP financial measures](#), for additional guidance on presenting free cash flow, and chapter 3 of that publication on the general requirements for presenting non-GAAP financial measures.

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.

 **Question 3.5.05^^**
When may cash flows be reported net?

Interpretive response: 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, which, depending on circumstances, may include a revolving credit arrangement (see [Question 12.4.20](#)) 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](#).

3.6 Other presentation considerations

Other presentation considerations include the presentation cash flows from related-party transactions.



Question 3.6.10
How are related-party transactions presented?

Interpretive response: SEC regulations require registrants to present related-party transactions separately on the balance sheet, in the income statement and in the statement of cash flows. [S-X Rule 4-08(k), 5-02, ASU 2023-06]

For an in-depth understanding of identifying, accounting for, and presenting transactions and balances with related parties, and the requirements of Topic 850, see chapter 8 of KPMG Handbook, [Financial statement presentation](#).

3.7 Disclosures



Excerpt from SEC staff speech

“The disclosures related to the statement of cash flows are also critical to investors. We remind issuers that the requirement to disclose significant accounting policies includes those policies that materially affect the determination of cash flow classification.”

Paul Munter, SEC Chief Accountant, The Statement of Cash Flows: Improving the Quality of Cash Flow Information Provided to Investors (December 4, 2023)
 – See [Appendix](#).

Topic 230 and various other Topics require specific disclosures in relation to the statement of cash flows. These disclosures fall into the following categories:

| Required disclosures | Examples |
|---|--|
| Accounting policies | Items treated as cash equivalents, classification of cash flows related to derivatives |
| Qualitative information | Restrictions on cash and cash equivalents |
| Quantitative cash flow information | Interest and income taxes paid |
| Quantitative information about noncash activities | Investing and financing noncash activities |

While qualitative and narrative disclosures are included in the notes to the financial statements, it may be appropriate to present certain quantitative

disclosures on the statement itself (e.g. in parentheses), in a tabular format under the statement or in the notes, depending on the circumstances.

At the AICPA & CIMA Conference on Current SEC and PCAOB Developments in both 2023 and 2024, Paul Munter, SEC Chief Accountant, highlighted that statement of cash flows disclosures are vital to investors. He encouraged preparers to focus on investor needs when determining how best to communicate relevant cash and noncash information. For example, investors needs could be better served by further disaggregating amounts reported on the statement and, for preparers using the indirect method, by providing additional voluntary disclosures. See [Appendix](#) for full remarks. [2023 AICPA Conf, 2024 AICPA Conf]

 **Question 3.7.10**
What accounting policy disclosures are required for the statement of cash flows?

 **Excerpt from ASC 235-10**

> Accounting Policy Disclosure

50-1 Information about the accounting policies adopted by an entity is essential for financial statement users. When financial statements that are issued or are available to be issued (as discussed in Section 855-10-25) purport to present fairly financial position, cash flows, and results of operations in accordance with generally accepted accounting principles (GAAP), a description of all significant accounting policies of the entity shall be included as an integral part of the financial statements...

 **Excerpt from ASC 230-10**

> Cash Equivalent 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.

> Accounting Policy for Derivative Instruments

Pending Content

Transition Date: (P) June 30, 2027; (N) June 30, 2027 | Transition Guidance: 105-10-65-7

50-9 An entity shall disclose its accounting policy for where cash flows associated with derivative instruments and their related gains and losses are presented.

Interpretive response: Topic 230 requires disclosure of the following accounting policies.

| Policy | Chapter reference |
|--|-------------------|
| An entity’s policy for determining which items are classified as cash equivalents in its financial statements, along with any changes in that policy | Chapter 6 |
| How cash flows associated with derivative instruments and their related gains and losses are classified. ¹ [230-10-50-9, S-X Rule 4-08 (n)] | Chapter 13 |
| Note: 1. Currently required for SEC registrants, but we believe this disclosure is best practice, and when ASU 2023-06 becomes effective (see chapter 1) will be required, for all entities. | |

Further, Topic 235 requires that all significant accounting policies applied in preparing financial statements be disclosed. In determining which accounting policies to disclose regarding the statement of cash flows, an entity should consider those that materially affect the statement, whether quantitatively or qualitatively. This includes when an entity has the option to make policy elections, as discussed throughout this Handbook. See Question 6.3.10 of KPMG Handbook, [Financial statement presentation](#), for additional information about determining which accounting policies are significant.

 **Question 3.7.20#**
What other disclosures beyond accounting policies are required by Topic 230?

 **Excerpt from ASC 230-10**

> 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.

Pending Content

Transition Date: (P) December 16, 2024; (N) December 16, 2025 |
 Transition Guidance: 740-10-65-9

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.

50-2A Income taxes paid (net of refunds received) shall be disclosed in accordance with paragraphs 740-10-50-22 through 50-23.

> 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 referenced to the statement of cash flows.

> 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 a tabular format (see paragraphs 230-10-55-12A and 230-10-55-18A).

Interpretive response: The following table presents specific disclosure items required by Topic 230 as well as disclosure requirements mandated in other Topics and that are discussed in this Handbook.

| Disclosure | Handbook reference |
|---|-------------------------------------|
| Cash receipts and payments directly resulting from bankruptcy proceedings (indirect method) | Question 3.3.05 |
| Change in presentation method (e.g. indirect to direct method) | Question 3.3.20 |
| Interest paid (indirect method) | Section 3.3.30 |
| Income taxes paid (indirect method), prior to ASU 2023-09 | Section 3.3.30 |
| Income taxes paid, post-ASU 2023-09 | Question 3.7.30 |
| Noncash investing and financing activities | Section 4.7.20 |
| Restrictions on cash and cash equivalents | Questions 6.4.10, 11.3.30 |
| Share-based payment awards | Questions 16.3.30, 16.4.20, 16.5.10 |
| Cash flows from discontinued operations | Section 20.2.40 |



Question 3.7.30**

What disclosures of income taxes paid are required after adoption of ASU 2023-09?



Excerpt from ASC 740-10

Pending Content

Transition Date: (P) December 16, 2024; (N) December 16, 2025 |
Transition Guidance: 740-10-65-9

> Statement of Cash Flow Related Disclosures

50-22 For each annual reporting period, all entities shall disclose the amount of income taxes paid (net of refunds received) disaggregated by federal (national), state, and foreign.

50-23 For each annual reporting period, all entities shall disclose the amount of income taxes paid (net of refunds received) to each individual jurisdiction in which income taxes paid (net of refunds received) is equal to or greater than 5 percent of total income taxes paid (net of refunds received).

Interpretive response: Topic 740 requires an entity to disclose income taxes paid (net of refunds received) disaggregated by domestic federal, domestic

state and foreign and income tax paid to an individual jurisdiction when the amount is at least 5% of the total income taxes paid during the period, either on the face of the statement of cash flows or in the notes to the financial statements. These disclosures are required regardless of whether the direct or indirect method is used. [740-10-50-22 – 50-23]

See KPMG Hot Topic, [Income tax disclosures](#), for additional guidance on the income taxes paid disclosure. See [section 3.3.30](#) for guidance on the income taxes paid disclosure prior to adoption of ASU 2023-09.

4. Classification principles

Detailed contents

Item significantly updated in this edition: #

4.1 How the standard works

4.2 Investing activities

4.3 Financing activities

4.4 Operating activities

4.5 More than one class of cash flows

Question

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

4.6 Change in classification

4.6.10 Assessing a voluntary change in classification

4.6.20 Accounting for a change in accounting principle

4.6.30 Evaluating an error in classification

Questions

4.6.10 How is a change in the classification of a cash flow item treated?

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

4.6.30 How is an error in the classification of a cash flow item treated?

4.7 Noncash activities

4.7.10 Constructive receipt and disbursement

4.7.20 Noncash investing and financing activities #

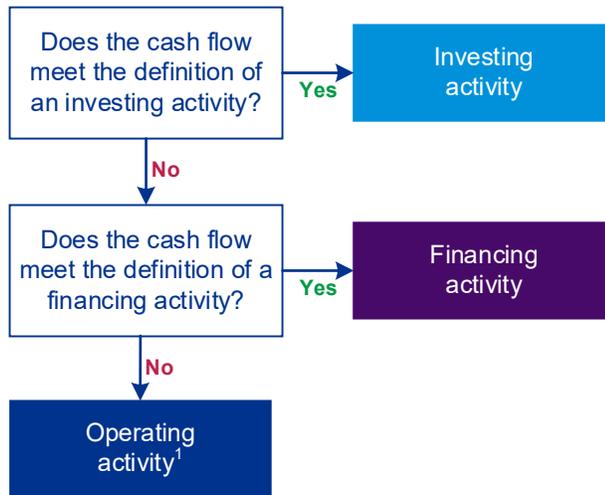
Question

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

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.



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.

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:

- 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
- 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
- Receipts from sales of property, plant, and equipment and other productive assets
- Subparagraph not used
- 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

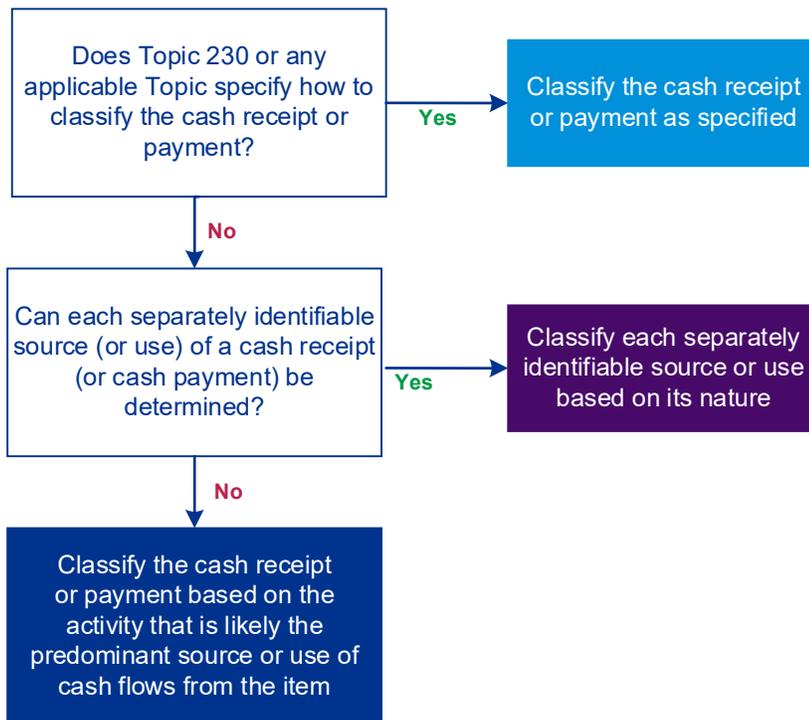
- > More than One Class of Cash Flows

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.

Topic 230 addresses situations where a cash receipt or payment has characteristics of more than one class of cash flows, and when to apply the predominance principle. [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: Topic 230 does not require specific disclosures when the predominance principle is used to determine classification. This is because the predominance principle is not an accounting policy. However, we believe entities should provide sufficient disclosures to inform users of the basis for the classification selected. [ASU 2016-15.BC41]

4.6 Change in classification



Excerpt from SEC staff speech

Accurately classifying cash flows as operating, investing, or financing activities is paramount to investors understanding the nature of the issuer's activities that generated and used cash during the reporting period.

Paul Munter, SEC Chief Accountant, The Statement of Cash Flows: Improving the Quality of Cash Flow Information Provided to Investors (December 4, 2023)
– See [Appendix](#).

Topic 230 does not address changes in classification (i.e. as **operating**, **investing** or **financing**) of cash flow items. Therefore, an entity has to apply the principles of Topic 250 (accounting changes and error corrections) to determine whether a change in classification is a change in accounting principle or whether such a change is indicative of a correction of an error in prior financial statements.

4.6.10 Assessing a voluntary change in classification

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 voluntary 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]

See sections 3.3 and 6.2 of KPMG Handbook, [Accounting changes and error corrections](#).



Question 4.6.10

How is a change in the classification of a cash flow item treated?

Interpretive response: We believe a change in an acceptable classification (i.e. as **operating**, **investing** or **financing**) of a cash flow item to another acceptable classification should be assessed in accordance with Topic 250.

If an entity changes the classification of a cash flow item, it recasts its prior-period statement of cash flows (if presented), and use the new classification for the comparative periods. The notes to the financial statements also disclose the classification change. See sections 3.3 and 3.5 in KPMG Handbook, [Accounting changes and error corrections](#). [250-10-45-5, 50-1]

4.6.20 Accounting for a change in accounting principle

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

Retrospectively presenting 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 recognized 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 4.6.20

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.

4.6.30 Evaluating an error in classification



Excerpt from SEC staff speech

“The statement of cash flows has consistently been a leading area of restatements, and we have observed that a significant majority of these restatements represent prior period errors corrected in the current period comparative financial statements, or what are referred to colloquially as “little r” restatements. This indicates that issuers... are routinely making a determination that errors in the statement of cash flows do not constitute a material error in prior periods..... conclude an error in the statement of cash flows is not material because it is an error in classification only. We have not found such analyses and their corresponding arguments persuasive since classification itself is the foundation of the statement of cash flows.

Paul Munter, SEC Chief Accountant, The Statement of Cash Flows: Improving the Quality of Cash Flow Information Provided to Investors (December 4, 2023)
– See [Appendix](#).



Question 4.6.30

How is an error in the classification of a cash flow item treated?

Interpretive response: An entity should evaluate errors in classification in the statement of cash flows in the same manner as errors in any other financial statement, as noted in an SEC speech (see [Appendix](#) for full remarks). Since the statement of cash flows is centered on classification, an argument that an error is not material because it only affects classification is not persuasive, but, as with other errors, the evaluation should consider the total mix of information available to the user. [2023 AICPA Conf]

See chapter 4 in KPMG Handbook, [Accounting changes and error corrections](#).

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]

- purchases of PP&E with unpaid costs accrued within accounts payable (see [section 8.2.30](#));
- exchanges of nonmonetary assets;
- transfers between held-to-maturity or available-for-sale and trading portfolios that result in a noncash transfer between investing and operating activities (see [Question 9.2.70](#));
- reinvestment of dividends and distributions for investment companies;
- the initial recording of an asset retirement obligation;
- issuance of equity securities to retire debt, including conversion of debt or preferred shares to common shares (see [Question 12.3.75](#));
- acquisition of assets by assuming liabilities (including obtaining a ROU asset in exchange for a lease liability – see [Questions 14.2.20](#) and [14.2.30](#)) or by issuing equity securities;
- issuance of shares in exchange for goods or services (see [Questions 16.2.10](#) and [16.3.30](#));
- 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 (see [Question 18.2.10](#)).

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]

At the 2024 AICPA & CIMA Conference on Current SEC and PCAOB Developments, Paul Munter, SEC Chief Accountant, highlighted the importance of the statement of cash flows and related cash and noncash disclosures to investors, urging preparers and auditors to provide the same quality focus as they do for other components of financial statements. [[2024 AICPA Conf](#)]

5. Interim reporting

Detailed contents

5.1 How the standard works

5.2 General interim reporting requirements

Questions

- 5.2.10 What periods does an SEC registrant present in its interim statement of cash flows?
- 5.2.20 May a public entity present quarterly statements of cash flows in a registration statement?
- 5.2.30 May an SEC registrant abbreviate its interim statement of cash flows?
- 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?

Example

- 5.2.10 Interim statements of cash flows

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

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New item added in this edition: **

Item significantly updated in this edition: #

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6. Cash, cash equivalents and restricted cash

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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 |
|---|--|--|
| <p>Funds that may be deposited or withdrawn at any time without prior notice or penalty for withdrawal.</p> <p>Examples include:</p> <ul style="list-style-type: none"> — currency on hand — demand deposits — negotiable instruments on hand, such as: <ul style="list-style-type: none"> – money orders – certified checks – cashier's checks – personal checks – bank checks. | <p>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.</p> <p>Examples include:</p> <ul style="list-style-type: none"> — US Treasury bills* — certificates of deposit* — commercial paper* — registered money market funds — federal funds sold (for an entity with banking operations)*. <p>*with original maturity of less than three months</p> | <p>Cash and cash equivalents that are restricted for withdrawal or use.</p> <p>Restrictions include:</p> <ul style="list-style-type: none"> — 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. We believe 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](#)). [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, we believe 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, including:

- cash collateral posted for derivative contracts
- cash pledged as collateral for securities sold short
- unrestricted cash
- other general funds.

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 the definition of 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 (e.g. 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 when:

- the entity has the ability (through rights it holds) to direct the payments of the funds, including the ability to invest the funds before their disbursement, even if the ability to invest is limited to specific asset classes through contractual or regulatory restrictions; and
- the entity benefits from the resulting investment income, including through the ability to share the investment income with third parties.

We would expect the ability to direct the payments of the funds to exist when the funds are held in an account that is in the name of the entity, although it may also exist when the funds are held in an account designated as 'for the benefit of' or 'on behalf of' another party.

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 the SEC staff has expressed in comment letters to registrants. 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.

If the entity makes temporary investments using funds held for others, we believe the associated cash flows (from/for sales and purchases) should be

presented separately from the changes noted above and classified as cash flows from **investing** activities (provided the investments are not cash equivalents).

Cash receipts and payments are reported gross, unless they qualify for net reporting under the criteria detailed in [section 3.5](#). [230-10-45-7 – 45-8]

Entity does not have control over the funds

If the entity does not have control over the funds, it does not recognize them as an asset. 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?



Excerpt from ASC 210-20

> Implementation guidance

- > Other considerations

55-18A Cash on deposit at a financial institution shall be considered by the depositor as cash rather than as an amount owed to the depositor.

Interpretive response: No. Cash overdrafts are excluded from cash as presented on the balance sheet and in the statement of cash flows. Instead, they are presented on the balance sheet as described below.

Bank overdrafts

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]

Additionally, to determine if a bank overdraft exists, positive and overdrawn accounts with the same bank cannot be offset. If the bank would allow the offset (e.g. through an overdraft protection feature), this would already be reflected in the account balance. Cash on deposit at a bank is considered cash

by the depositor, not as an amount owed by the bank to the depositor (i.e. it is not a receivable). Conversely, accounts in an overdraft position are considered amounts owed to the bank (a liability). [210-20-55-18A]

Book overdrafts

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 current 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.

Additionally, to determine if a book overdraft exists when an entity has accounts with positive balances with the same bank, we believe the right of offset among the accounts should be considered.

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]



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.

6.2.30 Centralized cash management arrangements (cash pools)

Large organizations often maintain centralized cash management arrangements to effectively manage liquidity across multiple legal entities, jurisdictions and currencies. These arrangements can take different forms but generally have in common that each participating entity maintains its own bank account with the same bank in its respective jurisdiction(s), where it can deposit or withdraw funds in local currency. Each individual bank account can be in a cash positive position or a cash negative position (overdraft).

One entity within the organization is responsible for the centralized cash management function and operates as the treasury function (can be the parent, a regional or a finance subsidiary; i.e. the 'cash management entity'). Centralized cash management arrangements fall into two broad categories: physical cash pools and notional cash pools.

Physical cash pooling arrangement

In a physical cash pooling arrangement (also known as zero balancing), excess cash generated by a participating entity is physically swept periodically (e.g. daily wire transfer) from the participating entity's bank account into a centralized cash pool and the participating entity's cash requirements are met through withdrawals or borrowings from that pool. Usually, the cash pool is invested in bank deposit accounts in the cash management 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 across the organization.

Because funds move across jurisdictions, physical cash pools necessitate intercompany accounting, may create foreign currency gains and losses and may have tax consequences.

Notional cash pooling arrangement

In a notional cash pooling arrangement, there is typically no physical movement of funds among the accounts or physical comingling of funds, and the legal and tax separation of the individual bank accounts within the pool is maintained. While some participating entities make a physical temporary transfer of positive cash positions to offset overdraft positions on a periodic basis, the previous positions are reestablished shortly thereafter to avoid potential legal or tax implications of comingling of funds across various jurisdictions.

The bank computes a net notional position by currency, by combining all the participant accounts in that currency. The cash management entity will typically create an overdraft position in its account to invest the net notional balance in an overnight investment vehicle or for other liquidity needs of the organization.



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 (i.e. participating entity) 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 (i.e. cash management 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 to, 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

Can positive and negative balances in a centralized cash management arrangement be presented net in a subsidiary's stand-alone financial statements?

Interpretive response: It depends. When assessing whether negative and positive balances resulting from a centralized cash management arrangement can be netted, we believe a subsidiary (i.e. participating entity) should consider the following:

- the contractual terms of the arrangement;
- the nature of the balances (e.g. cash, cash equivalents, receivables); and
- whether a legal right of offset exists. Offsetting of cash overdrafts is discussed in [Question 6.2.40](#); general offsetting guidance under Topic 210 is discussed in section 3.4 of KPMG Handbook, [Financial statement presentation](#).

This assessment is performed independently from the assessment performed by the parent for presentation of these balances in its consolidated financial statements.

If, after considering the legal right of offset, one or more of the subsidiaries' cash balances is overdrawn, the subsidiary presents the overdraft position as a liability on its balance sheet. The classification in the statement of cash flows follows [Question 6.2.50](#).



Question 6.2.75

Can positive and negative balances in a notional pooling arrangement be presented net in the parent's consolidated financial statements?

Background: The FASB discussed the presentation of a notional pooling arrangement in the parent company's consolidated financial statements at its December 16, 2015 meeting. During that meeting, the FASB staff indicated that it understands there is diversity in practice in this area, whereby some present the cash deposit and overdraft balances gross on the balance sheet while others present them net. Despite the diversity in practice, the Board unanimously agreed not to address the issue.

Interpretive response: Generally, no. In its consolidated financial statements, we believe a parent should take a legal and ownership view and present gross

the amounts owed to and from the bank by the participating entities and the cash management entity in a notional pooling arrangement. Subtopic 210-20 states that positive and overdrawn accounts cannot be offset even if they are with the same bank (see [Question 6.2.40](#)). We believe this guidance applies in the context of a notional pooling arrangement because the accounts remain in the name of different legal entities, even though the balances are under the same contractual arrangement. [210-20-55-18A]

In the consolidated financial statements, those individual bank accounts that are positive should be reflected as *cash* while those individual bank accounts that are negative should be reflected as *a liability* – which is identical to how each entity presents its individual bank account in its stand-alone financial statements (see [Question 6.2.40](#)). This would include the account of an entity that created an overdraft position in its account to invest the net notional balance into an overnight investment.

We understand that an alternative view that these amounts can be presented net has led to the diversity in practice, considering that a notional pooling arrangement functions like a master netting arrangement. This alternative view may have been developed because the gross presentation in the consolidated financial statements is thought to overstate the amount of cash readily available for immediate use (see [Example 6.2.05](#)).

While we believe presenting notional pooling arrangements on a gross basis in the consolidated financial statement is supported under current literature, given the fact that the FASB recognized the diversity in practice and decided not to address that diversity, we would not object if an entity that has a historical practice of presenting notional pooling arrangements on a net basis in the consolidated financial statements continues to follow this presentation practice.

We believe the presentation approach applied should be disclosed. Additionally, the notes to the stand-alone and consolidated financial statements should explain the details of the notional pooling arrangement and its effect on the balance sheet (including the restrictions for any cash accounts), the income statement (if applicable), and the statement of cash flows.



Example 6.2.05

Notional pooling arrangement – gross presentation

US Parent has four foreign subsidiaries in a notional pooling arrangement. For illustrative purposes, this example ignores the fact that each of the individual bank accounts in the pool can be in a different foreign currency. At the reporting date, these four subsidiaries had the following bank account balances.

| | |
|---------------------------------|-----------------|
| Subsidiary 1 | EUR1,000 |
| Subsidiary 2 | EUR5,000 |
| Subsidiary 3 | (EUR2,000) |
| Subsidiary 4 | - |
| Total net cash available | EUR4,000 |

Given the net cash available of EUR4,000, Subsidiary 4 (cash management entity) takes on an overdraft position by withdrawing EUR4,000 to purchase a security.

Under the gross presentation approach discussed in [Question 6.2.75](#), the consolidated financial statements of US Parent present the following.

| Assets | |
|------------------|----------|
| Cash | EUR6,000 |
| Securities owned | EUR4,000 |
| Liabilities | |
| Bank borrowings | EUR6,000 |

Typically, the bank would not provide access to the EUR6,000 of cash in the bank accounts of Subsidiaries 1 and 2 to any party to the notional pooling arrangement due to the EUR6,000 of overdrafts in the accounts of Subsidiaries 3 and 4. From a practical standpoint, the parties to the notional pooling arrangement have no cash position and no overdrafts.



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 that is a participating entity may conclude the balance that results from a centralized cash management arrangement (where the parent is the cash management entity) 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 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 (cash management entity) maintains a centralized cash management arrangement, or cash pool, with certain of its operating subsidiaries (participating entities). 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: In our experience, centralized cash management arrangements are generally presented net in the statement of cash flows.

Most centralized cash management arrangements require that funds are due on demand. Therefore, the cash management entity acts like a bank to the participating entities – holding and disbursing cash on the participating entities' behalf and the balance is presented net.

As discussed in [section 3.5](#), cash receipts and payments can be reported on a net basis in limited circumstances, such as when the entity is substantively holding or disbursing cash on behalf of its customers – e.g. customer demand deposits of a bank. [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).

Topic 230 does not define 'readily convertible to known amounts of cash', but the concept of readily convertible to cash is discussed in Topic 815 (derivatives); see [section 3.5.40](#) of KPMG Handbook, [Derivatives and hedging](#). [815-10 Glossary]

The characterization of an investment as a cash equivalent does not affect its measurement, which is based on the form of the instrument, nor the required disclosures as applicable under other topics – e.g. fair value disclosures under Topic 820, see [Question 2.2.50](#) in KPMG Handbook, [Investments](#). KPMG Handbook, [Fair value measurement](#), discusses Topic 820 requirements. [230-10-50-1, 55-12, 55-18, 820-10-50-2E]



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, 55-12, 55-18]



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, CAQ 07/2008]



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 but aims to maintain a stable net asset value (NAV). 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.

In the US, money market funds are governed by Rule 2a-7 of the Investment Company Act of 1940 (registered money market funds), which defines the attributes of registered money market funds.

Generally, registered money market funds maintain a constant per-share NAV (usually \$1 per share) by adjusting the periodic interest rates paid to investors. Further, investors can generally make withdrawals on short notice without incurring a penalty. However, these general features may be subject to exceptions.

Over the years, the SEC has adopted varying rules designed to reduce the risk of investor runs on registered money market funds during periods of market stress. To improve the resiliency and transparency of money market funds, amendments were made to the Investment Company Act of 1940 that may, for example: [[Investment Company Act of 1940, Rule 2a-7x](#)]

- increase minimum liquidity requirements;
- require certain funds to impose a liquidity fee; and
- grant or remove the ability for funds to suspend redemptions temporarily (i.e. gate) if liquidity falls below a threshold.

Outside of the US, money market funds are generally required to follow the local regulations of their governing jurisdictions, which may vary greatly across

jurisdictions. Non-registered money market funds that are not subject to the SEC's rules require analysis to determine classification as a cash equivalent based on the individual attributes of the fund, such as the investment objectives, risk of changes in value, liquidity and any restrictions on withdrawal (see [Question 6.3.65](#)).



Question 6.3.60

Do registered 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 in its scope. Therefore, we believe registered money market funds generally meet the definition of cash equivalents. 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 registered 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 6.3.65

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 non-registered cash management products.



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, we believe 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 that has the ability to impose redemption restrictions or liquidity fees would still qualify as a cash equivalent. 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 treatment of a money market fund (e.g. from cash equivalent to investment) presented?

Interpretive response: When a money market fund no longer meets the definition of a cash equivalent, or is no longer treated as such, its removal from total cash and cash equivalents is considered a cash outflow. Because the security represents an investment, the change in treatment is typically a cash outflow for **investing** activities. However, facts and circumstances may support classification as a cash outflow for **operating** activities, as discussed in [section 9.2](#). [230-10-45-13(b), 45-20]

6.3.50 Auction rate securities

Auction rate securities may be issued as debt or preferred shares. 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 shares, 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 certificate of deposit (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 | | |
| More than three months | Cash equivalent | Generally, not a cash equivalent; see further analysis below | Not a cash equivalent |

CD's maturity is three months or less

We believe a CD with a stated or effective maturity of three months or less can 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 and early withdrawal is not possible

We believe a CD with a stated maturity of more than three months and no early withdrawal feature 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.

CD's maturity is more than three months and 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 whether the loss in value to the holder is other than insignificant.

A 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.

6.3.80 Stablecoins**

While there is no universally accepted definition of 'stablecoin', the term is used throughout this section to refer to tokens designed to maintain a stable value relative to a fiat currency, most commonly the US dollar. In practice, there are three primary types of stablecoins.

- **Fiat-backed stablecoins:** These are the most common and straightforward tokens. For every stablecoin issued, a central entity (the issuer) holds an equivalent amount of reserve assets. These reserves are typically cash or other highly liquid, low-risk assets like US Treasury bills. This 1:1 backing gives holders confidence that they can redeem their stablecoin for fiat currency on demand.

- **Crypto-backed stablecoins:** These maintain a stable value, but through collateralization by other crypto assets instead of the types of reserves held for fiat-backed stablecoins. They are typically managed by decentralized smart contracts rather than by a central issuer. To account for the volatility of the underlying crypto collateral, these systems are generally 'over-collateralized' – meaning the value of the crypto assets locked in reserve is significantly higher than the value of the stablecoins issued. If the collateral's value drops, the smart contract can automatically liquidate it to maintain the stablecoin's pegged value.
- **Algorithmic stablecoins:** These are not backed by reserves; they rely on computer algorithms to maintain their stable value. Because they are generally not backed by reserve assets, they are generally at a higher risk of de-pegging than stablecoins backed by reserve assets.



Question 6.3.140

Can fiat-backed stablecoins meet the definition of a cash equivalent?

Interpretive response: Yes, but it depends on the specific nature and structure of the stablecoin. An entity (stablecoin holder) should obtain an understanding of the contractual terms of the stablecoin and the regulatory environment in which the stablecoin operates, including requirements for segregated and liquid reserves. We believe a stablecoin meets the definition of a cash equivalent if the stablecoin:

- meets the definition of a financial asset;
- is designed to maintain a 1:1 peg to a fiat currency;
- is designed to be fully backed by an equivalent amount of liquid assets, which would otherwise be considered cash equivalents; and
- either:
 - is puttable to the issuer on demand, and the issuer is obligated to redeem it for cash without significant penalty; or
 - the holder can sell it in an active market with available quoted prices for the stablecoin and that market can rapidly absorb the quantity held by the entity without significantly affecting the price.

The SEC staff has not objected to the classification of a US dollar-pegged stablecoin as a cash equivalent, in a fact pattern whereby the following exist. [\[AICPA Conf 2025\]](#)

- A specific agreement with the stablecoin issuer, separate from the general terms and conditions of the issuer, provides the holder a guaranteed 1:1 redemption of the stablecoin to US dollars within two business days.
- The issuer is subject to regulation that requires all stablecoin issued to be fully backed by an equivalent amount of specified liquid assets, limited to financial instruments that otherwise would be considered cash equivalents.

The characterization of stablecoin as a cash equivalent does not affect its measurement, which is based on the form of the instrument, or the required disclosures related to the instrument as applicable under other Topics.

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]



Question 6.4.05

Are transfers between unrestricted and restricted cash balances presented in the statement of cash flows?

Interpretive response: No. Transfers between unrestricted and restricted cash balances are not presented as cash flows from operating, investing or financing activities in the statement of cash flows. Both unrestricted and restricted cash balances are included in the total cash and cash equivalents in the statement of cash flows. [230-10-45-4 – 45-5]



Question 6.4.08

How are unrestricted and restricted cash balances classified in a classified balance sheet?

Interpretive response: In a classified balance sheet, unrestricted cash balances are typically classified as current assets. Restricted cash balances are typically classified as noncurrent unless the restrictions are for short-term use – for example, the restricted cash balances offset maturing debt that has properly been classified as a current liability (see [section 6.4.20](#) for guidance on identifying restricted cash). For additional information about balance sheet classification, see section 3.3 of KPMG Handbook, [Financial statement presentation](#).

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?

Interpretive 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, 55-18A]

| | 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.

6. Cash, cash equivalents and restricted cash

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

Item significantly updated in this edition: #

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Example

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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.

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](#).



Question 7.2.15

How are changes in the allowance for credit losses on receivables presented?

Interpretive response: The change in allowance for credit losses on receivables is a noncash item recorded through net income in the current period. It is included as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see [section 3.2](#)). [230-10-45-16(a), 45-28 – 29]

Topic 230 does not provide guidance on whether the change in allowance should be presented separately or netted with the change in receivables. However, Topic 230 provides an example statement of cash flows that presents the change in allowance separately from the change in receivables. [230-10-55-13]

In our experience, there is diversity in practice in this area. Many entities present the change in allowance separately from the change in receivables. We believe this presentation is best practice, as it is consistent with the Topic 230 example – this approach is illustrated in [Example 7.2.10](#). However, given the diversity in practice, and the lack of guidance, we believe presenting the change in allowance together with the change in receivables is also acceptable.



Example 7.2.10#

Trade accounts receivable and allowance for credit losses

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 \$325,000. Product P is delivered to Customer at the time of sale; however, Customer will pay ABC for Product P in 90 days (i.e. on March 15, Year 2). The cost of Product P to ABC is \$200,000. ABC records an allowance for credit losses of \$25,000 associated with the receivable.

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 | |
| Allowance for credit losses | 25 |
| Change in assets and liabilities: | |
| Increase in accounts receivable | (325) |
| Decrease in inventory | 200 |
| Net cash provided by (used in) operating activities | \$ - |
| Note: | |
| 1. Revenue of \$325 less cost of goods sold of \$200, and credit loss expense of \$25. | |

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 | |
| Allowance for credit losses | (25) |
| Change in assets and liabilities: | |
| Decrease in accounts receivable | 325 |
| 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 9.2.20](#)). [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 upfront 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.

| <i>\$'000s</i> | |
|---|-------------|
| 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.

| <i>\$'000s</i> | |
|---|----------------|
| 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 upfront payment classified?

Interpretive response: It depends on whether the entity expects to refund the upfront (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 [Question 14.3.30](#)).

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 upfront payment

On December 15, Year 1, ABC Corp. enters into a contract to sell Product P to Customer for an upfront 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 upfront 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 one year or less. [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. [230-10-45-28(b)]



Question 7.4.30

How are cash flows for costs of implementing cloud computing arrangements classified by the customer?

Background: 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) aligns with one that does. A 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. For an in-depth understanding of the requirements for cloud computing arrangement implementation costs in Subtopic 350-40, see KPMG Handbook, [Software and website costs](#).

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. [230-10-45-28(b)]



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?

Interpretive response: A broadcaster licensee classifies cash payments to purchase the rights acquired under a license agreement for program material 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

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Item significantly updated in this edition: #
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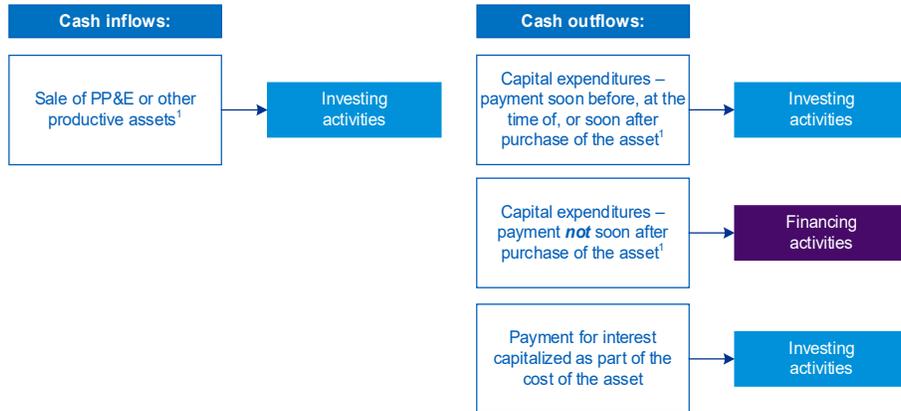
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8.1 How the standard works

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](#)). For example, if real estate is acquired by a real estate developer to be subdivided, improved, and sold in individual lots, then the cash payment to purchase that real estate would be classified as an **operating** cash outflow because the real estate is acquired specifically for resale and is similar to inventory in other businesses. [970-230-45-1]

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-use 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 <i>not</i> soon before purchase | investing activities [230-10-45-13(c)] |
| Payments after, but <i>not</i> 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]



Question 8.2.17#^^

How are cash flows for the cost of purchasing or developing external-use software classified?

Background: The costs of software to be sold, leased or otherwise marketed (i.e. 'external-use software') that is acquired in an asset purchase (i.e. not a business combination) or internally developed are either (1) expensed as incurred as an R&D cost, or (2) capitalized, depending on the facts and circumstances. See sections 5.2.10 and 5.3.30 in KPMG Handbook, [Software and website costs](#). [985-20-25-8 – 25-10; 55-13 – 55-14]

Interpretive response: It depends on whether the costs must be expensed when incurred or capitalized, and if the latter, why the costs are being capitalized.

Costs required to be expensed when incurred

If the software costs are required to be expensed as an R&D cost when incurred, we believe the cash outflows should be classified in the same manner as described in [Question 8.2.15](#) for an R&D asset or IPR&D with no alternative future use.

Software capitalized because technological feasibility is established

If the software costs are capitalized because technological feasibility has been established (see section 5.2.10 in KPMG Handbook, [Software and website costs](#)), we believe the cash outflows for the costs should be classified as **investing** activities. This is because Subtopic 985-20 states that capitalized software in its scope is an 'amortizable intangible asset', and such software will

usually qualify as a 'productive asset' (see [Question 8.2.05](#)) – e.g. the company's ownership of or rights to the software will permit the company to create and sell licenses to the software to others. [985-20-45-2]

However, we have observed some entities classify cash outflows for capitalizable costs of external-use software as **operating** activities. In the absence of any further guidance from the FASB or the SEC staff, we believe this classification is also acceptable given the parallels drawn by the FASB in FASB Statement No. 86 (which was ultimately codified as Subtopic 985-20) between capitalized external-use software costs and inventory costs, especially when the software will – akin to a raw material – form an integral part of a tangible product. [FAS 86.44, 48]

Software capitalized based on alternative future use

If technological feasibility of acquired external-use software has not yet been established, but the software has an alternative future use, we believe classification of the cash outflows for the purchase depends on the alternative future use(s) identified. Specifically, an entity's cash flow classification based on the software's alternative future use could differ from the classification that would apply if technological feasibility is established.

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 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 (see [Question 8.2.30](#)).

 **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.

| | |
|--|----------------|
| <i>\$’000s</i> | |
| 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.

| | |
|--|--------|
| <i>\$'000s</i> | |
| 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)

In some cases, capital expenditures are financed through a lending arrangement with a third-party unaffiliated with the vendor. This may affect the presentation of the corresponding cash flows.

 **Question 8.3.10**
How are cash flows for capital expenditures financed by a third-party lender classified?

Interpretive response: When a buyer finances capital expenditures through a third-party lender unaffiliated with the vendor, the following presentation applies.

When financing is obtained

| | |
|---|---|
| If the lender remits payment to the buyer and the buyer pays the vendor | Present: <ul style="list-style-type: none"> — Cash inflow from financing activities (proceeds from 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 the classification of payments remitted directly from a third-party lender to the vendor and in our experience, there is diversity in practice in buyers' cash flow statement presentation for such transactions. We believe the predominant and preferred approach is for the buyer to present the transaction as a constructive receipt and disbursement (see section 4.7.10): <ul style="list-style-type: none"> — Cash inflow from financing activities (proceeds from 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)] Alternatively, some buyers present such transactions as noncash activities, which we believe is also acceptable. In that case the buyer discloses: [TQA 1300.19, 230-10-50-3] <ul style="list-style-type: none"> — Noncash investing activity (purchase of PP&E or other productive asset) — Noncash financing activity (issuance of debt) |

When financing is repaid

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.

| | |
|--|---------------|
| <i>\$’000s</i> | |
| 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.

Although there was no direct cash exchange between ABC and Vendor, ABC observes that Bank paid Vendor on its behalf and the transaction achieves the same economic outcome as if ABC had paid Vendor. Therefore, the transaction creates constructive cash flows. ABC concludes it is appropriate to present its statement of cash flows as illustrated in [Example 8.3.10](#), i.e. as if it had received the funds from Bank and remitted the funds to Vendor directly.

Alternatively, ABC can present the transaction as **noncash** activities (see [Question 8.3.10](#)).

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.

| <i>\$'000s</i> | |
|---|--------------|
| 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 [section 14.3.20](#)). 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)]

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

New item added in this edition: **

Item has been moved in this edition: ^^

9.1 How the standard works

9.2 Debt and equity securities

- 9.2.10 Overview **
- 9.2.20 Debt securities ^^
- 9.2.30 Equity securities ^^
- 9.2.40 Other presentation considerations ^^

Questions

- 9.2.05 How do investment companies classify purchases and sales of investments? **
- 9.2.10 How are cash flows from/for trading securities classified?
- 9.2.15 How is a change in allowance for credit losses presented?
- 9.2.20 How are cash flows from/for purchases and sales of equity securities classified?
- 9.2.30 [Not used]
- 9.2.40 Can purchases and sales of investments be presented on a net basis?
- 9.2.50 Can purchases and sales of alternative investments be presented on a net basis?
- 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?
- 9.2.70 How are transfers between investment categories presented?
- 9.2.80 How are interest and dividend income earned on investments classified?
- 9.2.90 How are unrealized gains (losses), including impairment or changes in the allowance for credit losses, on investments presented?
- 9.2.95 How are realized gains (losses) on investments classified when an entity classifies cash flows from investments as investing activities?
- 9.2.100 How are periodic cash receipts in excess of interest income from a debt security purchased at a premium classified?

9.2.110 How are settlement proceeds from a debt security purchased at a discount classified?

9.3 Equity method investments

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

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

9.3.30 [Not used]

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

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

Example

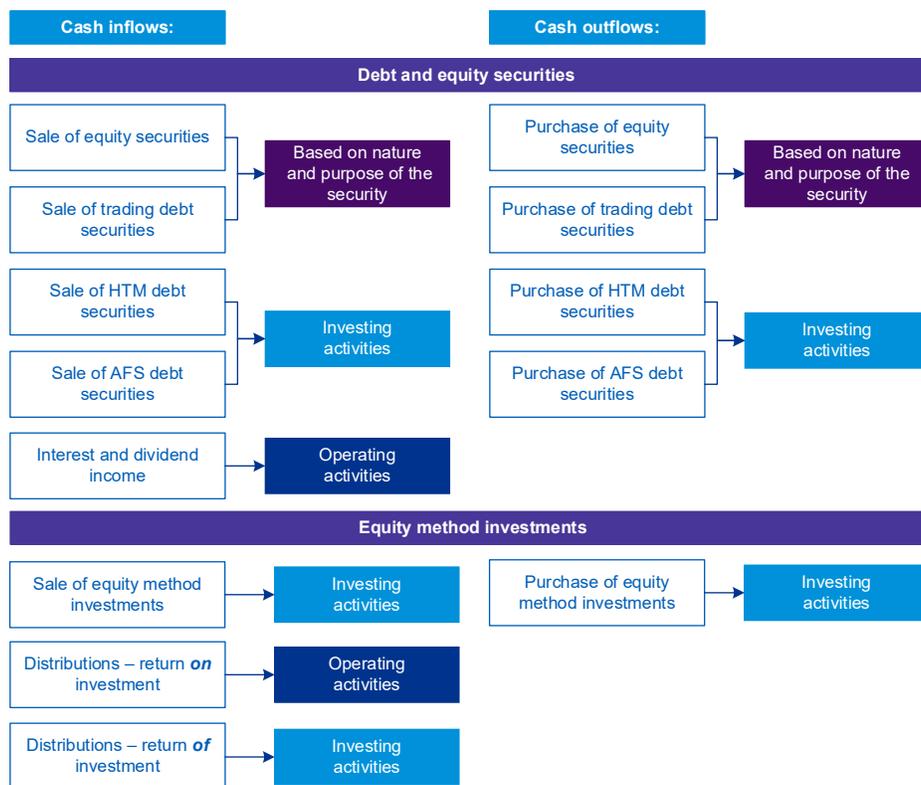
9.3.10 Cumulative earnings approach

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 Overview**



Excerpt from ASC 230-10

> Classification

- > Acquisitions and Sales of Certain Securities, Loans, and Crypto Assets

45-18 Banks, brokers and dealers in securities, and other entities may carry securities and other assets in a trading account. Characteristics of trading account activities are described in Topics 255 and 940.

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 and 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.

45-20 Cash receipts and cash payments resulting from purchases and sales of other securities and other assets shall be classified as operating cash flows if those assets are acquired specifically for resale and are carried at **fair value** in a trading account.

Topic 230 specifically addresses the classification of securities that are:

- classified as trading debt securities accounted for under Topic 320 (debt securities) – see [section 9.2.20](#);
- equity securities accounted for under Topic 321 (equity securities) – see [section 9.2.30](#); and
- other securities acquired specifically for resale and carried at fair value in a trading account.

Topics 320 and 321 provide additional guidance for debt and equity securities in their respective scopes. These Topics, however, do not apply to entities in certain specialized industries, that account for substantially all investments at fair value. Examples of those entities are:

- brokers and dealers in securities (Topic 940);
- defined benefit pension, other postretirement, and health and welfare plans (Topics 960, 962, and 965); and
- investment companies (Topic 946).

Further, Topic 321 does not apply to equity investments in consolidated subsidiaries and investments accounted for under the equity method. Cash flows from/for purchases and sales of such investments are further discussed in [chapter 18](#) and [sections 19.4](#) and [9.3](#).



Question 9.2.05**

How do investment companies classify purchases and sales of investments?

Interpretive response: Investment companies are excluded from the scope of Topics 320 and 321. However, because investment companies' activities consist of generating returns from investment income, capital appreciation, or both, we believe it is acceptable for an investment company to classify cash flows from investment transactions as cash flows from **operating** activities. [946-10-15-6]

We believe this is consistent with widespread industry practice to classify an investment company's investing activities as cash flows from **operating** activities. [AAG-INV 7.163, TQA 6910.26]

For more guidance on the statement of cash flows of investment entities, see sections 9.2 and 9.3 in KPMG Handbook, [Investment companies](#).

9.2.20 Debt securities^^



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, 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 |
|--|---|---|
| <p>Debt security defined or designated as trading – Debt security acquired with the intent of selling it within hours or days.</p> <p>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)]</p> | <p>Fair value through earnings [320-10-45-1(a)]</p> | <p>Based on nature and purpose for which the security was acquired (see Question 9.2.10) [230-10-45-19, 320-10-45-11]</p> |
| <p>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)]</p> | <p>Amortized cost [320-10-45-1(c)]</p> | <p>investing activities [320-10-45-11]</p> |
| <p>Available-for-sale debt security – Debt security not designated as trading security or as held-to-maturity security. [320-10-25-1(b)]</p> | <p>Fair value through OCI [320-10-45-1(b)]</p> | <p>investing activities [230-10-45-11, 320-10-45-11]</p> |

 **Question 9.2.10**
How are cash flows from/for trading securities classified?

Interpretive 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]

 **Question 9.2.15**
How is a change in allowance for credit losses presented?

Interpretive response: The change in allowance for credit losses for held-to-maturity and available-for-sale debt securities is 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 it is a noncash item recorded through net income in the current period. [[230-10-45-28\(b\)](#)]

9.2.30 Equity securities^^



Excerpt from ASC 230-10

- > Acquisitions and Sales of Certain Securities, Loans, and Crypto Assets

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 shares 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 with a readily determinable fair value are measured at fair value with changes in fair value recorded through net income. However, for equity securities without a readily determinable fair value, an entity may elect the measurement alternative and measure the equity security at cost minus impairment +/- fair value adjustments when there are observable prices. Once elected, the measurement alternative is applied until the equity security no longer qualifies for it. [[321-10-35-2](#)]

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?

Interpretive 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](#).

9.2.40 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 9.2.20](#)).



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?

Interpretive 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), including impairment or changes in the allowance for credit losses, on investments presented?

Interpretive 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 9.2.20](#)) or equity securities for which the measurement alternative is not elected (see [section 9.2.30](#)). [230-10-45-28(b)]

The following changes are also noncash items recorded through net income and reported as noncash reconciling items in the reconciliation of net income to net cash flows from **operating** activities (see [section 3.2](#)): [230-10-45-28(b)]

- change to the carrying amount of equity securities without a readily determinable fair value for which the measurement alternative has been elected; and
- change in allowance for credit losses, whether due to impairment or other factors.



Question 9.2.95

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

Interpretive 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: When a debt security is purchased at a premium over par value, the periodic cash receipts for interest exceed the amount recognized as interest income. This is 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.



Question 9.2.110

How are settlement proceeds from a debt security purchased at a discount classified?

Background: When a debt security is purchased at a discount from par value, the cash amount received at maturity (settlement proceeds), which is equal to the par value, is greater than the amount invested. This discount is amortized to interest income over the holding period such that the book value at maturity is equal to the par value/amount received. The periodic cash receipts for interest are less than the amount recognized as interest income. See chapter 3 in KPMG Handbook, [Investments](#).

See [Question 12.2.10](#) for a discussion of debt discounts.

Interpretive response: Topic 230 provides guidance on how a debt issuer classifies the cash settlement of debt issued at a discount (see [Question 12.2.70](#)); however, it does not address how the holder classifies the corresponding proceeds. In our experience, there is diversity in practice in this area. We believe there are two acceptable approaches to classify settlement proceeds from such investments.

Approach 1: Always bifurcate settlement proceeds

The settlement proceeds are bifurcated as follows (see [section 4.5](#) for additional guidance on transactions with more than one class of cash flows). [230-10-45-22, 45-12(a), 45-16(b)]

- Proceeds up to the amount invested are a return of the investment and classified as cash flows from **investing** activities.
- Proceeds in excess of the amount invested are considered a return on the investment and classified as cash flows from **operating** activities.

Approach 2: Analogize to Topic 230 guidance for debt issuers

Under this approach, the holder of the debt security first needs to determine if the coupon rate is either zero or insignificant in relation to the effective interest rate of the security – i.e. deeply discounted. See [Question 12.2.90](#).

- If the debt security is deeply discounted, then similar to Approach 1, the settlement proceeds are bifurcated. Proceeds up to the amount invested are a return of the investment and classified as cash flows from **investing**

activities. Proceeds in excess of the amount invested are considered a return on the investment and classified as cash flows from **operating** activities.

- If the debt security is not deeply discounted, the entire proceeds are classified as cash flows from **investing** activities. [230-10-45-17(d)]

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?

Interpretive 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

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10.3 Repurchase and reverse repurchase agreements

Question

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

10. Securitizations and other transfers of financial assets

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.

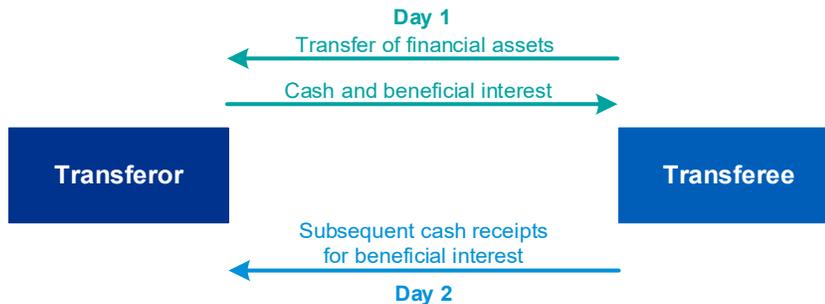
If the transferor does not consolidate the transferee under Topic 810 (consolidation), the transfer of financial assets is then evaluated under Topic 860 to determine if sale accounting has been achieved.



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: We believe 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 the majority of the cash flows.

Lender retains majority of the cash flows

If a lender intends to securitize loans but still retains the *majority* (i.e. greater than 50%) 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 does not retain majority of the cash flows

A lender may intend to not retain the majority 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, we believe 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.

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. [AAG-BRD Ex 6-7]
 - 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

11.2 Lending activities

Questions

- 11.2.10 How does a lender classify cash flows from lending activities?
- 11.2.20 How are loan origination fees and costs classified?
- 11.2.30 Can loan originations and principal collections be presented on a net basis?
- 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?
- 11.2.50 How does a lender classify cash flows from prepayment penalties received?
- 11.2.60 What types of noncash investing and financing activities can occur with lending activities?

11.3 Other considerations

Questions

- 11.3.10 How are cash flows from the FDIC as part of a loss-sharing agreement classified?
- 11.3.20 How does a bank classify cash flows from customer deposits?
- 11.3.30 How does a bank disclose restrictions on cash balances?

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’.

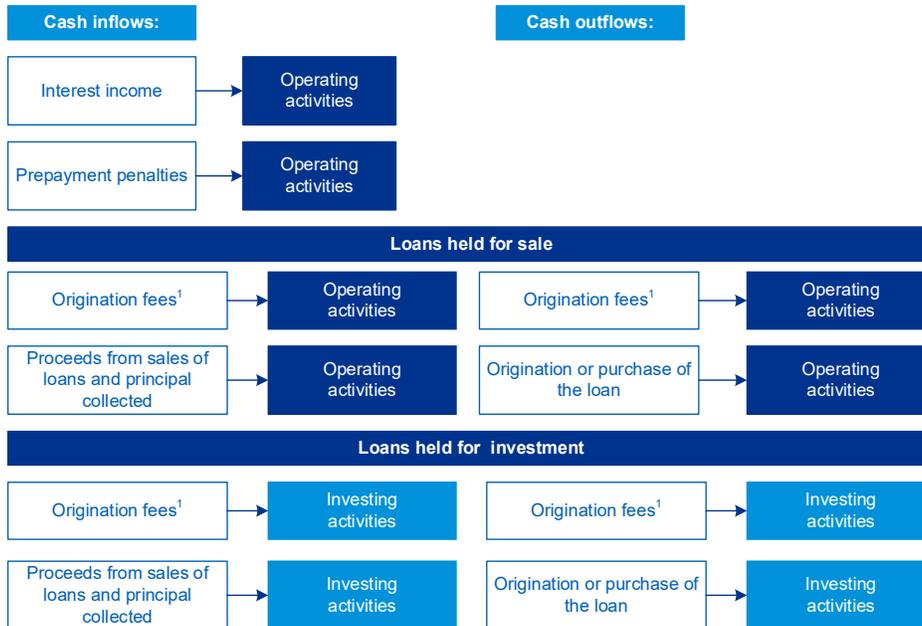
Cash flows from/for lending activities relate to the origination, purchase and sale of loans and the collection of principal on those loans. In addition to the loan itself, related cash receipts and payments usually occur for interest and prepayment penalties, and origination fees and costs.

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, Loans, and Crypto Assets

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 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), AAG-DEP 6.28]

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), AAG-DEP 6.19]

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.6.22]

- 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, AAG-DEP.6]

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. [\[942-210-50-1, AAG-DEP.6\]](#)

12. Debt financing transactions for debtors

Detailed contents

New item added in this edition: **

Item significantly updated in this edition: #

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12.2 Issuance and repayment of debt

- 12.2.10 Overview
- 12.2.20 Issuance of debt
- 12.2.30 Amortization of debt discounts/premiums and issuance costs
- 12.2.40 Repayment of principal and interest

Questions

- 12.2.10 How does the issuance of debt at a discount or premium affect the statement of cash flows?
- 12.2.20 How are proceeds from the issuance of debt with conversion features, options or warrants classified?
- 12.2.30 How are cash flows for debt issuance costs classified?
- 12.2.40 How are cash flows from/for creditor fees classified?
- 12.2.50 How are cash flows for creditor fees paid to a third-party intermediary classified?
- 12.2.60 How does negative amortization of debt affect the statement of cash flows?
- 12.2.65 How is the amortization of debt premium presented?
- 12.2.70 Should the settlement payment for a discounted bond be bifurcated between interest and principal?
- 12.2.80 [Not used]
- 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?

Examples

- 12.2.10 Debt at a discount – issuance
- 12.2.12 Debt at a premium
- 12.2.15 Debt at a discount but not deeply discounted
- 12.2.20 Zero-coupon bond – settlement at maturity

- 12.2.30 Zero-coupon bond – repurchase before maturity
- 12.2.40 Settlement of debt and accrued interest at maturity
- 12.2.50 Paid-in-kind (PIK) debt instruments
- 12.2.60 PIK construction loan

12.3 Debt restructuring

- 12.3.10 Overview
- 12.3.20 Debt modification
- 12.3.30 Debt extinguishment
- 12.3.40 Troubled debt restructuring

Questions

- 12.3.10 How are cash flows for debt restructuring classified? #
- 12.3.20 How does a nontroubled debt restructuring with no change in principal affect the debtor's statement of cash flows? #
- 12.3.25 How does an entity determine the cash flow effect of a nontroubled debt restructuring in a loan syndication? **
- 12.3.30 How does the rollover of a loan affect the debtor's statement of cash flows?
- 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?
- 12.3.50 How are cash flows for debt prepayment or debt extinguishment costs classified?
- 12.3.60 [Not used]
- 12.3.70 How does a debt extinguishment gain or loss affect the statement of cash flows?
- 12.3.75 How does the extinguishment of debt through the issuance of equity securities affect the statement of cash flows?
- 12.3.80 How does the extinguishment of debt through the transfer of property affect the statement of cash flows?
- 12.3.90 How are post-TDR payments classified?
- 12.3.100 How are fees paid as part of a TDR classified?

Examples

- 12.3.05 Refinancing treated as debt extinguishment
- 12.3.08 Refinancing in a debt syndication **
- 12.3.10 Extinguishment of debt through transfer of property
- 12.3.20 TDR – debt carrying amount exceeds total future payments post TDR (Scenario 3A)

12.4 Other financing arrangements

12.4.10 Structured payable arrangements

12.4.20 Revolving credit arrangements

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

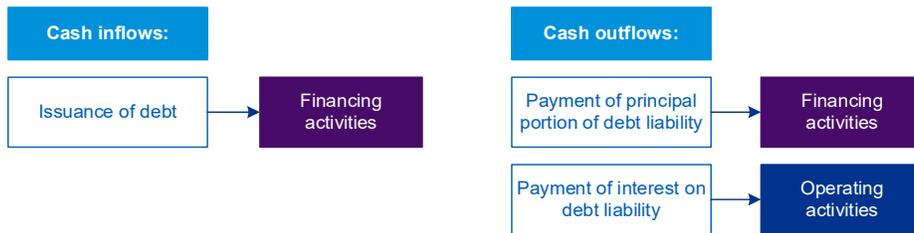
12.1 How the standard works

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]

In contrast, we believe that payments made to potential lenders in failed debt issuances are cash outflows for **operating** activities. [230-10-45-17]



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 an agent, 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.

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

| <i>\$'000s</i> | |
|---|-----------------|
| 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 activities² | \$ (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

| <i>\$'000s</i> | |
|--|-------------------|
| 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 for **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% ($3\% \div 15\%$) 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.

| <i>\$'000s</i> | |
|--|-------------------|
| 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.

| <i>\$'000s</i> | |
|--|-----------------|
| 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 (e.g. investment bankers, underwriters, or agents).

Several Subtopics apply to the accounting for debt restructuring, and each generally requires the analysis to be performed on a creditor-by-creditor basis.

- 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 troubled 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.

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](#).

See chapter 4 in KPMG Handbook, [Debt and equity financing](#) for further information on troubled debt restructurings, debt modifications and extinguishments.



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.

A debt restructuring may also involve changing the members, or the participation rate of existing members, in a loan syndicate. A loan syndicate involves a group of lenders, and a lead (agent) bank who receives fees for its role in arranging the syndicate.

See section 4.7 in KPMG Handbook, [Debt and equity financing](#), which discusses loan participations and syndications.

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 assesses whether debt extinguishment accounting applies under either Subtopic 405-20 or Subtopic 470-50. If debt extinguishment accounting 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. In instances where debt is obtained through a group of lenders, such as in a loan syndication or participation, determining whether there is a single creditor (e.g. the lead bank) or multiple creditors may require judgment. See section 4.7 in KPMG Handbook, [Debt and equity financing](#), for further guidance on making this determination.

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 . |
| <p>Note:</p> <p>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.</p> | | |



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 repayment to Bank A is accounted for as a debt extinguishment under Topics 405 and 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 the existing debt 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 12.3.25**

How does an entity determine the cash flow effect of a nontroubled debt restructuring in a loan syndication?

Interpretive response: In a loan syndication, performing an assessment on a creditor-by-creditor basis, as discussed in [Question 12.3.20](#), might result in some loans within the syndicate being accounted for as modifications, and others as extinguishments. It may also mean a new lender has joined the syndicate. We believe that the creditor-by-creditor assessment performed for accounting purposes should also be applied to the statement of cash flows, so that:

- the amounts for loans for which modification accounting has been applied (with the same creditor) without a cash flow effect (i.e. no cash paid and no proceeds received) do not need to be presented in the statement of cash flows;
- the amounts for loans for which extinguishment accounting has been applied without a cash flow effect are either disclosed as noncash activities or presented as constructive cash flows as explained in the table in [Question 12.3.20](#); and
- the amounts for loans provided by new creditors into the syndication are reflected as gross cash inflows.

Therefore, we believe it would be inappropriate to present the net cash effect, if any, of the syndication restructuring in the statement of cash flows.

Alternatively, if the creditor-by-creditor assessment results in some loans being modified and others extinguished, we believe it is also acceptable for the debtor to present the modified loans as if they had been extinguished.

[Example 12.3.08](#) illustrates cash flow presentation of a loan syndicate restructuring.



Example 12.3.08* *

Refinancing in a debt syndication

In Year 1, ABC Corp. enters into a debt syndication with Bank A (as lead bank) and Bank B (as a member of the syndicate). In Year 2, ABC restructures the debt such that Bank A increases its outstanding principal, Bank B decreases its outstanding principal and Bank C joins the debt syndication as a new lender. The table below shows the refinancing activity. For purposes of this example, assume the activity of Bank A and Bank B are determined to be modifications under Topic 470.

| <i>\$'000s</i> | Debt outstanding before refinancing | Debt outstanding after refinancing | Net change from refinancing |
|--------------------------|-------------------------------------|------------------------------------|-----------------------------|
| Bank A (lead bank) | \$ 70 | \$100 | \$30 |
| Bank B | 30 | 10 | (20) |
| Bank C | - | 50 | 50 |
| Total syndication | \$100 | \$160 | \$60 |

Because of the syndication, ABC received net proceeds of \$60 from Bank A (i.e. there was no cash transferred between ABC and Bank B or C). However, because the presentation of cash flows in a refinancing is assessed creditor-by-creditor (i.e. lender-by-lender), it would be inappropriate for ABC to present a net financing cash inflow of \$60.

Instead ABC presents the gross cash inflows and outflows from each lender. This cash flow presentation captures all cash outflows from all lenders, as a **financing** cash outflow of \$20, and all cash inflows from all lenders, as a **financing** cash inflow of \$80 (30+50).

Alternatively, ABC can present constructive cash flows as if each loan in the syndicate had been extinguished, and each creditor is providing new loans. Under this approach, ABC presents a **financing** cash outflow of \$100, and a **financing** cash inflow of \$160.



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 modification or exchange of a debt instrument does not meet the debt extinguishment criteria, the restructuring is accounted for as a debt modification. [470-50-40-9 – 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 effective 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 for **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 for **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 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]

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 it meets certain criteria. [470-50-40-6, 40-9 – 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 shares or other equity securities instead of remitting cash. This may happen because the issuer settles its obligation in a variable number of shares (i.e. share-settled debt) or debt was issued with conversion features or options. [Question 12.2.20](#) addresses how to classify proceeds from convertible debt. See chapter 10 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, 55-11, 55-15]



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.

| <i>\$'000s</i> | |
|--|-------------|
| 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 terms – i.e. no transfer of assets or equity | A. Debt carrying amount is greater than the total future payments Carrying amount of debt adjusted to the amount of total future cash payments. Gain on restructuring of debt recognized. | See Question 12.3.90 |
| | 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. $\$1,500,000 \times 9\% \div 4 = \$33,750$.

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. $\$33,750 \times 4 = \$135,000$. | |



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 expends 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

New item added in this edition: **

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13.2 Derivatives with an 'other-than-insignificant' financing element

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- 13.2.20 Does a financing element exist?
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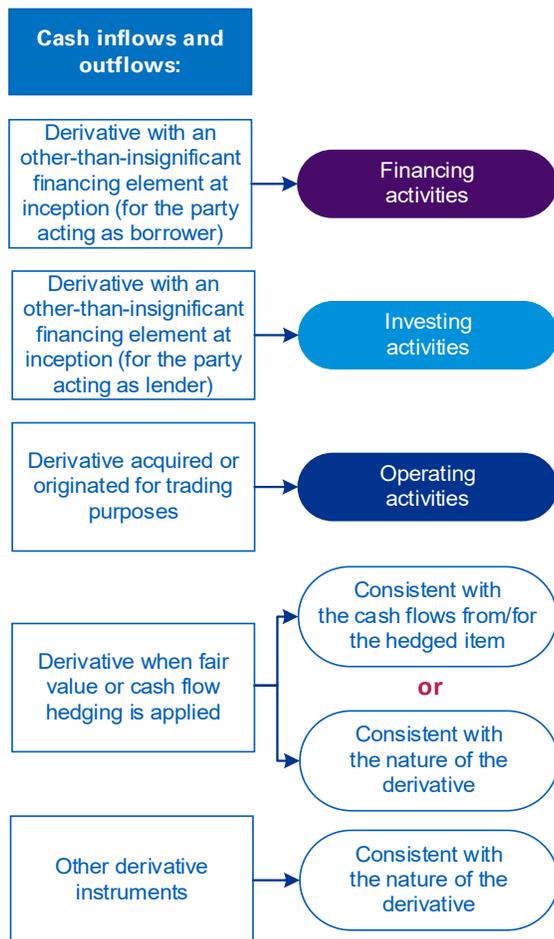
13.1 How the standard works

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 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.

See [Question 13.2.45](#) for guidance on option contracts.



Question 13.2.45

When does an option contract contain an other-than-insignificant financing element?

Background: As discussed in [Question 13.2.20](#), an option contract does not contain an other-than-insignificant financing element when the payment made at inception to the writer of the option is only for the option's time value. [815-10-45-14]

Interpretive response: At inception of the contract, if a significant amount of the purchase price of the option is related to the option's intrinsic value, judgment is required to determine whether such payment represents an other-than-insignificant financing element. Some factors to consider when making such determination include the likelihood:

- of exercise of the option; and
- that all, or substantially all, of the intrinsic value paid at inception will be returned to the purchaser of the option over the option's term.

The higher the likelihood that the option will be exercised and return the intrinsic value paid at inception to the purchaser, the more likely it is that the option contract contains an other-than-insignificant financing element.



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](#)).

Therefore, we believe it would be inappropriate for a lender to classify any amounts paid upfront as a financing cash outflow, even if the derivative instrument (e.g. option) is purchased as part of a debt transaction. Instead, if there is an other-than-insignificant financing element, the amounts paid upfront and all subsequent cash flows under the derivative instrument would be classified as cash flows from **investing** activities.



Example 13.2.40

Interest rate swap with an other-than-insignificant financing element – borrower's perspective

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 upfront 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.



Example 13.2.50

In-the-money interest rate cap – lender's perspective

ABC Corp. enters into a variable-rate debt agreement with Bank whereby Bank requires ABC to purchase an interest rate cap at 1% to hedge its variable-rate debt. Because the market interest rate is 7%, the cap is in-the-money and ABC pays a premium of \$1 million to the cap counterparty. The cap is designated as a cash flow hedge of the interest rate risk on the debt. Because the cap counterparty (Bank) is the party benefiting from the financing in the earlier periods of the instrument's term, it is considered the borrower and ABC is considered the lender.

At inception, ABC determines the option contains an other-than-insignificant financing element because:

- the option is so deep in-the-money that exercise of the option is reasonably assured; and
- ABC expects that all, or substantially all, amounts paid up front related to the option's intrinsic value will be repaid over the term of the contract.

As such, ABC classifies the payment of the premium and the subsequent cash receipts as cash flows from **investing** activities.



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 at 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

A derivative is designated as a hedge when an entity elects to apply hedge accounting (and meets the required criteria). Derivatives that are not designated as hedges fall into two categories:

- derivatives not used for hedging purposes (called nonhedging derivatives);
- and

- derivatives used for hedging purposes but for which the entity has not elected, or does not qualify, to apply hedge accounting (called economic hedges).

Generally, when a derivative is not designated as a hedge, the nature of the derivative drives its cash flow classification. [230-10-45-27]



Question 13.3.10

How are cash flows from a derivative that is not designated as a hedge classified?

Interpretive response: The nature of a derivative that is not designated as a hedge generally is that of an investment, unless it is:

- held for trading (see [Question 13.4.20](#)); or
- intended to be physically settled (see below).

Therefore, we believe it is generally appropriate to classify cash flows from/for a derivative not designated as a hedge as cash flows from **investing** activities, even if the entity's policy under Topic 230 for derivatives designated as cash flow or fair value hedges is to classify their cash flows in the same category as the cash flows from/for the item being hedged (see [Question 13.3.20](#)).

Practice regarding economic hedges

Despite the above, in practice some entities have established an accounting policy for economic hedges that is consistent with the policy election for derivatives designated as cash flow or fair value hedges (see [Question 13.3.20](#)). Specifically, when a derivative is used as an economic hedge and does not contain an other-than-insignificant financing element, some entities classify its cash flows in the same category as the cash flows from/for the item being hedged.

We understand regulators have acknowledged this practice. Therefore, we believe it is acceptable for entities to apply this policy to derivatives in economic hedges when the policy is:

- consistent with the entity's policy for derivatives designated as cash flow or fair value hedges, if any;
- consistently applied to all economic hedges; and
- clearly disclosed.

Derivatives intended to be physically settled

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.

Classification of some common derivatives

The following table lists some common derivatives and identifies the acceptable cash flow classification based on the above analysis. In all cases it is assumed that the derivative does not have an other-than-insignificant financing element.

| Derivative | Cash flow classification |
|---|---|
| <p>Interest rate swap An entity enters into an interest rate swap to economically hedge the interest cost on its variable-rate debt.</p> | <p>investing activities. This is consistent with the general nature of derivatives not held for trading. [230-10-45-27] or operating activities. If the entity's accounting policy is to classify cash flows for derivatives in economic hedges in the same category as the cash flows from/for the item being hedged, the cash flows would be classified as operating activities to be consistent with the classification of cash flows related to the economically hedged interest costs.</p> |
| <p>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.</p> | <p>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.</p> |
| <p>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.</p> | <p>investing activities. This is consistent with the general nature of derivatives not held for trading. [230-10-45-27] or operating activities. If the entity's accounting policy is to classify cash flows for derivatives in economic hedges in the same category as the cash flows from/for the item being hedged, the cash flows would be classified as operating activities to be consistent with the cash flows related to sales and/or costs of goods sold.</p> |
| <p>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.</p> | <p>investing activities. This is consistent with the general nature of derivatives not held for trading. [230-10-45-27] or financing activities. If the entity's accounting policy is to classify cash flows for derivatives in economic hedges in the same category as the cash flows from/for the item being hedged, the cash flows would be classified as financing activities to be consistent with the classification of the cash payments to repay amounts borrowed.</p> |

| Derivative | Cash flow classification |
|---|---|
| <p>Equity forward contract</p> <p>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.</p> | <p>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]</p> |

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 classified: [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 policy.

The following table contains common uses for derivatives and the related classification of the hedged item.

| Derivative instruments used to hedge: | 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)] |
| 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 determining the appropriate cash flow classification.

**Question 13.3.25******How are cash flows from derivatives hedging forecasted debt issuance classified?**

Interpretive response: We believe that the classification of cash flows from a derivative hedging a forecasted debt issuance depends on the specific risk being hedged. An entity analyzes the hedging relationship to determine if it is intended to hedge the variability in future interest payments, or the future proceeds to be received. The cash flows are then classified in the same category as the cash flows from/for the item being hedged (see [Question 13.3.20](#)).

Hedging the variability in future interest payments

If an entity is hedging its exposure to variability in future contractually specified interest payments on a forecasted debt issuance, we believe the cash flows from the hedging instrument are classified as cash flows from **operating** activities. This is consistent with the classification of interest payments on debt. [230-10-45-17(d)]

For example, in January an entity decides it will issue a fixed-coupon bond within the next six months *at the then-current market interest rate*. The entity enters into a forward-starting interest rate swap to protect against an increase in interest rates before issuance. In March, the bonds are issued, and the swap is terminated. The cash flows from the termination of the swap would be classified as **operating** activities because the instrument hedged the variability in the future interest payments on the forecasted debt.

Hedging the future proceeds to be received from the issuance of debt

If an entity is hedging its exposure to changes in the future proceeds to be received from a forecasted debt issuance, we believe the cash flows from the hedging instrument are classified as cash flows from **financing** activities. [230-10-45-14(b), 45-15(b)]

For example, in January an entity decides it will issue a fixed-coupon bond within the next six months, *with the coupon rate fixed at the January rate*. The entity enters into a forward-starting interest rate swap to hedge the future proceeds to be received from the issuance of debt, because the bond will be issued in the future at a premium or discount, depending on how the actual market interest rate at issuance date compares to the fixed coupon rate. In March, the bonds are issued, and the swap is terminated. In this scenario, the cash flows from the termination of the swap would be classified as **financing** activities because they are directly related to the issuance of the debt itself, and not the subsequent interest payments.



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 – e.g.:

- the derivative is novated;
- the forecasted transaction does not occur; or
- the entity elects to dedesignate the hedging relationship.

Interpretive response: It depends on (1) whether the derivative continues to be used as an economic hedge and (2) the entity's accounting policy. As discussed in [Question 13.3.10](#), we believe it is acceptable to establish accounting policies for derivatives in economic hedges that are consistent with the policy elections permitted by Topic 230 for derivatives designated as cash flow or fair value hedges (see [Question 13.3.20](#)). Therefore, when hedge accounting is discontinued, the classification of cash flows is not affected if:

- the derivative continues to be used as an economic hedge; and
- the entity has elected to apply the same cash flow statement accounting policies for derivatives designated as cash flow or fair value hedges and economic hedges.

If an entity has not elected to apply the same cash flow statement accounting policies for derivatives designated as cash flow or fair value and economic hedges, cash flows subsequent to the discontinuance of hedge accounting are classified based on the nature of the derivative, and not the item previously hedged. Therefore, the classification of cash flows for the derivative may change. [\[230-10-45-27\]](#)



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's cash flows in the same category as the cash flows from/for the item being hedged. Therefore, it classifies the forward contract's 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. However, the derivative continues to economically hedge the payments for inventory and therefore becomes an economic hedge. ABC does not apply an accounting policy to classify cash flows from derivatives in economic hedges consistent with the policy elections permitted by Topic 230 for derivatives designated as cash flow or fair value hedges.

Therefore, once hedge accounting is discontinued, ABC no longer classifies the forward contract cash flows consistent with the classification of the cash flows of the inventory. Instead, it classifies them as cash flows from **investing** activities because it 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 existing 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 existing 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 recorded through net income 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.

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](#)).



Question 13.4.70

What disclosures does an SEC registrant include related to the cash flows from derivatives?

Interpretive response: A registrant's accounting policies disclosure include, to the extent material, where in the statement of cash flows derivatives, and their related gains and losses, as defined by US GAAP, are reported. See [Question 3.7.10](#). [Reg S-X 4-08(n)]

14. Leases

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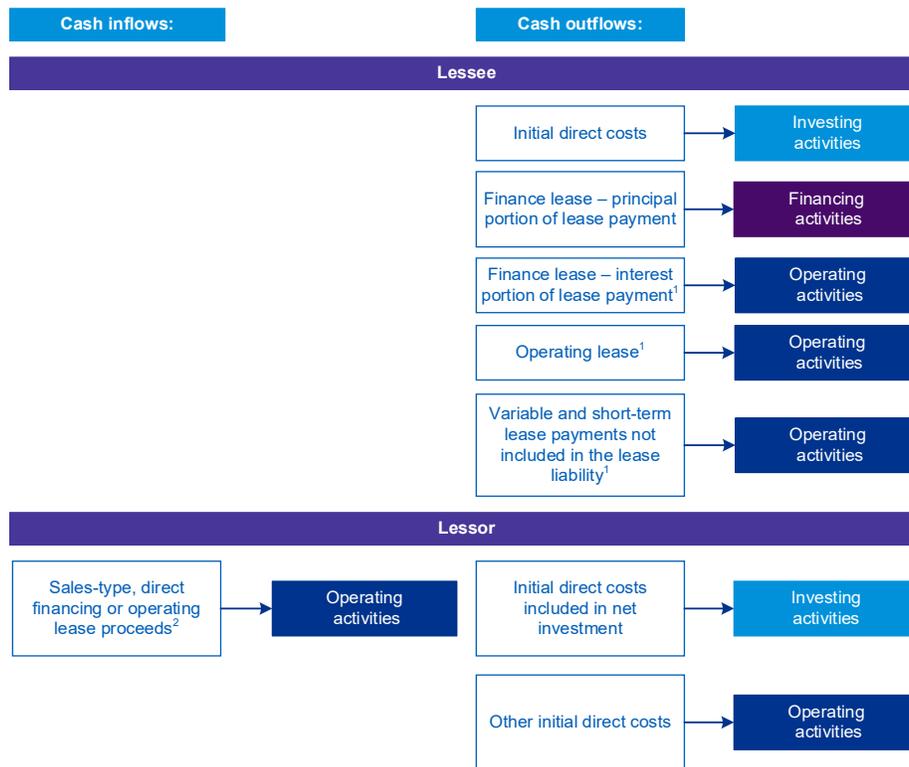
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14.1 How the standard works

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](#)).

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](#).

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. The lease classification distinction 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, 55-11, 55-15, 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 | ✓ | |

| Event | Increase to ROU asset and lease liability | Decrease to ROU asset ¹ and lease liability |
|--|---|--|
| Modifications granting the lessee an additional right of use, but not accounted for as a separate contract | ✓ | |
| 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 | ✓ | ✓ |
| <p>Note:</p> <p>1. The ROU asset will not be decreased for one of these events if its pre-event carrying amount is already \$0.</p> | | |

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)] |

| Finance lease | |
|---|---|
| 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)] |
| 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 for **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 upfront 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: [230-10-45-13]

- 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. 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, 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 (or IDCs) 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 6.6.80 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 for **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

| <i>\$'000s</i> | Approach 1 | Approach 2 |
|---|-------------------|-------------------|
| Cash flows from investing activities | | |
| Capital expenditures ¹ | (1) | (74) |
| Net cash provided by (used in) investing activities | \$(1) | \$(74) |
| 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. [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 |
| 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 (or IDCs).

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?

Background: Initial direct costs are incremental costs of a lease that would not have been incurred if the lease had not been obtained (i.e. had not been executed). [842-10 Glossary]

Initial direct costs typically include broker commissions and payments made to an existing tenant to incentivize that tenant to terminate the lease and exclude most legal fees and costs of (1) negotiating the lease and (2) evaluating the prospective lessee's financial condition.

Section 5.5 of KPMG Handbook, [Leases](#), provides additional guidance on 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:

- Lease classification is determined at lease commencement. Therefore, a lessor may not *definitively* know the classification of a lease at the time it pays initial direct costs. 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.
- 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.” Further, because lessors are generally in the business of entering into leases, such payments generally represent payments that are cash flows from **operating** activities. [230-10 Glossary]

Under the legacy lease guidance (Topic 840), there was diversity in practice; some lessors classified payments for initial direct costs as cash outflows for **operating** activities, others as cash outflows for **investing** activities. Because (1) the FASB appears to have not intended to change how lessors present lease-related cash flows from how they were presented under Topic 840 and (2) Topic 842 does not explicitly address cash flow classification of payments for initial direct costs, the above notwithstanding, we believe it is acceptable for a lessor to continue to classify these payments as cash flows from **operating** or **investing** activities, consistent with its legacy practice under Topic 840, if that classification is disclosed and consistently applied. [ASU 2016-02.BC328, BC387]

 **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.

When the sales price of the underlying asset exceeds its fair value, the excess represents additional financing from the buyer-lessor to the seller-lessee (see section 9.2.2 of KPMG Handbook, [Leases](#)). In essence this is no different from granting the seller-lessee a loan in addition to purchasing the seller-lessee’s asset. Under Subtopic 842-40, any such additional financing is accounted for under other Topics, like any other loan. As such, loan origination and principal

repayment cash flows are classified by the seller-lessee as **financing** activities, and by the buyer-lessor as **investing** activities (see [Question 11.2.10](#)). [842-40-30-2(b), 55-28 – 55-30; ASU 2016-02.BC 363]

Seller-lessee

| Transaction | Classification |
|---|---|
| Proceeds from sale of underlying asset – up to fair value | investing activities [230-10-45-12(c)] |
| Proceeds from sale of underlying asset – in excess of fair value (i.e. additional financing received) | financing activities [230-10-45-14(b)] |
| Lease payments | Consistent with classification of other operating lease ¹ payments made by lessee (see section 14.2.30) |
| Repayments of additional financing | financing activities [230-10-45-15(b)] |

Buyer-lessor

| Transaction | Classification |
|--|---|
| Payment to purchase underlying asset – up to fair value | investing activities [230-10-45-13(c)] |
| Payment to purchase underlying asset – in excess of fair value (i.e. additional financing granted) | investing activities [230-10-45-13(a)] |
| Receipts of lease payments | Consistent with other operating lease ¹ payments received by lessor (see section 14.3.30) |
| Receipts of additional financing repayments | investing activities [230-10-45-12(a)] |

Note:

1. 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]

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)] |

15. Employee benefit plans

Detailed contents

15.1 How the standard works

15.2 Contributions to employee benefit plans

Questions

- 15.2.10 How are cash flows for contributions to an employee benefit plan classified?
- 15.2.20 [Not used]
- 15.2.30 How is the change in the pension liability or asset presented?
- 15.2.40 How are cash flows from the termination of an overfunded pension plan classified?

Example

- 15.2.10 Change in pension liability

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?

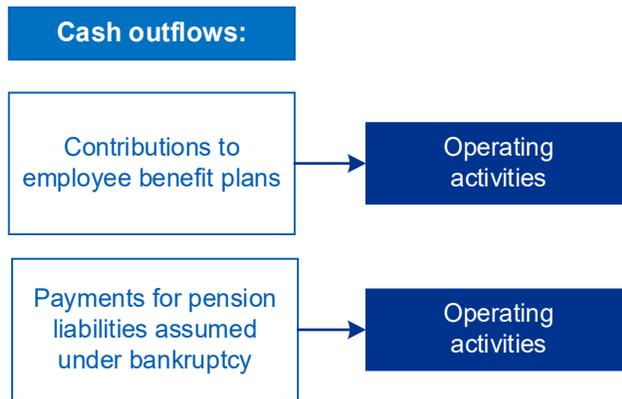
15.1 How the standard works

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 an NFP entity and in [Example 22.2.10](#) for an 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.

| <i>\$'000s</i> | |
|--|----------------|
| 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.

| <i>\$'000s</i> | |
|--------------------------------------|---------------|
| 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.

| <i>\$'000s</i> | |
|--------------------------------------|-----------------|
| 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 either presented as a separate line item or netted against pension plan contributions within cash flows from **operating** activities. If the amount is netted against pension plan contributions, 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

New item added in this edition: **

Item significantly updated in this edition: #

Item has been moved in this edition: ^^

16.1 How the standard works

16.2 Grant of share-based payment awards

Questions

- 16.2.10 How is the grant of a share-based payment award presented?
- 16.2.20 How are ESPP contributions made by employees through payroll deductions presented?

Examples

- 16.2.10 Grant of share-based payment awards
- 16.2.20 ESPP with payroll deductions

16.3 Share settlement of share-based payment awards

Questions

- 16.3.10 How are cash flows from the exercise of share-based payment awards classified?
- 16.3.20 How are cash flows from the early exercise of a share-based payment award by employees classified?
- 16.3.30 Are there required cash flow disclosures related to the issuance of shares under share-based payment awards?

Example

- 16.3.10 Exercise of share-based payment awards

16.4 Excess tax benefit from share-based payment awards

Questions

- 16.4.10 How are excess tax benefits and tax deficiencies classified?
- 16.4.20 Are there required cash flow disclosures related to excess tax benefits from share-based payment awards?

Examples

- 16.4.10 Excess tax benefit
- 16.4.20 Excess tax benefit resulting from awards issued in a business combination

16.5 Tax withholdings on share-based payment awards #**Questions**

- 16.5.10 How are taxes paid on a grantee's behalf classified when the grantor withholds shares for tax withholding purposes in a net-share-settled award? #^^
- 16.5.20 [Not used]
- 16.5.30 How are cash flows from sell-to-cover transactions classified? **

Example

- 16.5.10 Repurchase of shares to satisfy tax withholding

16.6 Cash settlement of share-based payment awards

- 16.6.10 Cash settlement of equity-classified share-based payment awards
- 16.6.20 Cash settlement of liability-classified share-based payment awards

Questions

- 16.6.10 How are cash flows for the settlement of an equity-classified award classified?
- 16.6.20 How are cash flows for the settlement of a liability-classified award classified?

Example

- 16.6.10 Cash settlement of equity-classified restricted stock units

16.7 Forfeiture of share-based payment awards**Question**

- 16.7.10 How is the forfeiture of a share-based payment award presented?

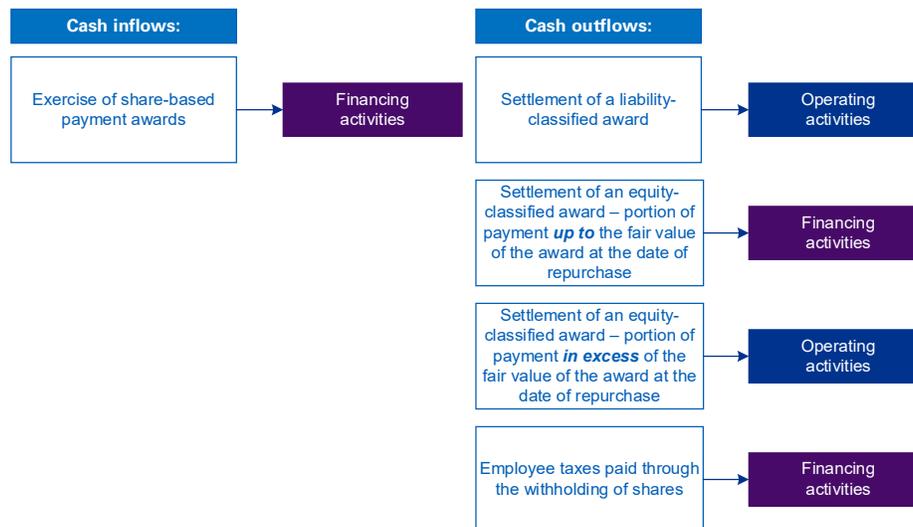
Example

- 16.7.10 Forfeiture of share-based payment awards

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.

The accounting for a share-based payment award typically begins on the grant date. The grant date is the date on which the grantor (e.g. employer) and the grantee (e.g. employee) reach a mutual understanding of the key terms and conditions of the award (e.g. number of shares, vesting schedule and any performance criteria). At this point, the grantor typically begins recognizing the fair value of the award as an expense over the service or vesting period, which is the period during which the grantee becomes entitled to the share-based award. [718-10-25-5, 35-2]

See KPMG Handbook, [Share-based payment](#), 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 that is not presented in the statement of cash flows and does not require disclosure under Topic 230.

Any compensation or other noncash 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]

Any compensation or other noncash cost recognized as capital expenditures (see [Question 8.2.05](#)) is disclosed as a **noncash** investing activity (see [section 4.7.20](#)).

Changes in the fair value of a liability for a share-based payment arrangement are recognized as compensation cost in net income during the service or vesting period. This noncash activity is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities. [718-30-35-2; 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 ($\$100,000 \div 4$ 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.

| \$'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 | \$ - |



Question 16.2.20

How are ESPP contributions made by employees through payroll deductions presented?

Background: An employee share purchase plan (ESPP) allows an employee to purchase shares from the employer (entity) or its parent at a discount from market price. Typically, the employee can elect to pay for the shares through payroll deductions.

As the entity withholds these payroll deductions, it recognizes a liability to the employee for the unpaid payroll relating to these deductions, generally an accrued payroll liability. The liability is extinguished upon issuance of the shares to the employee, at the end of the offering period. If the withheld payroll deductions are not used to purchase the shares, the cash is returned to the employee. The payroll amount contributed by the employee for purposes of purchasing shares through the ESPP is taxable income to the employee, as if paid, in the period it was earned.

Interpretive response: In our experience, there is diversity in practice in the classification of ESPP contributions.

Some entities include the change in the accrued payroll liability in the change in assets and liabilities, as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see [section 3.2](#)). Under this practice, we believe the following two approaches are acceptable for presenting the cash flows upon issuance of the shares. Other approaches may also be acceptable; the presentation approach selected should be disclosed and consistently applied.

Approach 1: Constructive cash flows

We believe it is appropriate to consider that the amount deducted from payroll is paid in its entirety to the employee, then contributed by the employee to the entity to purchase shares – i.e. present constructive cash flows (see [section 4.7.10](#)). This approach is consistent with the fact that the amount deducted from payroll is taxable income to the employees and that the employees would have received cash had they not elected to participate in the ESPP. This may be done by:

- including the effect of the reversal of the accrued payroll liability in the change in assets and liabilities in the reconciliation of net income to net cash flows from operating activities; and
- presenting a cash inflow in **financing** activities, consistent with proceeds from the sale of equity instruments (see [Question 19.2.10](#)).

Approach 2: Noncash disclosures

Alternatively, upon issuance of the shares, we believe the entity may disclose the transaction as a **noncash** financing activity representing the issuance of equity instruments to extinguish the liability.



Example 16.2.20

ESPP with payroll deductions

Under ABC Corp.'s ESPP, eligible employees can purchase ABC's common shares at 85% of the lower of the grant-date share price or the share price at the end of the offering period. Enrolling employees can elect to pay for the shares by contributing up to 20% of their compensation through payroll deductions during a three-month offering period that closes on Jan 1, Year 2.

As of December 31, Year 1, ABC has deducted a total of \$100,000 from the payroll of enrolling employees and records an accrued payroll liability of \$100,000. Total compensation expense in Year 1 is \$1,000,000, which includes \$15,000 of share-based compensation expense relating to the ESPP.

On January 1, Year 2, enrolling employees purchase ABC's shares at the 15% discount for a total of \$100,000. Total compensation expense in Year 2 is \$1,200,000. For simplicity purposes assume no contributions to the ESPP are made in Year 2.

The following illustrates the effect of this transaction on ABC's statement of cash flows, which is prepared under the indirect method. In Year 2, ABC presents the effect of ESPP payroll deductions under Approach 1 (see [Question 16.2.20](#)).

Year 1

| | |
|--|-----------------|
| \$'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: | |
| Share-based compensation expense | 15 |
| Change in assets and liabilities: | |
| Increase in accounts payable and accrued expenses | 100 |
| Net cash provided by (used in) operating activities | \$ (885) |

Year 2

| | |
|--|-------------------|
| \$'000s | |
| Cash flows from operating activities | |
| Net income (loss) | \$ (1,200) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | |
| Change in assets and liabilities: | |
| Increase in accounts payable and accrued expenses | (100) |
| Net cash provided by (used in) operating activities | \$ (1,100) |
| Proceeds from issuance of common stock under ESPP | 100 |
| Net cash provided by (used in) financing activities | \$ 100 |

16.3 Share settlement of share-based payment awards

In share-settled arrangements, the recipients of the share-based payment awards receive equity instruments, such as shares or stock options, as part of their compensation. The recipients typically need to meet certain service or vesting conditions to benefit from the awards. Once the conditions are met, the recipients are issued the equity instruments. If these are stock options, the recipients then have the right to exercise the options and receive shares. Regardless of the classification of the award under Topic 718 (stock compensation) – i.e. as an equity- or liability-classified award – the grantee may pay cash to the grantor upon exercise of stock options and similar instruments.

 **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 share 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.

| | |
|--|--------------|
| <i>\$'000s</i> | |
| 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 shares 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. See also discussion beginning at paragraph 3.041 in KPMG Handbook, [Share-based payment](#). [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 cash flow disclosures related to the issuance of shares under share-based payment awards?

Interpretive response: It depends. There are required disclosures about the cash and noncash effects of share-based payment awards that may apply, depending on the circumstances.

Topic 718 cash flow effects disclosures

Subtopic 718-10 requires annual disclosure about the cash flow effects of share-based payments. This general requirement specifically includes the amount of cash received from exercise of stock options and similar instruments granted under share-based payment arrangements, for each year that a statement of cash flows is presented. See [Question 16.4.20](#) for additional disclosure requirements related to excess tax benefits. [718-10-50-1, 50-2A]

While there is no specific provision for an entity to separately disclose arrangements with nonemployees from those with employees, if this information is important to understanding their effect, separate disclosure should be provided. [718-10-50-2]

Topic 230 noncash disclosures

When shares are issued under a share-based payment award, disclosures for **noncash** financing activities (see [section 4.7.20](#)) are required if the issuance affects recognized assets or liabilities. For example, this would be the case when settling a liability-classified award in shares. [230-10-50-3]

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 shares on the exercise date and the amount the CEO pays to exercise the options (\$130,000 = (\$33 fair value of ABC's common shares - \$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. $\$130 \times 21\%$.
2. $\$100 \times 21\%$.

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.

| <i>\$'000s</i> | |
|--|-------------|
| 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 awards issued in 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 ($\$2 \text{ million} \times 21\%$) 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.

| <i>\$'000s</i> | <i>Debit</i> | <i>Credit</i> |
|-----------------------------------|--------------|---------------|
| Income tax payable ¹ | 525 | |
| Deferred tax expense ² | 420 | |
| Current tax expense | | 525 |
| Deferred tax asset | | 420 |

Notes:

1. $\$2,500 \times 21\%$.
2. $\$2,000 \times 21\%$.

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 cash flow disclosures related to excess tax benefits from share-based payment awards?

Interpretive response: Yes. For each year a statement of cash flows is presented, an entity discloses the tax benefit from stock options exercised during the year, as well as total income tax paid. See [Question 16.3.30](#) for additional disclosure requirements. [230-10-45-25(f), 50-2, 718-10-50-2A]

16.5 Tax withholdings on share-based payment awards#

A grantor typically has statutory tax withholding requirements when a grantee exercises share-based payment awards, or vests in a restricted stock award. Under Topic 718, to qualify for equity classification of the share-based payment award, the amount withheld by a grantor cannot exceed the grantee's maximum statutory tax rate in the applicable jurisdiction(s). See paragraphs 3.031 to 3.035 in KPMG Handbook, [Share-based payment](#), for guidance on the effect of tax withholding on the classification of share-based payments.

At the grantee's discretion, the grantor often withholds shares from the award in an amount sufficient to satisfy its statutory tax withholding requirement (i.e. net-share settlement). Alternatively, the grantee may enter into a 'sell-to-cover' transaction, typically facilitated through a broker-assisted cashless exercise program. In a sell-to-cover transaction the grantee receives all underlying shares from the exercise but immediately sells a portion of those shares with a fair value equal to the tax owed. The proceeds from the sale are remitted to the grantor and used to pay the tax liability. Through a sell-to-cover transaction, grantees can satisfy their tax obligations without paying taxes out-of-pocket. In these transactions the full number of shares are issued and outstanding.

Either way, the grantor eventually disburses cash to pay the taxing authority, which may be at a different date from when the shares are withheld or sold. This timing difference results in a liability being recorded at the reporting date, which in our experience, is often presented as an accrued expense or within the taxes payable account.



Question 16.5.10#^^

How are taxes paid on a grantee's behalf classified when the grantor withholds shares for tax withholding purposes in a net-share-settled award?

Interpretive response: When directly withholding shares for tax withholding purposes, a grantor classifies cash paid to a taxing authority on the employee's behalf 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 concluded that withholding shares from an award is in substance a repurchase of shares. This means the grantor is treated as having issued the gross number of shares to the grantee 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. Additionally, there are no income effects from a grantor directly withholding shares for tax withholding purposes; therefore, classification as an operating activity would be inconsistent with the definition of operating activities which states, in part, that operating activities are "generally the cash effects of transactions and other events that enter into the determination of net income." [ASU 2016-09.BC19 – BC20]

This accounting treatment applies to all net-share settlements of share-based payment awards, regardless of whether the share-based award is liability- or equity-classified.

Timing difference at the reporting date

The timing of when the withheld taxes are remitted to the taxing authority does not affect the classification in the statement of cash flows. Therefore, the change in the liability resulting from the timing difference should not be inadvertently included as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see [section 3.2](#)). Instead, this timing difference should be disclosed as a **noncash** financing activity (see [section 4.7.20](#)). [230-10-50-3]



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 share 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.

| <i>\$'000s</i> | |
|---|--------------|
| 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 16.5.30**

How are cash flows from sell-to-cover transactions classified?

Interpretive response: We believe proceeds received by a grantor from a grantee in a sell-to-cover transaction represent cash flows from **financing** activities as the funds are held by the grantor for others – in this case, for the grantee to cover its tax liability. Similarly, the cash remitted to the taxing authority should be classified as cash flows from **financing** activities. These cash flows relate to a pass-through of tax amounts from the grantee, who sells shares to cover their tax liability (irrespective of the grantor's obligation to withhold). See also [Question 6.2.36](#). [230-10-45-15(a)]

Further, an entity should consider the netting guidance (see [section 3.5](#)) to determine if net presentation is appropriate.

16.6 Cash settlement of share-based payment awards

16.6.10 Cash 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](#)).

See sections 3 and 5 in KPMG Handbook, [Share-based payment](#).



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 award is 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]

An entity discloses the amount of cash used to settle equity instruments granted under share-based payment arrangements. It should consider whether this disclosure requirement is met through the presentation of the statement of cash flows or whether additional disclosure is necessary. [718-10-50-2(k)]

**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 share 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.

| <i>\$'000s</i> | |
|--|----------------|
| 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 Cash 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 therefore is a cash outflow for **operating** activities. [230-10-45-17(b)]

An entity discloses the amount of cash used to settle equity instruments granted under share-based payment arrangements. It should consider whether this disclosure requirement is met through the presentation of the statement of cash flows or whether additional disclosure is necessary. [718-10-50-2(k)]

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 or meet a performance condition. 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 section 4 in 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, similar to the grant of the award itself (see [Question 16.2.20](#)); 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 \times \$10 \div 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 \times \$10 \times 1.5 \div 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.

| <i>\$'000s</i> | |
|--|-------------|
| 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. Contingencies and insurance premiums and proceeds

Detailed contents

Item significantly updated in this edition: #

17.1 How the standard works

17.2 Property, casualty and liability insurance policies

17.2.10 Premiums paid

17.2.20 Settlement proceeds

Questions

17.2.10 How are cash flows for the payment of insurance premiums on property, casualty and liability insurance policies classified?

17.2.20 How are cash flows from the settlement of insurance claims on PP&E classified?

17.2.30 How are cash flows from the settlement of insurance claims for business interruption, inventory or minor repairs of PP&E classified?

17.2.40 How are cash flows from the settlement of multiple insurance claims classified?

Example

17.2.10 Allocating a lump-sum settlement payment for more than one loss

17.3 Corporate-owned and bank-owned life insurance policies

17.3.10 Premiums paid

17.3.20 Settlement proceeds

Questions

17.3.10 How are cash flows for insurance premiums on corporate-owned life insurance policies classified?

17.3.20 How are cash flows from a corporate-owned life insurance settlement classified?

17.4 Contingencies

Question

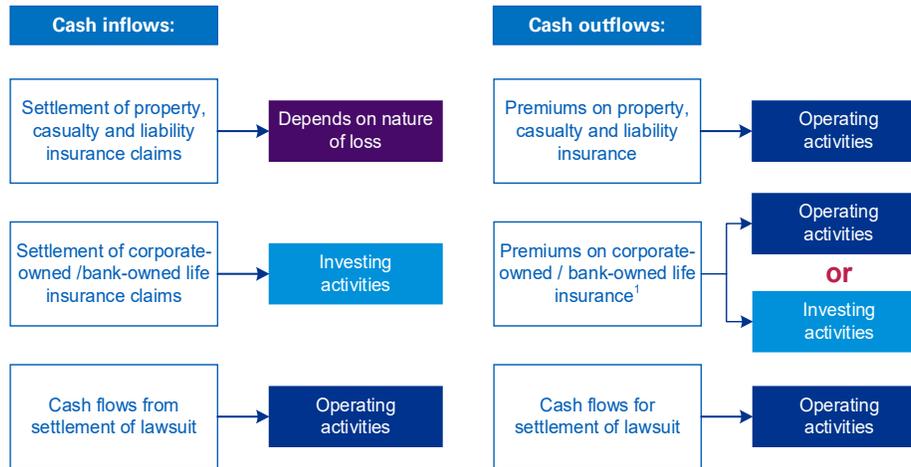
17.4.10 How are cash flows from/for settling a lawsuit and other contingencies classified? #

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.

Further, this chapter also addresses contingencies, in particular cash settlements paid or received in lawsuits. These are classified as cash flows from **operating** 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:** We believe 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]

17.4 Contingencies

Loss and gain contingencies may give rise to cash payments or receipts. Topic 230 specifically addresses the classification of cash flows from/for lawsuits.



Question 17.4.10#

How are cash flows from/for settling a lawsuit and other contingencies classified?

Interpretive response: An entity classifies cash received or paid to settle a lawsuit as cash flows from **operating** activities. We believe this guidance is broadly applicable to payments to settle loss and gain contingencies in the scope of Topic 450, even if settlement does not involve a lawsuit. [230-10-45-16(c), 45-17(f)]

Accruals of expected future operating cash payments are included as noncash items in the reconciliation of net income to net cash flows from operating activities. [230-10-45-28, 45-29]

See section 5.2.30 in KPMG Handbook, [Contingencies, commitments and guarantees](#), for additional guidance.

18. Business combinations

Detailed contents

New item added in this edition: **

Item significantly updated in this edition: #

18.1 How the standard works

18.2 Acquisition of a business

Questions

- 18.2.10 How are cash flows for the acquisition of a business classified?
- 18.2.20 How are cash flows for settling a preexisting relationship through a business combination classified?
- 18.2.30 How are cash flows for IPR&D acquired in a business combination classified?

Examples

- 18.2.10 Acquisition of a business for cash
- 18.2.20 Acquisition of a business for shares

18.3 Transaction costs incurred

Questions

- 18.3.10 How are cash flows for transaction costs incurred in a business combination classified?
- 18.3.20 How are cash flows for (from) a break-up fee paid (received) in a failed merger transaction classified?

18.4 Contingent consideration paid

- 18.4.10 Overview
- 18.4.20 Equity-classified contingent consideration
- 18.4.30 Liability-classified contingent consideration

Questions

- 18.4.10 How is the grant of an equity-classified contingent consideration presented?
- 18.4.20 How is the initial recognition of liability-classified contingent consideration presented?
- 18.4.30 How is the subsequent remeasurement of liability-classified contingent consideration presented?
- 18.4.40 How are cash flows for liability-classified contingent consideration settled *soon after* the acquisition date classified?

- 18.4.50 How should 'soon after' be interpreted in classifying cash flows for liability-classified contingent payments?
- 18.4.60 [Not used]
- 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?

18.6 Sale of a business resulting in the loss of control

Questions

- 18.6.10 How are cash flows for the sale of a business resulting in the loss of control classified?
- 18.6.20 How are cash flows from contingent consideration classified?

18.7 Common control transactions **

Question

- 18.7.10 How do the receiving entity and transferring entity classify payments and receipts in a common control transaction?

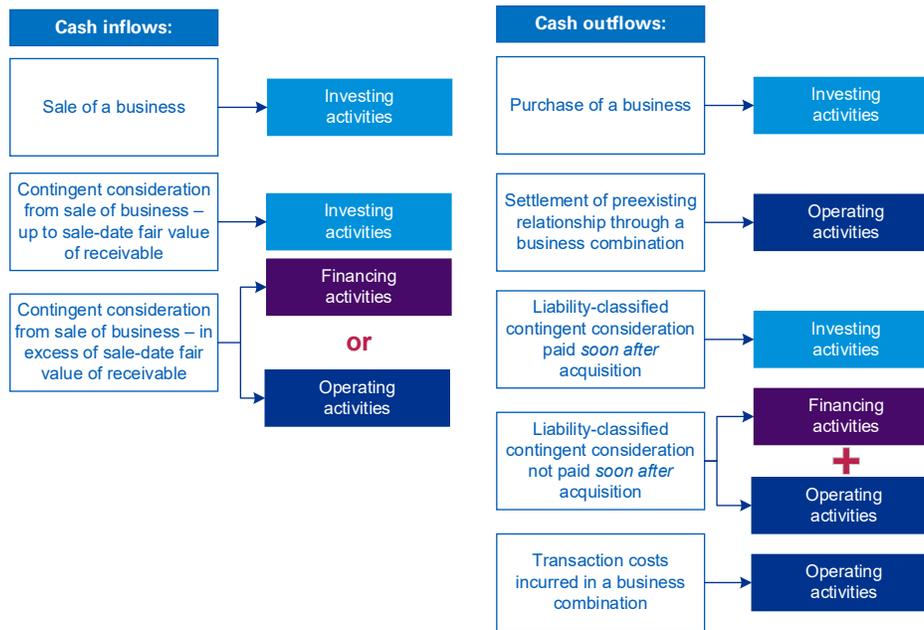
Examples

- 18.7.10 Transfer of equipment between entities under common control – no basis difference
- 18.7.20 Transfer of business between entities under common control – with basis difference

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 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 shares, preferred shares, stock options, warrants, debt instruments). Timing of payment may vary, with certain payments being contingent on future events.

Consideration transferred includes only the consideration exchanged by the acquirer for the acquiree – e.g. it excludes amounts to settle preexisting relationships between the two parties. To understand which amounts to include in the consideration transferred in a business combination, see section 6 in KPMG Handbook, [Business combinations](#).

Topic 230 specifically addresses the classification of payments made by an acquirer in a business combination to settle a contingent consideration liability. However, it does not specifically address other payments for consideration transferred. [\[230-10-45-13\(d\), 45-15\(f\)\]](#)

Question 18.2.10 How are cash flows for the acquisition of a business classified?

Interpretive response: We believe cash flows for consideration transferred for the acquisition of a business should be classified by the acquirer based on the type and timing of payment, as follows.



| Type of payment | Classification |
|--|---|
| Advance payment | investing activities. This is consistent with the classification of cash outflows for loans originated for investment (see Question 11.2.10). [230-10-45-13(a), 45-13(c)] |
| Payment soon before or after ¹ acquisition date (i.e. down payment) | investing activities. This is consistent with the classification of cash outflows for purchases of productive assets. [230-10-45-13(c)] |
| Deferred fixed payment | <ul style="list-style-type: none"> — At the acquisition date: disclosure as noncash investing and financing activities (see section 4.7.20). [230-10-50-3] — At the date of payment: financing activities. [230-10-45-15(c)] <p>This is consistent with the classification of cash outflows for purchases of productive assets and directly related seller-financed debt.</p> |

| Type of payment | Classification |
|--|------------------------------------|
| Payment for contingent consideration | See section 18.4 . |
| Note: | |
| 1. Questions 8.2.20 and 18.4.50 explain the meaning of 'soon before or after'. | |

The statement of cash flows reflects, as a single line item, cash paid for consideration transferred net of any cash acquired. Additionally, cash flows from the acquired business are only reflected in the consolidated statement of cash flows of the acquirer from the date of acquisition. Therefore, when the indirect method is used, changes in assets and liabilities presented in the reconciliation of net income to operating activities are net of effects of business combinations. [230-10-55-13]

Any **noncash** investing and financing activities in relation to a business combination, including any noncash consideration included in the consideration transferred, are either disclosed in a narrative format or summarized in a schedule (see [section 4.7.20](#)). [230-10-50-3, 55-11, 55-15]



Example 18.2.10

Acquisition of a business for cash

On November 1, Year 1, Parent acquires all of the share capital of Target for cash of \$2 million. The acquisition is a business combination.

At 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 acquisition | (2,000) |
| Target liabilities assumed | \$ 580 |



Example 18.2.20 Acquisition of a business for shares

Assume the same facts as [Example 18.2.10](#), except that the consideration exchanged is 50,000 common shares of Parent. At the acquisition date, the fair value of one share 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 shares) 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 common shares of Parent issued in exchange for acquisition of Target | (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)]

After 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 paid

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 at 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 consideration 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 [Example 18.4.20](#) 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.

| <i>\$'000s</i> | |
|--|-------------|
| 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.

| | |
|--|----------------|
| <i>\$'000s</i> | |
| 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 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 at 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.

18.6 Sale of a business resulting in the loss of control

Transactions resulting in the loss of control of a subsidiary 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. This is further explained in section 7.6 of KPMG Handbook, [Consolidation](#). [810-10-40-4]

This section addresses classification issues when:

- the parent of a subsidiary loses control of the subsidiary (or a group of assets that is a business) as a result of a sale, and
- the sale transaction is not subject to the guidance in Topics 932, 610-20 or 845.

Transactions with NCI holders when control is retained are addressed in [section 19.4](#).



Question 18.6.10

How are cash flows for the sale of a business resulting in the loss of control classified?

Interpretive response: We believe receipts from the sale of a business resulting in the loss of control are generally cash inflows from **investing** activities. This is consistent with the classification by the acquirer of cash flows for consideration transferred for the acquisition of a business (i.e. upon obtaining control) (see [Question 18.2.10](#)). This is also consistent with the classification of receipts from sales of productive assets. [230-10-45-12(c)]

[Question 18.6.20](#) discusses classification issues specific to contingent consideration.

The statement of cash flows reflects, as a single line item, cash received from the sale of the business net of any cash sold. Additionally, cash flows from the sold business stop being reflected in the seller's consolidated statement of cash flows from the date control is lost. Therefore, when the indirect method is used, changes in assets and liabilities presented in the reconciliation of net income to operating activities are net of effects of the sale. [230-10-55-13]

The remeasurement to fair value of any retained interest in a former subsidiary is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities (see [section 3.2](#)).



Question 18.6.20

How are cash flows from contingent consideration classified?

Background: There is limited guidance in US GAAP on the seller's accounting for contingent consideration. We believe a seller (former parent) can recognize contingent consideration that is not accounted for as a derivative under either of two approaches.

- Approach 1: as a receivable, recognized at fair value at the date of sale.
- Approach 2: as a contingent gain, recognized under Subtopic 450-30 when the contingency is resolved.

We believe either approach is an acceptable accounting policy based on current diversity in practice. However, we believe the policy should be disclosed and consistently applied.

See Question 7.6.30 of KPMG Handbook, [Consolidation](#), for further guidance.

Interpretive response: We believe cash flows from contingent consideration received from the sale and derecognition of a business should be classified consistently with the seller's accounting for the contingent consideration, as follows.

Under Approach 1, at the date of sale, no cash consideration is transferred, therefore the fair value of the contingent consideration included in the gain or loss on sale is presented as a noncash reconciling item in the reconciliation of net income to net cash flows from operating activities (see [section 3.2](#)). When the cash is received, we believe it would be appropriate to classify it as follows, by analogy to the classification of payments for contingent consideration by the acquirer (see [Question 18.4.70](#)):

- **investing** activities for receipts up to the sale-date fair value of the receivable; and
- **operating** activities for receipts in excess of the sale-date fair value of the receivable.

Under Approach 2, when the cash is received, we believe it should be classified as cash inflows from **operating** activities, consistent with payments to settle lawsuits (see [Question 17.4.10](#)).

The presentation approach followed should be disclosed and consistently applied.

18.7 Common control transactions**

An entity may transfer assets (e.g. a business, long-lived assets, financial assets, inventory) or equity interests to another entity under common control – e.g. a sister company with the same parent company.

With the exception of transfers of financial assets and inventory, the receiving entity generally records the assets or equity interests transferred at their carrying amount in the accounts of the transferring entity (or carrying amount in

the accounts of the parent entity, if different from the transferring entity), regardless of the proceeds exchanged. Any difference between the proceeds and the carrying amount is recorded as an adjustment to equity. [805-50-30-5]

With the exception of transfers of financial assets and inventory, there is no specific guidance in US GAAP that addresses the accounting by the transferring entity. We believe any difference between the carrying amount of assets or equity interests transferred and proceeds received should be recognized by the transferring entity as an equity transaction – i.e. recognized as a contribution to/distribution from shareholders. [845-10-30-10; 810-10-40-5]

The Codification provides specific guidance for transfers of financial assets under common control in Topic 860. [860-10-55-78]

See chapter 28 in KPMG Handbook, [Business combinations](#), for additional guidance on combinations of entities under common control.



Question 18.7.10

How do the receiving entity and transferring entity classify payments and receipts in a common control transaction?

Interpretive response: Topic 230 does not address how cash flows from transactions between entities under common control should be classified in the statement of cash flows. We believe that the cash flow statement presentation of transactions between entities under common control should follow the accounting for the transaction. Here are examples:

| Transaction | Accounting treatment | Receiving entity | Transferring entity |
|--|--|---|--|
| Transfer of net assets (business) or long-lived assets | Cash paid by the receiving entity to the transferring entity in excess of the carrying amount of the assets is considered an adjustment to equity (i.e. a capital distribution for the receiving entity and a capital contribution for the transferring entity). [805-50-30-5] | Investing activities up to the carrying amount of the asset received used to initially measure the assets in the accounts of the receiving entity. Financing activities for cash payments in excess of the carrying amount of the assets received. | Investing activities up to the carrying amount of the assets transferred in the accounts of the transferring entity. Financing activities for proceeds exceeding the carrying amount of the assets transferred. |
| Sale of financial assets | Fair value is used as the basis because the transaction is a sale, with a gain or loss recognized in the income | Investing or operating activities, based on the nature and purpose for which the financial assets were | Investing or operating activities, based on the nature and purpose for which the financial assets were |

| Transaction | Accounting treatment | Receiving entity | Transferring entity |
|--|--|--|--|
| | statement. [860-10-40-4 – 40-5] | originated or acquired. See Questions 9.2.10 (debt securities), 9.2.20 (equity securities) and 11.2.10 (loans). | originated or acquired. See Questions 9.2.10 (debt securities), 9.2.20 (equity securities) and 11.2.10 (loans). |
| Sale of inventory in the ordinary course of business | Stepped-up value (selling price) is used as the basis. [606-10-32-2] | Operating activities | Operating activities |



Example 18.7.10

Transfer of equipment between entities under common control – no basis difference

Subsidiary A and Subsidiary B are under common control of Parent. On November 1, Year 1, Subsidiary A sells equipment with a carrying amount of \$5 million to Subsidiary B for \$6 million. The equipment has the same carrying amount in the separate financial statements of Subsidiary A and the consolidated financial statements of Parent.

The following illustrates the effect of this transaction on Subsidiary A's and Subsidiary B's Year 1 statement of cash flows.

Subsidiary A (transferor)

| | |
|--|-------------|
| \$'000s | |
| Cash flows from investing activities | |
| Sale of equipment | \$ 5 |
| Net cash provided by (used in) investing activities | 5 |
| Cash flows from financing activities | |
| Capital contribution from parent | 1 |
| Net cash provided by (used in) financing activities | \$ 1 |

Subsidiary B (transferee)

| | |
|--|------------|
| \$'000s | |
| Cash flows from investing activities | |
| Purchase of equipment | \$ (5) |
| Net cash provided by (used in) investing activities | (5) |

| | |
|--|---------------|
| Cash flows from financing activities | |
| Capital distribution to parent | (1) |
| Net cash provided by (used in) financing activities | \$ (1) |



Example 18.7.20

Transfer of business between entities under common control – with basis difference

Subsidiary A and Subsidiary B are under common control of Parent. On November 1, Year 1, Subsidiary A transfers a business to Subsidiary B for \$20 million. At that date, the carrying amount of the net assets of the business is \$15 million in the separate financial statements of Subsidiary A, and \$18 million in the consolidated financial statements of Parent. The amounts differ because Subsidiary A (inclusive of the business transferred) was acquired by Parent a few years ago and pushdown accounting has never been applied to the separate financial statements of Subsidiary A.

The following illustrates the effect of this transaction on Subsidiary A's and Subsidiary B's Year 1 statement of cash flows.

Subsidiary A (transferor)

| | |
|--|-------------|
| <i>\$'000s</i> | |
| Cash flows from investing activities | |
| Sale of business | \$ 15 |
| Net cash provided by (used in) investing activities | 15 |
| Cash flows from financing activities | |
| Capital contribution from parent | 5 |
| Net cash provided by (used in) financing activities | \$ 5 |

Subsidiary B (transferee)

| | |
|--|---------------|
| <i>\$'000s</i> | |
| Cash flows from investing activities | |
| Business acquisition | \$ (18) |
| Net cash provided by (used in) investing activities | (18) |
| Cash flows from financing activities | |
| Capital distribution to parent | (2) |
| Net cash provided by (used in) financing activities | \$ (2) |

Note: See paragraph 28.016 of KPMG Handbook, [Business combinations](#), for discussion about whether the transaction results in a change in reporting entity and the related accounting including retrospectively revising all comparative periods presented.

19. Transactions with shareholders

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19.5 Tax receivable agreements

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19.5.10 How is the initial recognition of a TRA liability presented?

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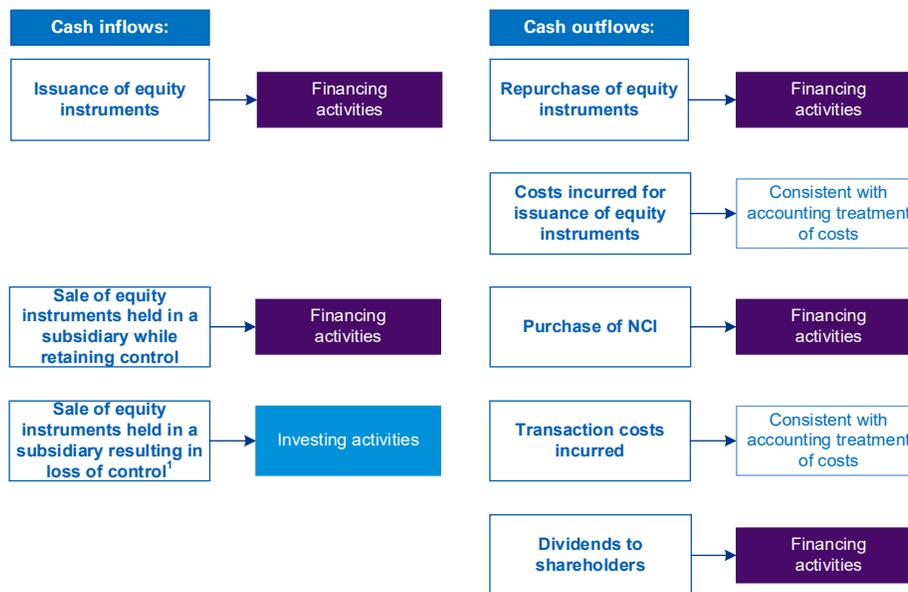
19.5.30 How are cash flows for TRA payments classified?

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.



Note:

1. See [section 18.6](#).

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 shares for cash

On December 31, Year 1, ABC Corp. issues 10,000 common shares for \$15 per share. The par value of each share is \$1.

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

| <i>\$'000s</i> | |
|--|--------------|
| 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 shareholders' 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 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 does a parent entity classify the reduction of cash resulting from a spinoff or split-off?

Background: Spinoffs and split-offs are different methods an entity (spinor or parent) can use to divest certain portions of its business.

A spinoff involves the transfer of assets that constitute a business by the spinor 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 spinor's shareholders, without the surrender by the shareholders of any stock of the spinor. [505-60 Glossary]

A split-off is a transaction in which a parent exchanges its stock in a subsidiary for parent stock held by its shareholders. [845-10 Glossary]

In both spinoffs and split-offs, the entity derecognizes the assets and liabilities of the divested business, including any cash, cash equivalents and restricted cash (collectively referred to as cash).

Interpretive response: We believe an entity should classify the reduction of cash resulting from a spinoff or a split-off as a cash flow from **financing** activities. This is because the cash included in the transaction (i.e. cash held by the divested business) is considered a cash distribution to owners.

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 or split-off 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 19.3.35

How is excise tax paid on share repurchases classified in the statement of cash flows?

Background: The Inflation Reduction Act of 2022 (IRA) was signed into law in August 2022. Among other things, it imposes a 1% excise tax on net share repurchases in a tax year that are made by certain publicly traded corporations. The tax applies to repurchases of common and preferred shares, net of issuances (including exercises of options or vesting of restricted shares). This new tax is effective in 2023 for calendar year-end public companies to which it applies.

The excise tax is not accounted for as an income tax under Topic 740 (income taxes). Instead, it generally is accounted for as a direct cost of a share repurchase transaction. How the cost is recorded depends on how the shares are classified before being repurchased. The cost is recorded to equity for shares that had been classified as permanent or temporary equity, and as a charge to pretax income if the shares had been classified as a liability. A repurchase of share-based payment awards subject to Topic 718 (stock compensation) may also trigger additional compensation expense in certain situations. Further, a company may complete multiple repurchase transactions during the year with varying purposes; therefore, the related charges for excise tax may affect both pretax income and equity.

See section 11.9 of KPMG Handbook, [Debt and equity financing](#), for accounting for the excise tax.

Interpretive response: Topic 230 does not specify the appropriate cash flow classification for excise tax paid; therefore, judgment is required, taking the relevant facts and circumstances into account. We believe it is appropriate to classify excise tax paid on share repurchases in line with the nature of the transaction, as follows.

| Excise tax paid for repurchase of: | Accounting treatment | Cash flow classification |
|--|-----------------------|--|
| Equity-classified shares (e.g. common shares) | Affects equity | financing activities. This is consistent with the classification of outlays to reacquire the entity's equity instruments (see Question 19.3.30). [230-10-45-15(a)] |
| Liability-classified shares (e.g. mandatory redeemable preferred shares) | Affects pretax income | financing activities. This is consistent with the classification of debt extinguishment costs (see Question 12.3.50). [230-10-45-15(g)] |

The excise tax for the current tax year is paid the following year. Because of this timing mismatch, there are some additional issues to consider.

- It may be necessary to present all or some of the excise tax accrued that affects pretax income in the period as a reconciling noncash item in the reconciliation of net income to net cash flows from operating activities.

- There may be noncash financing activities to disclose – e.g. the amount of excise tax charged to equity that is not paid in the period.



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

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. [\[810-10-45-23\]](#)

For transactions with NCI holders resulting in the loss of control in a subsidiary, see [Question 18.6.10](#).



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 common shares 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\(a\)\]](#)



Question 19.4.30

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)]

19.5 Tax receivable agreements

Tax receivable agreements (TRAs) are contractual arrangements commonly used in IPO or other transactions in which the historic owners of a business receive the right to a payment for a portion of the benefits from certain tax attributes (e.g. net operating loss carryforwards, a step-up in tax basis). The arrangements may involve existing corporate entities or Up-C structures whereby a newly formed corporation is used in the IPO. In Up-C structures, the new public entity uses cash raised in the IPO to acquire interests in a partnership or limited liability company where the operations of the business reside.

Under a typical TRA, the historic owners will be paid a percentage (commonly 85%) of the benefits realized by the new public entity for the tax attributes associated with conditions that existed at the IPO date. The TRA may be held by the original owner, may be transferred when the investment is sold, or may be sold outright.

The entity records a TRA liability upon the consummation of the IPO/transaction and typically remits the amount due when the tax savings are received by the entity. The TRA liability is initially recorded with a corresponding debit entry to equity, with subsequent measurement of the liability recorded through net income.

There is currently no authoritative guidance on accounting for TRAs. For more information see discussion beginning at paragraph 9.054 in KPMG Handbook, [Accounting for income taxes](#).



Question 19.5.10

How is the initial recognition of a TRA liability presented?

Interpretive response: We believe the initial recognition of a TRA liability should be reflected as a **noncash** financing activity. This is because there is no transfer of cash and the corresponding debit entry is to equity. The arrangement is either disclosed in a narrative format or summarized in a schedule (see [section 4.7.20](#)). See also [Question 19.5.30](#). [230-10-50-3]

 **Question 19.5.20**
How is the subsequent remeasurement of a TRA liability presented?

Interpretive response: The remeasurement of a TRA liability is a noncash reconciling item in the reconciliation of net income to net cash flows from operating activities (see [section 3.2](#)). This is because the remeasurement is noncash and recorded through net income.

 **Question 19.5.30**
How are cash flows for TRA payments classified?

Interpretive response: In the absence of specific authoritative accounting guidance, the classification of TRA payments is based on the nature of the transaction. If a transaction has more than one class of cash flows, each separately identifiable source of cash flows is identified based on its nature (see [section 4.5](#)). [230-10-45-10, 45-22]

We believe an entity can analogize to the guidance on contingent consideration in a business combination (see [Question 18.4.70](#)), as follows.

| Portion of TRA payment is ... | Classification |
|---|--|
| Up to the original TRA liability recorded | financing activities ¹ |
| In excess of the original TRA liability recorded | operating activities |
| Note: 1. Any difference between the amount paid and the original amount of the TRA liability represents a noncash reconciling item in the reconciliation of net income to net cash flows from operating activities (see section 3.2). | |

20. Discontinued operations

Detailed contents

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20.2 Cash flows from discontinued operations

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- 20.2.10 How are cash flows from discontinued operations presented?
- 20.2.20 What periods are affected by discontinued operations in the statement of cash flows?
- 20.2.30 What is the starting point in reconciling net income to net cash flows from operating activities?
- 20.2.40 How are cash flows from the sale of a discontinued operation classified?
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- 20.2.60 Can an entity disclose additional voluntary cash flow information about discontinued operations?
- 20.2.70 Are there additional cash flow-related disclosure requirements relating to discontinued operations?
- 20.2.80 Should an SEC registrant's Form 10-K disclose cash flows from discontinued operations in MD&A?

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

21.2 Transactions denominated in a foreign currency

Questions

- 21.2.10 How are the cash flow effects of transactions denominated in a foreign currency measured?
- 21.2.20 How are unrealized foreign currency transaction gains and losses presented?
- 21.2.30 How are cash flows resulting from the settlement of a foreign-currency denominated monetary asset or liability classified?
- 21.2.40 How is the effect of exchange rate changes on foreign-currency denominated cash, cash equivalents and restricted cash presented?

Examples

- 21.2.10 Foreign currency transaction – sale of goods
- 21.2.20 Foreign currency transaction – borrowing

21.3 Operations in a foreign currency environment

- 21.3.10 Foreign currency translation
- 21.3.20 Preparing and translating a statement of cash flows for an entity with foreign operations

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- 21.3.10 How are translation gains or losses presented?
- 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?

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- 21.3.10 Foreign currency translation – comprehensive example

21.4 Highly inflationary economies

- 21.4.10 Overview
- 21.4.20 Foreign operations in highly inflationary economies
- 21.4.30 Issuers in highly inflationary economies

Questions

- 21.4.10 How would a highly inflationary economy affect a foreign operation that reports to its parent in US GAAP?
- 21.4.20 How does an issuer that prepares price-level adjusted financial statements present its statement of cash flows?

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.



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, an entity may use an appropriate weighted average exchange rate for the period for remeasuring the foreign currency cash flows if the results are 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 |
| <i>To recognize revenue in USD based on exchange rate on date of transaction.</i> | | |
| 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 |
| <i>To recognize change in exchange rate as of end of period.</i> | | |
| 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.

| <i>USD</i> | <i>Debit</i> | <i>Credit</i> |
|---|--------------|---------------|
| Cash | 8,000 | |
| Accounts receivable | | 8,000 |
| <i>To record settlement of transaction.</i> | | |

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.

| <i>\$'000s</i> | |
|---|------------|
| 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 |
| <i>To record borrowing in USD based on exchange rate at date of transaction.</i> | | |
| 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 |
| <i>To recognize change in exchange rate as of end of period.</i> | | |
| 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 | 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]



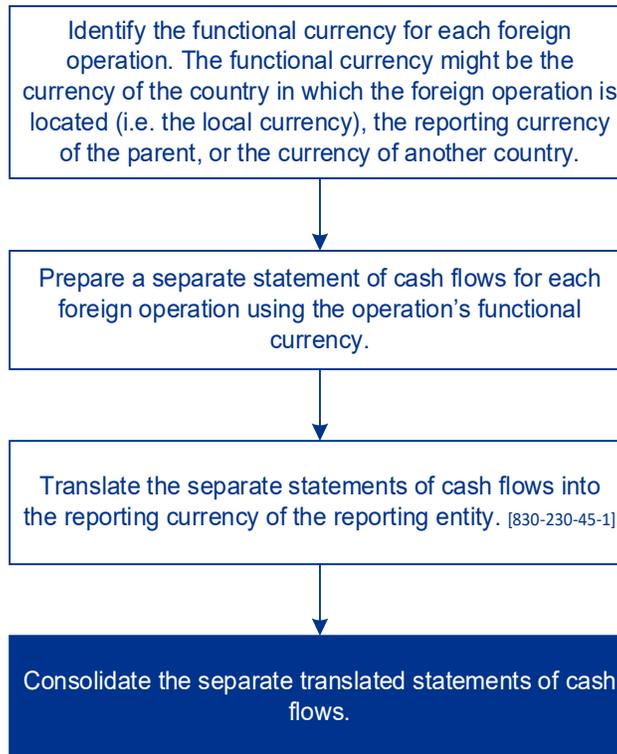
Question 21.3.10

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](#)).



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.

| | | |
|---|----------|---|
| <p>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.</p> | <p>+</p> | <p>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.</p> |
|---|----------|---|

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, an appropriately weighted average exchange rate for the period may be used for translation if the results are 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 |

| <i>\$'000s</i> | LC | Rate | USD |
|---------------------|--------------|-------------|--------------|
| Inventory | 400 | .80 | 320 |
| Fixed assets, net | 678 | .80 | 542 |
| Total assets | 1,233 | | \$986 |

| <i>\$'000s</i> | LC | Rate | USD |
|---|--------------|-------------|-------------------|
| Current liabilities | 279 | .80 | \$223 |
| Long-term debt | 800 | .80 | 640 |
| Shareholders' equity: | | | |
| Common shares | 100 | | 95 ¹ |
| Retained earnings | 54 | | 46 ² |
| Accumulated other comprehensive income | - | | (18) ³ |
| Total liabilities and shareholder's equity | 1,233 | | \$986 |

| <i>\$'000s</i> | 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 |

| <i>\$'000s</i> | LC | Rate | USD |
|--|-----------|-------------|------------------|
| Statement of comprehensive income | | | |
| Net income | | | \$ 28 |
| Other comprehensive income: | | | |
| Current year translation adjustment | | | (7) ³ |
| Comprehensive income | | | \$ 21 |

| <i>\$'000s</i> | 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 |

| \$'000s | LC | Rate | USD |
|--|-----------|------|-----------|
| 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) financing 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:

- Common shares were issued on June 30, Year 1 when exchange rate was 1 LC to .95 USD.
- Retained earnings represent accumulated net income. Therefore, it is translated at the same rate as (accumulated) net income.
- 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) |
- 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 |
| Shareholders' equity: | | | | |
| Common shares | 800 | 95 | \$ (95) | 800 |
| Retained earnings | 548 | 46 | | 594 |
| Accumulated other comprehensive income | - | (18) | | (18) |
| Total liabilities and shareholder'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 |

| <i>\$'000s</i> | 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 |

| <i>\$'000s</i> | 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) financing 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

The Codification does not specify financial statement requirements for an issuer whose primary economic environment is highly inflationary (though Topic 255 (changing prices) does provide optional disclosures). However, SEC guidance provides such issuers two options to prepare financial statements: 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

If the price-level currency approach is used, an issuer applies the principles in Topic 255.



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

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22.5.10 How are cash flows from/for debt securities classified by NFPs that are not business-oriented healthcare entities?

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Question

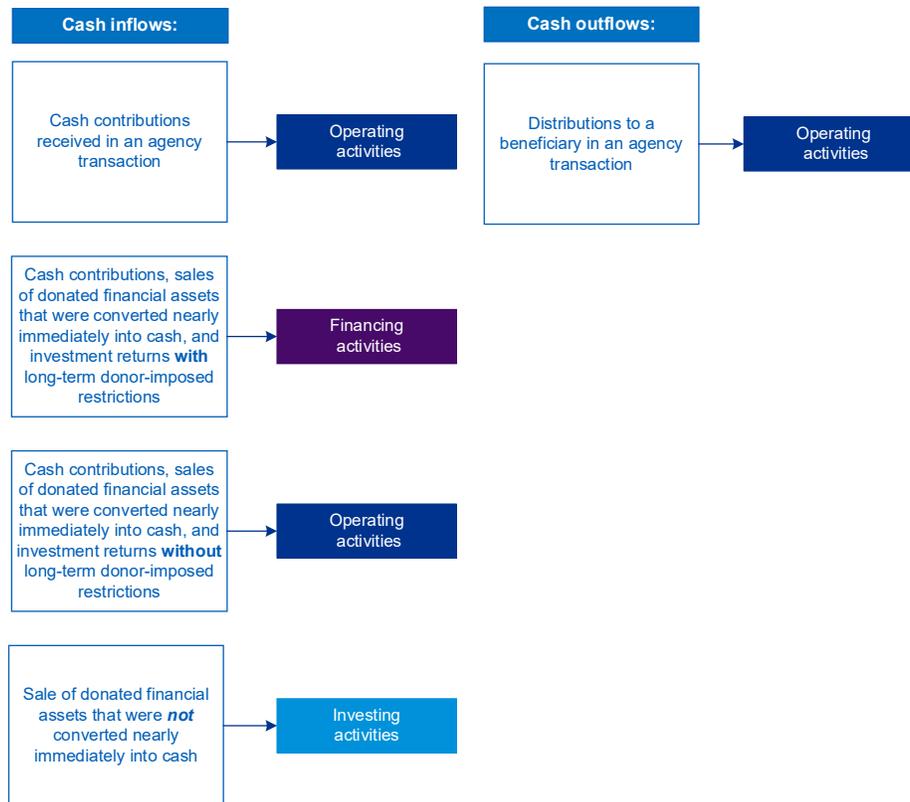
22.6.10 How are cash flows in agency transactions classified?

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.



Recent ASU reflected in this chapter

This chapter reflects the amendments of ASU 2023-08, *Accounting for and disclosure of crypto assets*. See [chapter 1](#) for an overview of the ASU and transition requirements. The ASU creates Subtopic 350-60.

Excerpts from the Codification included in this chapter are reproduced as if the pending content were currently effective for all entities.

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.

| <i>\$'000s</i> | |
|---|-----------------|
| 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.

NFPs apply the below requirements to present cash and cash equivalents, including restricted balances.

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.

Interpretive 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?

Interpretive 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?

Interpretive 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 funds¹
- Insurance reserves established under a contractual agreement with an insurer¹
- Escrows for maintenance or other purposes under a lease¹
- Collateral set aside for a line of credit, other debt arrangement, or swap¹
- Assets limited or restricted as to use.

Note:

1. 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.

| Transaction | Classification | |
|---|--|--|
| | 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 <i>not</i> 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?

Interpretive 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, Loans, and Crypto Assets

45-21A Cash receipts resulting from the sale of donated **financial assets** (for example, donated debt or equity instruments) or crypto assets accounted for in accordance with Subtopic 350-60 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 shares, with a fair value of \$30,000.

The donor specified that \$20,000 of the common shares is to be used in NFP's construction of a new medical office building; the use of the remaining \$10,000 of common shares 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, from a separate donor, another donation of common shares, with a fair value of \$40,000 and no restrictions on use. 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: | |
| <ol style="list-style-type: none"> 1. Contributions received (\$30 + \$40) and gain on sale of securities (\$5). 2. Donations of common shares (\$30 + \$40). 3. Immediate liquidation of the \$10 of common shares 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 shares 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 shares donated on June 1, Year 1 that is restricted for construction of the building. 7. Donation of the \$20 of common shares on June 1, Year 1 that is restricted for construction of the building (financing activity) and donation of \$40 of common shares on August 15, Year 1 that was without restrictions and not converted nearly immediately into cash. | |

22.4.40 Crypto assets donated to NFPs

This section only addresses cash flows from the sale of crypto intangible assets donated to NFPs. Other transactions by NFPs in crypto assets follow the guidance for business entities. See [chapter 24](#).



Question 22.4.50

How are cash flows from the sale of donated crypto intangible assets classified by an NFP?

Interpretive response: Proceeds from the sale of donated crypto intangible assets without long-term donor restrictions and that are converted nearly immediately into cash are classified as cash inflows from **operating** activities. [230-10-45-21A, 45-27A]

If, however, the donor restricted the use of the crypto intangible asset to the purposes of acquiring, constructing, or improving property, plant, equipment, or other long-lived assets or establishing or increasing a donor-restricted endowment fund, then those cash receipts are classified as cash inflows from **financing** activity. [230-10-45-21A]

'Nearly immediately' in the context of cash flows from crypto intangible assets refers to a prompt conversion that should be interpreted as a short period of time. When considering the threshold for a short period of time, unlike business entities (see [Question 24.2.30](#)), NFPs use the same threshold applied to sale proceeds of donated financial assets (e.g. a matter of days rather than months; see [Question 22.4.20](#)). [ASU 2012-05.BC8, ASU 2023-08.BC53].

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 9.2.20](#)). [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 9.2.30](#)).



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. Government grants received by for-profit entities

Detailed contents

Item significantly updated in this edition: #

23.1 How the standard works

23.2 Overview #

23.3 Grant proceeds

Questions

- 23.3.10 How are proceeds from government grants classified?
- 23.3.20 Are grant proceeds netted against the cash outflows they are intended to offset?
- 23.3.30 Is cash received under a government grant presented as restricted cash?

Examples

- 23.3.10 CARES Act – PPP loan accounted for as a grant
- 23.3.20 CARES Act – PPP loan accounted for as debt

23.4 Grant refunds and repayments

Questions

- 23.4.10 How are grant repayments classified?
- 23.4.20 Are grant refund payments netted against the grant proceeds?

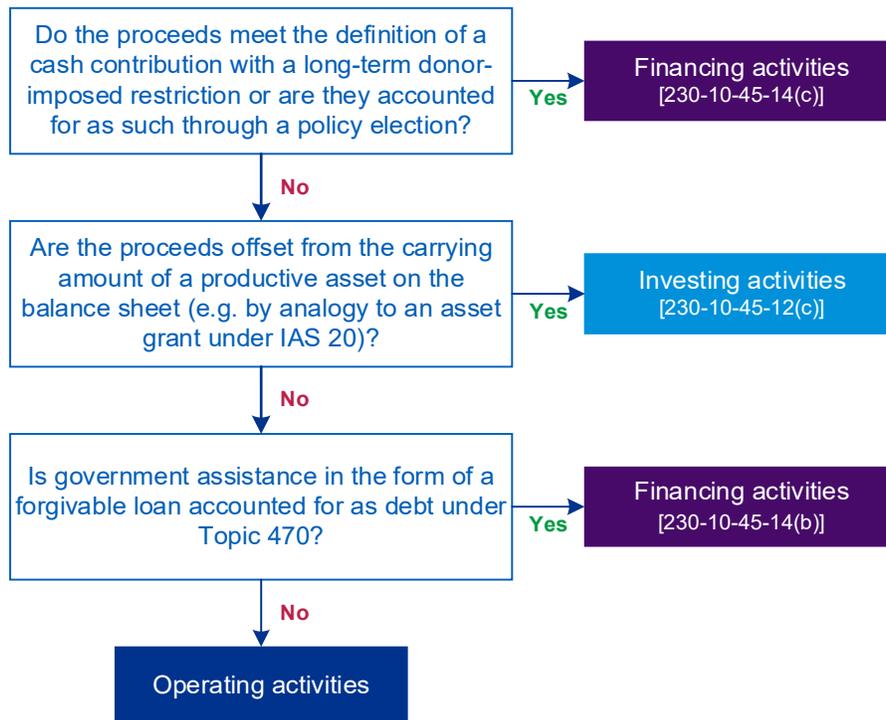
Example

- 23.4.10 CARES Act – voluntary repayment of PPP loan

23.1 How the standard works

Topic 230 provides no guidance on how to classify proceeds from government grants. Without guidance, an entity has to determine the appropriate classification by considering the accounting approach selected, the conditions of the grant and the timing of receipt. Generally, it is appropriate to classify grant proceeds consistent with the accounting treatment of the grant, as illustrated in the following decision tree.

The presentation approach followed should be disclosed and consistently applied.



Recent ASU affecting this chapter* *

This chapter does not reflect the amendments of ASU 2025-10, *Government Grants (Topic 832): Accounting for Government Grants Received by Business Entities*. ASC 832 as originally promulgated contained only disclosure requirements concerning the receipt of government assistance by business entities. The ASU expands ASC 832 to provide accounting guidance on the recognition, measurement and presentation of grants received by business entities from a government. The interpretive guidance in this section presumes the ASU has not been adopted.

See [chapter 1](#) for an overview of this ASU and transition requirements.

23.2 Overview#

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. We believe certain tax credits (e.g. refundable credits) are akin to government grants even if the entity intends to use them to offset an income tax liability (versus receive a cash refund). See KPMG Handbook, [Tax credits](#), for additional guidance.

Topic 832 (government assistance), as originally promulgated, is a disclosure-only topic (see KPMG Issues In-Depth, [Government assistance disclosures](#)). Therefore, prior to the adoption of ASU 2025-10, there is limited explicit US GAAP guidance about how a for-profit entity should account for government grants. This chapter 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[®] Accounting 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 it is probable 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](#).

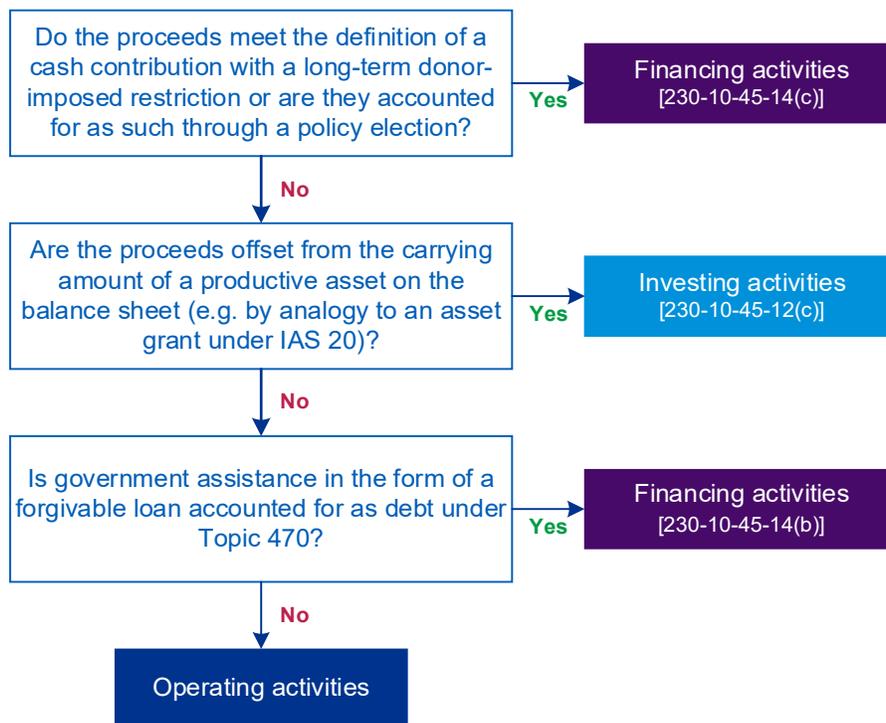
23.3 Grant proceeds



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 assets transferred or promised) 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 probable 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 loan as a **noncash** financing activity.



Question 23.3.30

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 assets transferred or promised) 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, the entity should disclose significant terms and conditions attached to the grant (see KPMG Issues In-Depth, [Government assistance disclosures](#)). [\[832-10-50-4\]](#)

23.4 Grant refunds and repayments

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.



Question 23.4.10

How are grant repayments classified?

Interpretive response: We believe that grant refund payments should generally be classified in the same category as the grant proceeds, even if repayment was not expected at the time the proceeds were received.

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 23.4.20

Are grant refund payments netted against the grant proceeds?

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]

As discussed in [section 3.5](#), 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 23.4.10

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.

24. Crypto intangible assets

Detailed contents

24.1 How the standard works

24.2 Presentation of cash flows for/from crypto intangible assets

Questions

- 24.2.10 Why do crypto intangible assets generally not meet the definition of cash or cash equivalents?
- 24.2.20 How do crypto intangible assets used as a means of payment affect the statement of cash flows?
- 24.2.30 How are cash flows from sales/for purchases of crypto intangible assets classified by business entities?
- 24.2.40 How are remeasurement and impairment of crypto intangible assets presented in the statement of cash flows?
- 24.2.50 [Not used]
- 24.2.60 How does a lender reflect the initial transfer of a loaned crypto intangible asset in the statement of cash flows?
- 24.2.70 How does a lender reflect crypto intangible asset loan fees paid in crypto intangible assets in the statement of cash flows?

24.1 How the standard works

Subtopic 350-60 (crypto assets) provides guidance for digital assets that:

- meet the US GAAP definition of an intangible asset;
- do not provide the asset holder with enforceable rights to or claims on underlying goods, services or any other asset(s);
- reside or are created on a distributed ledger (i.e. blockchain or similar technology);
- are secured through cryptography;
- are fungible; and
- are not created or issued by the reporting entity or its related parties.

This chapter addresses statement of cash flows issues for all crypto intangible assets – i.e. digital assets that meet criteria (a), (c) and (d) above – regardless of whether they meet all the criteria outlined above to be in the scope of Subtopic 350-60.

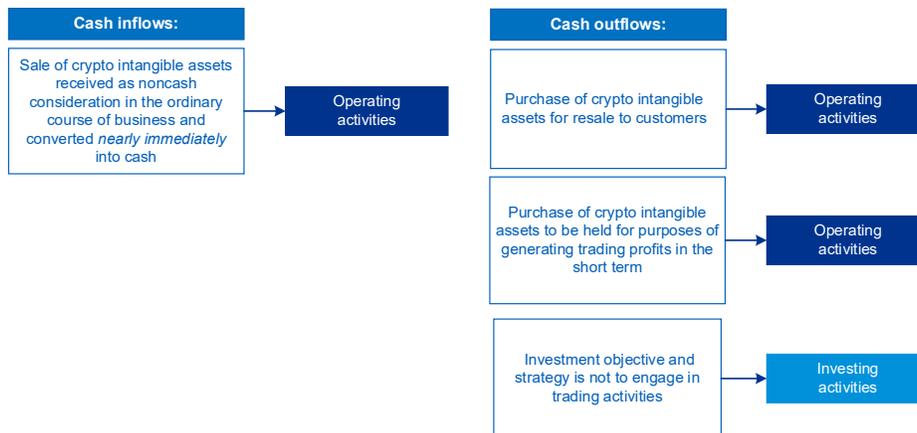
For digital assets that are not crypto intangible assets (e.g. digital assets that meet the definition of a financial, instead of intangible, asset), see other chapters of this Handbook as appropriate. Section 1.3 of KPMG Issues In-Depth, [Accounting and reporting for crypto intangible assets](#), discusses US GAAP balance sheet classification of digital assets.

Crypto intangible asset cash flows guidance in US GAAP

US GAAP does not explicitly provide statement of cash flows guidance for crypto intangible assets, except for the near-immediate sale of crypto intangible assets received as noncash consideration in the ordinary course of business (e.g. for goods or services) or as donations by NFPs. See [section 22.4.40](#) for guidance on crypto intangible assets received as donations by NFPs [230-10-45-21A, 45-27A, 350-60-45-3, 958-230-55-3]

Similar to other instances where explicit classification guidance is absent, we believe it is generally appropriate to consider the nature of the activity that gives rise to the cash flows when determining statement of cash flows classification.

The following chart outlines some classification scenarios encountered regarding crypto intangible assets, which are explained in more detail in this chapter.





Recent ASU reflected in this chapter#

This chapter reflects the amendments of ASU 2023-08, *Accounting for and disclosure of crypto assets*. See [chapter 1](#) for an overview of the ASU and transition requirements. The ASU creates Subtopic 350-60. Because we believe the guidance in this chapter applies equally to in-scope (Subtopic 350-60) and out-of-scope crypto intangible assets, we believe it also applies to all crypto intangible assets before or after an entity's adoption of ASU 2023-08.

Excerpts from the Codification included in this chapter are reproduced as if the pending content were currently effective for all entities.

This chapter also reflects SAB 122, issued on January 23, 2025, which rescinded SAB 121, *Accounting for Obligations to Safeguard Crypto-Assets an Entity Holds for its Platform Users*.

24.2 Presentation of cash flows for/from crypto intangible assets



Excerpt from ASC 230-10

> Statement of Cash Flows

45-27A If crypto assets accounted for in accordance with Subtopic 350-60 are received as noncash consideration in the ordinary course of business (for example, in exchange for goods and services transferred to a customer) and converted nearly immediately into cash, the cash received shall be classified as operating activities. In this context, the term nearly immediately refers to a short period of time that is expected to be within hours or a few days, rather than weeks.

Section 3.2 of KPMG Issues In-Depth, [Crypto intangible assets](#), highlights the following ways a crypto intangible asset can be acquired (not exhaustive):

- purchased for cash;
- received as payment for a good or service;
- purchased with another crypto intangible asset; or
- acquired via business combination or asset acquisition.

After their acquisition, all in-scope crypto intangible assets are measured at fair value under Topic 820. Out-of-scope intangible assets remain subject to the general requirements of Subtopic 350-30 after their acquisition.

Chapter 4 of KPMG Issues In-Depth, [Accounting and reporting for crypto intangible assets](#), discusses subsequent measurement of in-scope and out-of-scope crypto intangible assets in additional detail, while chapter 5 discusses their sale or other disposition.



Question 24.2.10

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, as discussed in [Question 6.3.140](#).



Question 24.2.20

How do crypto intangible assets used as a means of payment affect the statement of cash flows?

Interpretive response: As explained in [Question 24.2.10](#), crypto intangible assets do not qualify as cash or cash equivalents. Therefore, purchases paid for with crypto intangible assets are noncash transactions, with the following consequences, depending on the nature of the activity.

- The effect of purchases of goods and services 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](#)) are disclosed as a **noncash** investing activity (see [section 4.7.20](#)).

This approach applies similarly to purchases of crypto intangible assets paid for with other crypto intangible assets. These transactions are disclosed as a **noncash** investing activity, unless they affect net income, in which case their effect is presented as a reconciling item in the reconciliation of net income to net cash flows from operating activities.



Question 24.2.30

How are cash flows from sales/for purchases of crypto intangible assets classified by business entities?

Interpretive response:

Near immediate sale of crypto intangible assets in the ordinary course of business

ASU 2023-08 amends Topic 230 to specify that cash received by business (i.e. for profit) entities from the near immediate sale of crypto intangible assets is classified as cash inflows from **operating** activities when the assets are received as noncash consideration in the ordinary course of business (e.g. for goods or services). We believe this classification is appropriate even before the adoption of ASU 2023-08. [230-10-45-27A]

‘Nearly immediately’ in the context of cash flows from/for crypto intangible assets refers to a prompt conversion that should be interpreted as a short period of time. For entities other than NFPs, this means a matter of days, or even hours, rather than weeks. [ASU 2023-08.BC53]

Other cash flows

US GAAP does not explicitly address the classification of cash proceeds from other sales of, or cash payments to acquire, 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, when classifying cash flows from sales/for purchases of crypto intangible assets. In the absence of explicit guidance, we believe it is 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 be classified as cash flows from (not exhaustive):

- **operating** activities when the crypto intangible assets are acquired for resale to customers, consistent with the classification of cash payments to acquire other goods for resale to customers; [230-10-45-16, 45-17]
- **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.

See [Question 22.4.40](#) for guidance on classifying cash flows from sales/for purchases of crypto intangible assets by NFP entities.



Question 24.2.40

How are remeasurement and impairment of crypto intangible assets presented in the statement of cash flows?

Interpretive response: Remeasurement of in-scope crypto intangible assets and impairment of out-of-scope crypto intangible assets are presented as reconciling items in the reconciliation of net income to net cash flows from operating activities (see [section 3.2](#)). This is because those items are recorded through net income but are noncash items. [230-10-45-28(b)]



Question 24.2.60

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 intangible assets and recognizes a right to receive back in the future the loaned crypto intangible

assets (crypto intangible asset loan receivable) in their place. The crypto intangible asset loan receivable is initially measured at the fair value of the loaned crypto intangible 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 intangible assets for the crypto intangible 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 24.2.70

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 24.2.30](#) for guidance on how to classify cash proceeds from the sale of crypto intangible assets earned as loan fees.

25. Insurance entities

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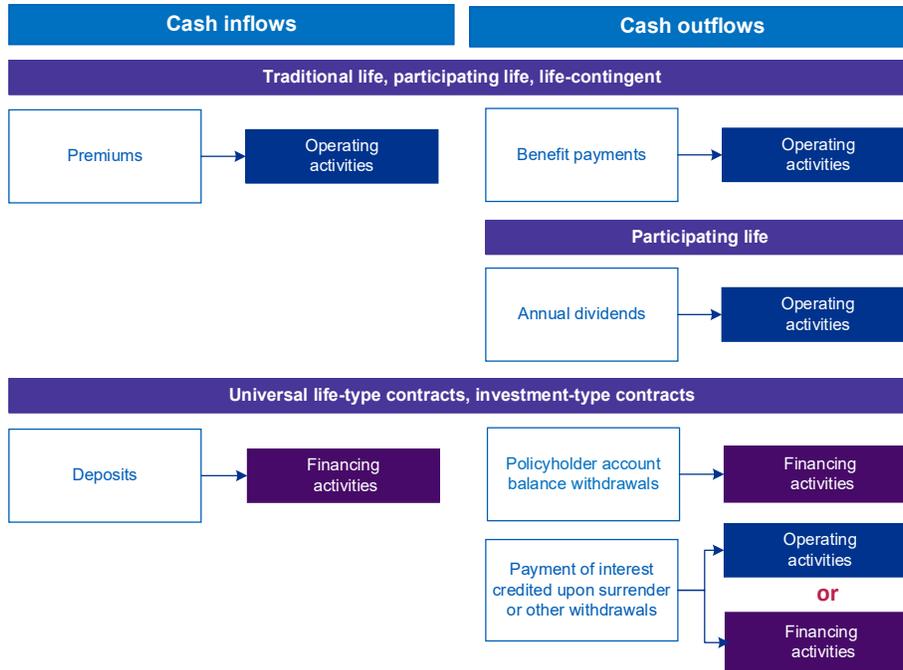
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25.1 How the standard works

Topic 944 (insurance) establishes industry-specific accounting and reporting guidance for insurance entities. It discusses the accounting for insurance contracts but does not discuss their classification in the statement of cash flows. The following diagram summarizes some of the classification issues encountered, which are explained in more detail in this chapter.



Further consideration is required for contracts or contract features that allow policy holders to participate in the risks and rewards of the capital markets.

25.2 Overview

Topic 944 addresses the accounting for an insurance or reinsurance contract issued by entities within its scope (referred to in this chapter as 'insurance entities'). The accounting depends on whether the contract is classified as short-duration, long-duration or is a financial guarantee and whether it transfers insurance risk. For long-duration contracts, the accounting is further dependent on the contract type (e.g. traditional life, limited-payment, participating life, universal-life type, investment) and the underlying contractual features (e.g. market risk benefits, embedded derivatives, annuitization, death or other insurance benefits). [944-20-15-2, 15-9 – 15-31]

Neither Topic 944 nor Topic 230 specifically address the classification of cash flows generated by insurance entities from their insurance activities. Following the general guidance of Topic 230, premiums received and benefits or claims paid are generally **operating** cash flows. However, there may be exceptions depending on the nature of the insurance or reinsurance contracts, especially certain long-duration contracts.

This chapter explores certain classification nuances for the following long-duration contracts:

- traditional life, participating life, and life-contingent limited payment contracts – [section 25.3](#); and
- universal life-type and investment contracts – [section 25.4](#).

25.3 Long-duration contracts – traditional life, participating life, and life-contingent limited-payment contracts

Traditional life contracts

Traditional life insurance contracts provide a fixed amount of insurance either for a fixed term (term life) or over the life of the insured (whole life). The death benefits are generally paid out upon the death of the insured. [944-20 Glossary]

An insurance entity recognizes premiums for traditional life contracts as revenue over the premium-paying periods when due from the policyholder. [944-605-25-3]

Participating life contracts

A participating life insurance contract is similar to a traditional life insurance contract, except it entitles the policyholder to participate in the earnings or surplus of the insurance entity. Participation occurs through the distribution of dividends to policyholders. [944-50 Glossary]

An insurance entity recognizes premiums for participating life insurance contracts as revenue over the premium-paying periods when due from the policyholder. [944-605-25-3]

Life-contingent limited-payment contracts

Life-contingent limited-payment contracts subject the insurer to risks arising from policyholder mortality and morbidity over a period that extends beyond the period or periods in which the insurance entity collects premiums. Because the collection of premiums under a limited-payment contract does not represent the completion of an earnings process, the insurance entity defers recognizing revenue from any gross premium received in excess of the net premium. [944-20 Glossary, 944-605-25-4A]



Question 25.3.10

How are cash flows for traditional life and life-contingent limited-payment insurance contracts classified?

Interpretive response: We believe that cash flows for premiums received and death benefits paid for traditional life and life-contingent limited-payment insurance contracts should be classified by an insurance entity as **operating** activities. This is because such receipts and payments represent the normal operations of an insurance entity from the sale of insurance contracts. [230-10-45-16, 45-17]



Question 25.3.20

How are cash flows for participating life insurance contracts classified?

Interpretive response: We believe that cash flows for premiums received and death benefits paid for participating life insurance contracts should be classified by insurance entities as **operating** activities. This is because such receipts and payments represent the normal operations of an insurance entity from the sale of insurance contracts. [230-10-45-16, 45-17]

Further, we believe that annual dividends paid to policyholders on participating life insurance contracts should be classified by insurance entities as cash flows from **operating** activities. This is because they represent normal operations per the terms of these contracts and this classification is consistent with the examples of cash outflows for **operating** activities, including cash refunds to customers. [230-10-45-17f]

25.4 Long-duration contracts – universal life-type or investment contracts

Universal life-type contracts

Universal life-type contracts are long-duration contracts that provide either death or annuity benefits and are characterized by any of the following features: [944-20-15-26]

- one or more of the amounts assessed by the insurer against the policyholder – including amounts assessed for mortality coverage, contract administration, initiation, or surrender – are not fixed and guaranteed by the terms of the contract;
- amounts that accrue to the benefit of the policyholder – including interest accrued to policyholder balances – are not fixed and guaranteed by the terms of the contract;
- premiums may be varied by the policyholder within contract limits and without consent of the insurer.

The insurance entity records premiums received on universal life-type contracts as a liability (policyholder's account balance) because they are considered deposits. The insurance entity does not record them as revenue. [944-605-25-5]

Investment contracts

Investment contracts are long-duration contracts that do not subject the insurance entity to risk arising from policyholder mortality or morbidity. [944-40 Glossary]

The insurance entity records the deposit received for an investment contract as a liability (policyholder's account balance) and accounts for the contract consistent with interest bearing or other financial instruments. [944-825-25-2]

Accrued policyholder's account balance

The accrued policyholder's account balance for universal-life type contracts and investment contracts consists of the following: [944-40-25-14]

- deposits (premiums) net of withdrawals (including surrenders)
- plus interest credited per the contract
- less fees and charges assessed (e.g. administrative charges)
- plus additional interest (e.g. persistency bonus)
- other adjustments (e.g. experience-rated contracts)



Question 25.4.10

How are cash flows for universal life-type contracts and investment contracts classified?

Interpretive response: For universal life-type contracts and investment contracts, we believe that cash deposits received and cash payments for policyholder account balance withdrawals should be classified by an insurance entity as cash flows from **financing** activities. This is because the policyholder's account balance represents funds held on behalf of the policyholder, meaning the account balance is a borrowing by the insurance entity settled through the policyholder's withdrawal. For guidance about the classification of changes in funds held for others, see [Question 6.2.36](#). For guidance about the issuance of debt, see [section 12.2.20](#). [230-20 Glossary, 230-10-45-14 – 45-15]

Fees and charges assessed against policyholders and unpaid interest credited to policyholders are presented as noncash reconciling items in the reconciliation of net income to net cash flows from **operating** activities. This is consistent

with the classification of interest accrued on debt, see [Example 12.2.40](#). [230-10-45-28(b)]

In our experience, there is diversity in practice in how insurance entities classify cash payments for contractual interest credited that are made upon surrender or other withdrawals. Some insurance entities classify these payments as cash flows from **operating** activities. This is consistent with the classification of interest coupon payments for debt (see [Question 12.2.65](#) and [Example 12.2.40](#)). However, other insurance entities classify them as cash flows from **financing** activities as part of withdrawal activities, which we believe is also acceptable. This is because the interest credited is part of the policyholder's account balance and the payment of this interest credited to the policyholder generally occurs as part of a policyholder account balance withdrawal. [230-10-45-17(d)]



Question 25.4.20

How are cash flows for other benefit features (in addition to the account balance) of a universal life-type contract or investment contract classified after adopting ASU 2018-12?

Background: Over time, the insurance industry has developed universal life-type contracts and investment contracts (or certain contract features within those contracts) that provide the policyholder with a benefit in addition to the account balance. This includes contracts or contract features that allow policyholders to participate in the risks and rewards of the capital markets.

When a universal life-type contract or investment contract includes benefits in addition to the account balance, the insurance entity assesses the appropriate accounting treatment for each individual contract or contract feature at contract inception. It determines the accounting for the contract or contract feature(s) in the following order: [944-40-25-25B, ASU 2018-12.BC66–BC67]

- market risk benefit(s) (MRB) – these contract or contract features provide the policyholder with protection from capital market risk by requiring the insurance entity to cover a shortfall between the guaranteed benefit and the account balance – i.e. the net amount at risk;
- derivative(s) or embedded derivative(s) – e.g. contract feature(s) within indexed life and annuity contracts; and then
- annuitization, death or other insurance benefit(s).

See Question 3.3.40 in KPMG Handbook, [Long-duration contracts: Targeted improvements](#), for additional guidance on the accounting treatment.

Interpretive response: We believe that an insurance entity's classification of its cash flows for other benefit features of a universal life-type contract or investment contract depends on the nature of the cash flows.

| Cash payments | Classification |
|--|--|
| Payment for market risk benefits (MRB) | <p>Insurance entities classify the portion of the payment for the account balance as financing activities. This is because the account balance represents a borrowing. An entity classifies cash payments for amounts borrowed as cash flows from financing activities. [230-10-45-15(b)]</p> <p>In our experience, there is diversity in practice in how insurance entities classify the portion of the payment in excess of the account balance. Some insurance entities classify this portion of the payment as operating activities. This is consistent with the nature of insurance benefits as it represents the normal operations of an insurance entity. However, other insurance entities classify this portion of the payment as cash flows from financing activities because the payment of the benefit generally occurs as part of policyholder account withdrawal activities. [230-10-45-16, 45-17]</p> |
| Payments of interest credited to the account balance from a contract feature accounted for as an embedded derivative ^{1, 2} | <p>Operating activities or financing activities - see Question 25.4.10. For example, certain universal-life type and investment contracts include a contract feature that results in basing the account balance's interest crediting rate on the performance of an equity index - e.g. S&P 500. This contract feature is accounted for as an embedded derivative and the interest credited is part of the policyholder's account balance. The payment of this interest credited to the policyholder generally occurs as part of a policyholder account balance withdrawal.</p> |
| Payments made for annuitization, death or other insurance benefits ^{1, 3} | <p>Operating activities. This is consistent with the nature of insurance benefits because it represents the normal operations of an insurance entity. [230-10-45-16, 45-17]</p> |
| <p>Notes:</p> <ol style="list-style-type: none"> 1. The classification of payments made under these contract features is the same pre- and post-adoption of ASU 2018-12. This is the case even when those contracts or contract features will be recognized and measured as a market risk benefit upon adoption of ASU 2018-12. 2. Prior to settlement, the change in the fair value of the embedded derivative is presented as a noncash reconciling item in the reconciliation of net income to net cash flows from operating activities. 3. These payments provide annuitization, death or other insurance benefits in addition to the account balance and are recognized and measured as an additional liability. [944-40-30-20 – 30-29] | |

Appendix: SEC staff guidance#

Reproduced below are the following SEC staff speeches:

- Paul Munter, SEC Chief Accountant, *Statement on The Statement of Cash Flows: Improving the Quality of Cash Flow Information Provided to Investors (December 4, 2023)*; and
- Paul Munter, SEC Chief Accountant, *Remarks before the 2024 AICPA & CIMA Conference on Current SEC and PCAOB Developments: Accounting Matters (December 9, 2024)*.



Excerpt from SEC staff speech

Paul Munter, SEC Chief Accountant, Statement on The Statement of Cash Flows: Improving the Quality of Cash Flow Information Provided to Investors (December 4, 2023)

Introduction: The Importance of Cash Flow Reporting for Investors^[1]

The statement of cash flows is integral to a complete set of financial statements, and it should therefore be subject to the same level of due professional care, effective internal controls, and robust, high-quality audit as other financial statements.^[2] Unfortunately, we have observed that preparers and auditors may not always apply the same rigor and attention to the statement of cash flows as they do to other financial statements, which may impede high quality financial reporting for the benefit of investors. This is evidenced by the statement of cash flows consistently being a leading area of financial statement restatements,^[3] and by our observations of material weaknesses in internal control over financial reporting (“ICFR”) around the preparation and presentation of the statement of cash flows.

The information presented in the statement of cash flows helps investors assess the issuer’s potential to generate positive future net cash flows, meet its financial obligations, and pay dividends or otherwise return cash to investors. Investors also may use cash flow information to evaluate an issuer’s need for external financing, to determine the reasons for differences between net income and associated cash receipts and payments, and to understand the effects of both its cash and noncash investing and financing transactions on an issuer’s financial position.^[4] In addition, cash flow information is often used as a proxy to understand earnings quality.^[5]

For these reasons, the statement of cash flows is a critical component of high quality financial reporting for investors. Accordingly, we remind issuers and auditors to approach the preparation, review, and audit of the statement of cash flows with a focus on quality for the benefit of investors.

Key Reminders of Professional Responsibilities around the Statement of Cash Flows**Materiality**

The statement of cash flows has consistently been a leading area of restatements,^[6] and we have observed that a significant majority of these restatements represent prior period errors corrected in the current period comparative financial statements, or what are referred to colloquially as “little r” restatements.^[7] This indicates that issuers are routinely making a determination that errors in the statement of cash flows do not constitute a material error in prior periods. We remind issuers, auditors, and others of the importance of performing an objective analysis from the perspective of a reasonable investor when evaluating the materiality^[8] of both the financial statement and ICFR impacts^[9] of an error in the statement of cash flows, including the significance of the statement of cash flows to the investor’s complete understanding of the financial condition of the company.

In certain instances, the staff in OCA have been presented with analyses that conclude an error in the statement of cash flows is not material because it is an error in classification only. We have not found such analyses and their corresponding arguments persuasive since classification itself is the foundation of the statement of cash flows. Accurately classifying cash flows as operating, investing, or financing activities is paramount to investors understanding the nature of the issuer’s activities that generated and used cash during the reporting period. Therefore, issuers and auditors must consider all relevant facts and circumstances to thoroughly and objectively evaluate the total mix of information and determine if such classification errors are material to a reasonable investor.

Presentation and Disclosure

We have observed that determining the appropriate classification of cash flows as operating, investing, or financing activities can, at times, require significant judgment. Accordingly, we believe it is important that issuers identify both routine and nonroutine transactions that may raise challenging cash flow classification issues early enough in the financial statement reporting process to allow sufficient time for the issuer to address and for the auditor to properly evaluate such issues.

The disclosures related to the statement of cash flows are also critical to investors. We remind issuers that the requirement to disclose significant accounting policies includes those policies that materially affect the determination of cash flow classification.^[10] Additionally, issuers must supplement the statement of cash flows with disclosure of noncash investing and financing activities^[11] to facilitate an investor’s understanding of how these activities affect recognized assets or liabilities even when there are no resulting cash receipts or payments during the period. We believe it is critical for issuers to focus on investor needs when determining how best to communicate relevant cash and noncash information.

Internal Controls

Appropriate risk assessment processes and controls in place to facilitate risk identification, analysis, and response related to the preparation and presentation of the statement of cash flows are essential to establishing and

maintaining effective ICFR.^[12] Because amounts reported in the statement of cash flows are reconciled to income statement activity and balance sheet changes,^[13] controls designed around those other financial statements may indirectly address risks in the statement of cash flows. However, we believe more direct controls are critical and should not be overlooked, such as those regarding the classification of cash flows and the disclosure of noncash items.

Independent Auditors

The importance of the statement of cash flows is also highlighted directly in the auditor's report. In forming its opinion, an auditor evaluates whether the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with the applicable financial reporting framework.^[14]

The risks of material misstatement related to the statement of cash flows, such as inaccurate classification of cash flows and incomplete supplemental disclosure of noncash items, are distinct from those in the other financial statements. We expect auditors to design and implement audit procedures that are specifically responsive to those risks in the statement of cash flows, rather than simply reconciling reported cash flows to the balance sheet or income statement.

Auditing the statement of cash flows starts during audit planning, which requires a comprehensive understanding of the issuer's business.^[15] We remind auditors that in planning the audit and when evaluating errors, a materiality level is established for the financial statements as a whole and it would not be appropriate for auditors to establish a materiality level for the statement of cash flows that exceeds the materiality level for the financial statements as a whole.^[16]

Improving Cash Flow Information for Investors

We encourage issuers to carefully consider how to best present cash and noncash information, and whether additional information should be disclosed to facilitate an investor's understanding of the statement of cash flows and the financial statements as a whole. For example, we believe issuers could further disaggregate amounts currently reported in the statement of cash flows, disclose additional information to better enable investors to understand the relationships between amounts reported in the statement of cash flows and those in the statement of financial position, and consider reporting operating cash flows under the direct method.

Investors have provided feedback regarding the need for such disaggregated cash flow information and the benefits of the direct method.^[17] Academic studies have also indicated that reporting cash flows under the direct method provides decision-useful information.^[18] Despite the fact that under U.S. GAAP issuers are encouraged to report major classes of gross cash receipts and gross cash disbursements from operating activities through use of the direct method,^[19] nearly all issuers continue to use the indirect method.^[20]

In light of continued requests from investors for additional cash flow transparency, we encourage issuers to carefully evaluate whether the needs of investors would be better served if issuers used the direct method. As part of this evaluation, we believe issuers should consider whether their ability to collect information about gross operating cash receipts and payments has been

improved by advances in technology. We note that those issuers that continue to report cash flows using the indirect method could supplement such cash flow information with disclosure of specific major classes of gross cash receipts and payments, such as cash collected from customers, cash paid to employees, and cash paid to suppliers.

We encourage audit committees, as part of their important oversight role, to discuss with management and the independent auditor the potential use of the direct method or additional disclosures of gross cash receipts and payments, with an emphasis on investor needs. We also note that independent auditors can use their communications with the audit committee around alternative accounting treatments to facilitate this dialogue.^[21]

Finally, we encourage investors, preparers, auditors, and other stakeholders to engage with standard setters whenever any standard-setting project could result in cash flow implications. Separately, the FASB recently added a project to its technical agenda to make targeted improvements to the statement of cash flows,^[22] and we believe it is critically important for stakeholders to provide constructive feedback as this project progresses. We also encourage stakeholders to provide observations that could inform additional potential standard-setting projects specific to the statement of cash flows.^[23] In our view, such stakeholder observations could include continued feedback on the benefits and costs related to application of the direct method, and specific, detailed suggestions that could help the FASB identify other timely and cost-effective solutions that would further enhance the decision usefulness of the statement of cash flows.

Conclusion

The responsibility of issuers to provide reliable, high quality financial information to investors is foundational to the integrity of our capital markets system. The statement of cash flows represents a critical piece of a complete picture of an issuer's financial health and operations. Issuers and auditors have a responsibility, under securities laws and professional standards, to apply the same high level of care and professionalism to the preparation, review, and audit of the statement of cash flows as is required for the other financial statements. Investors should be provided with transparent, meaningful, and high-quality cash flow information that is subject to rigor in both preparation and auditing, consistent with the other components of the financial statements.

As always, OCA is available for consultation on accounting, financial reporting, internal control, and auditing concerns or questions, especially those involving unusual, complex, or novel transactions for which no clear authoritative guidance exists, including any such matters related to the statement of cash flows.^[24]

^[1] This statement is provided in the author's official capacity as the Commission's Chief Accountant but does not necessarily reflect the views of the Commission, Commissioners, or other members of the staff. This statement is not a rule, regulation, or statement of the Commission. The Commission has neither approved nor disapproved its content. This statement, like all staff statements, has no legal force or effect: it does not alter or amend

applicable law, and it creates no new or additional obligations for any person. “Our” and “we” are used throughout this statement to refer to the staff of the Office of the Chief Accountant (“OCA”).

^[2] A complete set of financial statements includes statements of financial position, income and comprehensive income, stockholders’ equity, *and cash flows*, as well as notes to the financial statements. See Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 205-10-45-1A. See also ASC 235-10-05-1 through 05-4 and ASC 235-10-50-1 through 50-3. See also Rules 3-01 through 3-04 of Regulation SX [17 CFR §§ 210.3-01 – 3-04] and Rule 4-01 of Regulation S-X [17 CFR § 210.4-01]. While this statement focuses on considerations for financial statements prepared in accordance with U.S. GAAP, similar concepts and requirements would apply under International Financial Reporting Standards (“IFRS”). Foreign private issuers may prepare their financial statements in accordance with IFRS as issued by the International Accounting Standards Board without reconciliation to U.S. GAAP. See [Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards without Reconciliation to U.S. GAAP, Release No. 33-8879 \(Dec. 21, 2007\)](#) [73 FR 986 (Jan. 4, 2008)].

^[3] See Audit Analytics, *Financial Restatements, A 20-Year Review: 2003 – 2022*, at 5 and 10 (noting that cash flows have been the fourth most common accounting issue cited in restatements from 2003 through 2022, including the most frequently cited issue among large accelerated filers) (November 2023).

^[4] See ASC 230-10-10-1 through 10-2.

^[5] See Patricia Dechow, Weili Ge, & Catherine Schrand, *Understanding Earnings Quality: A Review of the Proxies, their Determinants, and their Consequences*, 50 J. Acct. & Econ. 344 (2010).

^[6] See *supra* note 3.

^[7] See Paul Munter, [Assessing Materiality: Focusing on the Reasonable Investor When Evaluating Errors](#) (Mar. 9, 2022).

^[8] The Supreme Court has held that a fact is material if there is “a substantial likelihood that the [...] fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976); see also *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988) (as the Supreme Court has noted, determinations of materiality require “delicate assessments of the inferences a ‘reasonable shareholder’ would draw from a given set of facts and the significance of those inferences to him....” *TSC Industries*, 426 U.S. at 450). See also FASB, *Statement of Financial Accounting Concepts No. 8—Conceptual Framework for Financial Reporting—Chapter 3, Qualitative Characteristics of Useful Financial Information (As Amended)* (Aug. 2018); Staff Accounting Bulletin (“SAB”) No. 99, *Materiality* (Aug. 12, 1999); SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (Sept. 13, 2006).

^[9] Management’s ICFR effectiveness assessment must consider the magnitude of the potential misstatement that could result from a control

deficiency, and we note that an actual error is only the starting point for determining the potential impact and severity of a deficiency.

^[10] See ASC 235-10-50-1 through 50-3. See also ASC 230-10-50-1.

^[11] See ASC 230-10-50-3 through 50-6.

^[12] See Paul Munter, [The Importance of a Comprehensive Risk Assessment by Auditors and Management](#) (Aug. 25, 2023).

^[13] As required by ASC 230-10-45-29, a reconciliation of net income of a business entity to net cash flow from operating activities shall be provided regardless of whether the direct or indirect method of reporting net cash flow from operating activities is used.

^[14] See Public Company Accounting Oversight Board (“PCAOB”) Auditing Standard (“AS”) 3101, *The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, paragraph .08(e).

^[15] See AS 2101, *Audit Planning*, paragraph .07.

^[16] See AS 2105, *Consideration of Materiality in Planning and Performing an Audit*, paragraphs .06 and .07.

^[17] See FASB, [Feedback Summary on the 2021 Invitation to Comment, Agenda Consultation](#).

^[18] See Jeffrey Hales & Steven F. Orpurt, A Review of Academic Research on the Reporting of Cash Flows from Operations, 27 *Acct. Horizons* 539 (2013). See also Steven F. Orpurt & Yoonseok Zang, Do Direct Cash Flow Disclosures Help Predict Future Operating Cash Flows and Earnings?, 84 *The Acct. Rev.* (2009).

^[19] See ASC 230-10-45-7 and ASC 230-10-45-25.

^[20] See James Schmutte and James R. Duncan, *The Statement of Cash Flows Turns 30: Common Reporting Deficiencies and Recent Changes*, *The CPA Journal* (2019), 8 (stating that “[a]lthough FASB has always encouraged the use of the direct method, the indirect method is the predominant presentation method”). See also Orpurt & Zhang supra note 18, 904 (finding, based on a sample of statements of cash flows included in public filings from 1989 through 2002, “approximately 2-3 percent...include a [direct method] disclosure with the percentage decreasing through time to 0.48 percent in 2002.”)

^[21] See AS 1301, *Communications with Audit Committees*, paragraph .13(g) (providing that the auditor must communicate to the audit committee all alternative treatments permissible under the applicable financial reporting framework for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the auditor). See also Section 10A(k) of the Securities Exchange Act [15 U.S.C. § 78j-1(k)] and Rule 2-07(a)(2) of Regulation S-X [17 CFR § 210.2-07(a)(2)].

^[22] See FASB, [Technical Agenda Project Update, Statement of Cash Flows—Targeted Improvements](#) (stating that “[t]he objective of this project is to make targeted improvements to the statement of cash flows to provide investors

with decision-useful information. The project will explore (1) reorganizing and disaggregating the statement of cash flows for financial institutions to improve the decision usefulness of that statement and (2) developing a disclosure about an entity's cash interest received.")

^[23] In addition to its technical agenda project on the statement of cash flows (see *supra* note 22), the FASB also has a project on its research agenda to explore further potential improvements to the statement of cash flows. See [FASB, Objectives of Research Projects, Statement of Cash Flows](#).

^[24] More information about how to initiate a dialogue with OCA, what to expect from the consultation process, and what information should be included in a consultation submission in order for OCA to most quickly address a company's or auditor's question is available on OCA's webpage, available at <https://www.sec.gov/about/divisions-offices/office-chief-accountant>.



Excerpt from SEC staff speech

Paul Munter, SEC Chief Accountant, Remarks before the 2024 AICPA & CIMA Conference on Current SEC and PCAOB Developments: Accounting Matters (December 9, 2024)

Thank you to the AICPA for inviting me to speak with you today.^[1] In my role as the SEC's Chief Accountant, I get to see first-hand the collective efforts put forth by the accounting profession towards the goal of ensuring that our financial markets continue to be supported by high quality financial information.

Like many of you, my experience in the accounting profession has been an exciting and unpredictable journey, taking me from colleges in Texas, Colorado and Florida to auditing in Miami and elsewhere; from an academic fellowship at the SEC here in Washington D.C. to serving as a partner at a large firm in New York and London, and now back once again at the SEC, leading the Office of the Chief Accountant for the past four years. Accounting has provided me with tremendous opportunities to travel the world, work with and learn from hundreds of incredible individuals from many different backgrounds and cultures, grow personally and professionally, and engage with and mentor the next generation of accounting professionals.

The most meaningful part of my accounting career has been the opportunity and responsibility to serve in the public interest. Now, when I say serving in the public interest, I'm not referring solely to my role as a civil servant at the SEC. Don't get me wrong—I feel fortunate to be in a position to have a meaningful impact on the quality of financial information and audit quality to protect investors and support capital formation—but when I say serving in the public interest, I am referring to what I believe makes accounting a profession and not just a job (and I'll add, it's certainly not an industry!). There are certain responsibilities that come along with being a member of a profession. In addition to important professional conduct responsibilities, there is a public interest aspect to being a CPA. Whether you are a civil servant, auditor, tax accountant, preparer, or other accounting professional, I urge you to always keep in mind the "Public" aspect of Certified *Public* Accountant.

Unfortunately, across the globe, we have observed high-profile cases of unethical behavior by accountants that were not limited to just one firm, one issuer, or one jurisdiction. The recurrence of ethical lapses has adverse consequences on the accounting profession and global capital markets, undermining public trust in both accounting professionals and financial reporting. It also raises broader concerns about the culture and governance within accounting firms and issuers.

Accountants serve as important gatekeepers to promote the integrity of our markets and protect investors regardless of whether they are internal or external auditors, preparers, tax professionals, audit committee members, or serve in other roles. The value of an accountant's services depends on their credibility and trustworthiness. Trust is hard to gain and easy to lose, both individually and as a profession, so accountants should consider the importance of building and maintaining trust every single day.

For auditors, the foundation of this trust lies in the auditor's required independence. Every member of an audit firm should keep this in mind, and audit firm leadership should reinforce this message by actively championing the principles in the auditor independence rules, as opposed to setting a tone of independence as a compliance exercise where independence violations and the resultant enforcement actions are merely a "cost of doing business."^[2]

For audit firms and issuers, a strong culture and tone at the top that prioritizes doing the right thing above all else empowers all accountants, regardless of their role or level of experience, to exercise professional skepticism and, where appropriate, to challenge management. In many cases, fraud is eventually uncovered by an accountant who exercises professional skepticism, refuses to stop asking questions, and doesn't succumb to pressure, but these behaviors are also key to elevating financial reporting and audit quality.

In addition to the importance of a strong, ethical tone at the top, there is academic research that shows that behavior is driven the most by the people that are directly around you, which some refer to as the "mood in the middle" or the "buzz at the bottom." For example, an academic study specific to auditors showed that staff auditors will be more influenced by the tone of their supervising senior than the partner when these two individuals provide conflicting tones.^[3] Leaders should therefore ensure that the tone they set at the top is actually flowing through the rest of the organization. While this academic study focused on auditors, I believe the same concept holds true across all practice areas of a firm or issuer—good ethical behavior has an impact on the decision-making and integrity of professionals. Further, when less-experienced accountants' professional experience is anchored in doing the right thing, they are more likely to become leaders with this same mindset.

With ongoing concerns in our profession about our ability to continue to attract and retain talented individuals who are dedicated to serving in the public interest, I believe we are at an inflection point.^[4] That is why all of us should remember that those professionals around us are learning by our example and taking our lead—it is incumbent upon each of us to take seriously our responsibility to build and maintain public trust in our profession. In this regard,

I'd like to share two examples of how we can promote public interest in our work.

- *First*, companies raising money from the public are part of a basic bargain under our federal securities laws. Under that basic bargain, investors get to decide what risks they wish to take, while those companies have an obligation to provide decision-useful information to investors on a regular basis. Fundamental to the functioning of this basic bargain is that the information companies provide to investors be of high quality. To this end, I believe it's critical that preparers view financial reporting as a communication activity, and not simply a compliance exercise. Companies benefit from a lower cost of capital when they report financial information that meets investors' information needs.
- *Second*, audit professionals have a difficult job—they must sometimes make difficult determinations that potentially pit the public interest against self- or firm-interest. But that is precisely how public accountants fulfill their critical gatekeeping function to protect investors: by ensuring that issues are promptly identified and addressed. Keeping in mind the important role of the independent auditor as a gatekeeper, auditors would be well-served to view investors, and not management, as their client. This is why, by statute it is not management but the independent audit committee that is directly responsible for the appointment, compensation, and oversight of the work of the auditor.^[5] Audit committees can set a proper tone by emphasizing to the independent auditor that the auditor is required to directly report to the audit committee and not to management, and also that the auditor should view investors as the auditor's ultimate client.

Again, these are just two examples, so please remember: what you do matters, not just to the issuer you may be engaged by, but to investors and the public at large. Your work has a direct bearing on the financial well-being of the global economy and all participants in that economy.

Reflecting on the importance of working together as members of a profession in the public interest, I'm reminded of a speech I heard 35 years ago at the AICPA's sixteenth annual National Conference on Current SEC Developments. I was sitting in the audience, much like you are today, when then-SEC Chair, David Ruder, shared his perspectives on the interaction between the accounting profession, including the Financial Accounting Standards Board ("FASB"), the business community, and the SEC in setting accounting standards.^[6] I would like to expand on some of the themes included in that speech and build on the relevance of his message for standard setting in today's environment.

Just as Chair Ruder said 35 years ago, high quality standard setting requires the cooperative efforts of all involved parties, including the standard setter, the many different stakeholders impacted by the quality of standard setting, including investors, and the Commission, which has a vital oversight responsibility. Today, we are focused on standard setting not just by the FASB as the SEC-recognized private-sector accounting standard setter for U.S.

GAAP, but also by the Public Company Accounting Oversight Board (“PCAOB”), International Accounting Standards Board (IASB), and others.

Essential to the cooperative efforts of all parties involved is a continued focus on the underlying objective to provide high quality financial information, supported by high quality independent audits, for the benefit of investors. The development of high quality standards, and high quality implementation of those standards, leads to investors receiving decision-useful financial information and promotes investor confidence in our markets, which results in a lower cost of capital for issuers.

To further frame my remarks today, I’d like to highlight several points in the history of our accounting standard-setting process that are especially relevant to our activities today.

- Among other authorities, the Securities Act of 1933 gave the Commission, at its inception, broad authority to prescribe the accounting standards to be followed by issuers for the purpose of complying with federal securities laws.^[7]
- In 1937, through Accounting Series Release (“ASR”) No. 1, the Commission announced that it would publish “opinions on accounting principles for the purpose of contributing to the development of uniform standards and practices on major accounting questions.”^[8] Driving uniformity in standards and practices remains equally important today. I believe financial reporting that is comparable for similar facts and circumstances, both between companies and over time, should be a primary goal of accounting standard setting.
- In 1938, the Commission issued ASR No. 4, warning that “financial statements . . . prepared in accordance with accounting principles for which there is no substantial authoritative support . . . will be presumed to be misleading or inaccurate despite disclosures . . . provided the matters involved are material.”^[9] To translate that prescient message for today’s environment, I would say that accounting is critical, and disclosure is no substitute for getting the accounting right on difficult or complex issues, particularly since getting the accounting right is vital to consistency and comparability for investors. That message is relevant to both preparers applying accounting standards and the standard setters themselves. In standard setting, I believe that expanded disclosures can be beneficial to investors, but should never be viewed as an alternative to developing authoritative recognition and measurement standards that accurately reflect the economic substance of a transaction.
- In 1973, the FASB was formed as an independent organization responsible for setting accounting and financial reporting standards, and the Commission formally recognized the FASB’s standards as “authoritative” in the absence of any additional or contrary determination by the Commission.^[10] Almost thirty years later, in the Sarbanes-Oxley Act of 2002, Congress established statutory criteria and principles for the Commission to designate a private entity standard setter for accounting and auditing purposes and recognize the accounting principles established by such entity as “generally

accepted” for purposes of the federal securities laws, which critically required an equitable shared funding mechanism with accounting support fees that foreclosed ‘voluntary’ payments by issuers in exchange for actual or perceived preferential standard-setting outcomes.^[11]

Back in 1989, then SEC Chair Ruder remarked that, “While the formation of the FASB was a response to criticisms, it was not intended to end criticism. Because of the controversial nature of standard setting, ongoing criticism was to be expected.”^[12] He went on to describe Congressional criticism of the SEC when it decided to continue looking to the private sector for authoritative accounting standard setting. However then-SEC Chair Ruder also noted a 1977 Congressional report that cited the accounting profession’s desire and willingness to respond to criticism and take initiatives for improvement as a factor that weighed in favor of private independent standard setting.^[13] I believe that desire and willingness to address today’s accounting standard-setting challenges is very much present within today’s accounting profession, and I encourage all stakeholders to engage in the standard-setting process through constructive engagement and cooperation. Engagement with the accounting and auditing standard-setting process is more constructive when it includes suggestions on how to improve a standard rather than simply criticizing a proposal.

As I mentioned in a recently published statement regarding the significance of the FASB completing its comprehensive updates to the Conceptual Framework for Financial Reporting, I believe a focus on the Conceptual Framework by the FASB and all stakeholders involved in standard setting can facilitate effective collaboration.^[14] Feedback from stakeholders that is grounded in the Conceptual Framework, including a focus on financial statements being relevant and faithfully representing the underlying economics, effectively ensures that such feedback is, in fact, constructive. I also encourage FASB Board members to clearly articulate the basis for their individual standard-setting decisions and to explain the reasons for any deviation from the principles laid out in the Conceptual Framework to help stakeholders better understand both the standard in question and its application.

I encourage all of you to provide thoughtful feedback to the FASB as part of its current agenda consultation process. One accounting topic that is currently on the FASB’s research agenda in response to calls by investors for improvements is the statement of cash flows.^[15] A clear and accurate depiction of the nature and quality of an issuer’s cash flows can serve as an important tool for investors to make informed judgments regarding an issuer’s ability to generate positive future net cash flows, meet its financial obligations, and pay dividends or otherwise return cash to investors. I am supportive of the FASB continuing to evaluate approaches to improve this critical component of high quality financial reporting for investors, including ways to improve consistency and comparability in cash flow classification, transparency of the relationship between the statement of cash flows and the balance sheet and income statement, and more information about non-cash transactions. Given the importance of cash flow information for investors, I also remind preparers and auditors to ensure that the statement of cash flows and related cash and non-cash disclosures are provided the same quality focus as other components of the financial statements. I also think that discussions concerning statement of

cash flows provide a good reminder that when considering investor input to the FASB, it is important to dig deeper into that input and better understand what investors are telling us about their informational needs. For example, I have heard some investors say they either do not want or need a direct method cash flow statement. Instead, some investors say they want more information about things like cash collected from customers, cash paid to employees, cash paid to suppliers and other creditors, etc., all of which sounds like direct method cash flow information without the label!

Turning now to the Commission's oversight role with respect to auditing standards, much like the comments then-SEC Chair Ruder made 35 years ago related to accounting standards, audit standard setting requires the desire and willingness to respond to input and undertake initiatives for improvement. The development of new auditing standards fundamentally changed with the passing of the Sarbanes-Oxley Act of 2002, which led to the establishment of the PCAOB. The Commission has responsibilities defined by statute related to oversight of the PCAOB's standard-setting and rulemaking process. Once the Board adopts an audit standard or rule, the Commission publishes the new standard or rule in the Federal Register for public comment. Thereafter the Commission considers any comments received and determines whether the PCAOB's new standard or rule is consistent with Title I of SOX, is in the public interest, and serves an investor protection purpose. As demonstrated with the Commission's recent approval of several PCAOB standards and rules, including the PCAOB's update to the general responsibilities of the auditor in conducting an audit^[16] and the PCAOB's standard regarding the quality control systems of audit firms,^[17] overseeing the PCAOB's audit standards is an important statutory responsibility of the Commission because those standards and rules are the basis for trust in the audited financial statements on which investors make investment and voting decisions. My earlier comments about engaging constructively in the standard-setting process are equally applicable to the PCAOB's standard-setting and rule-making process as well as to the Commission's consideration of those standards and rules.

In closing, I wish to reiterate my firm belief that accounting and auditing matter and our profession is vital to capital formation and capital flows. Our financial markets and our economy rest on the bedrock confidence of investors in financial reporting, which in turn relies upon the collective efforts of all accounting professionals involved in our financial reporting system. Every accountant has a professional responsibility to conduct our work in a manner consistent with applicable standards, rules, and ethical obligations. When you maintain a focus on investors and the public interest in every decision you make, the broader objective of providing high quality financial information can be achieved, ensuring that what you do matters. Thank you for your dedication to advancing our profession and I look forward to your questions.

^[1] This statement describes, among other things, opening remarks and other matters discussed by the Commission's Chief Accountant and other staff of the Office of the Chief Accountant at the 2024 AICPA & CIMA Conference on Current SEC and PCAOB Developments held on December 9, 2024, in Washington, D.C. This statement is provided in the author's official capacity as the Commission's Chief Accountant but does not necessarily reflect the views of the Commission, the Commissioners, or other members of the staff. It is

not a rule, regulation, or statement of the Commission. The Commission has neither approved nor disapproved its content. This statement, like all staff statements, has no legal force or effect. It does not alter or amend applicable law, and it creates no new or additional obligations for any person.

^[2] See Paul Munter, Chief Accountant, [Fostering a Healthy “Tone at the Top” at Audit Firms](#) (May 15, 2024) and see Paul Munter, Chief Accountant, [The Critical Importance of the General Standard of Auditor Independence and an Ethical Culture for the Accounting Profession](#) (June 8, 2022).

^[3] See Jeffrey S. Pickerd, Scott L. Summers, and David A. Wood, [An Examination of How Entry-Level Staff Auditors Respond to Tone at the Top vis-à-vis Tone at the Bottom](#), *Behavioral Research in Accounting* (2015) 27 (1): 79–98.

^[4] See, e.g., International Federation of Accountants, [Attractiveness of the Profession](#) (Nov. 2023).

^[5] 15 U.S.C. 78j-1(m).

^[6] See Chairman David S. Ruder, [Remarks Before the AICPA Sixteenth National Conference on Current SEC Developments](#) (Jan. 10, 1989).

^[7] See, e.g., Sections 7 and 19(a) of the Securities Act of 1933. [15 U.S.C. §§ 77g, 77s.]

^[8] U.S. Securities and Exchange Commission, ASR No. 1 (April 1, 1937).

^[9] U.S. Securities and Exchange Commission, ASR No. 4 (April 25, 1938).

^[10] See U.S. Securities and Exchange Commission, ASR No. 150 (Dec. 20, 1973), which states that “[f]or purposes of this policy, principles, standards and practices promulgated by the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support.”

^[11] See 15 U.S.C. 77s.

^[12] *Supra* note 6 at page 7.

^[13] *Supra* note 6 at page 8.

^[14] See Paul Munter, Chief Accountant, [Addressing Investor Needs through Application of the Updated Conceptual Framework in FASB Standard Setting](#) (Aug. 12, 2024).

^[15] See FASB, [Technical Agenda Overview, Research Projects, Statement of Cash Flows](#).

^[16] See SEC Press Release, [SEC Approves New and Updated PCAOB Audit Standards and an Amendment to the PCAOB’s Contributory Liability Rule](#) (Aug. 20, 2024).

^[17] See SEC Press Release, [SEC Approves a New PCAOB Quality Control Standard](#) (Sept. 9, 2024).

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. The following symbols are used throughout this Handbook to indicate the types of revisions made in this edition for sections, Questions, Examples and other items:

- ** new item
- # significant updates or revisions to the item
- ^^ item moved (see moved guidance table)

1. Recent ASUs

ASU 2025-10: Accounting for government grants received by business entities **

3. Format of the statement

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

3.3.30 Indirect method #

[Questions](#)

3.2.20 What should be considered when reconciling net income to operating cash flows in the statement of cash flows? **

3.5.05 When may cash flows be reported net? ^^

3.7.20 What other disclosures beyond accounting policies are required by Topic 230? #

3.7.30 What disclosures of income taxes paid are required after adoption of ASU 2023-09? **

4. Classification principles

4.7.20 Noncash investing and financing activities #

6. Cash, cash equivalents and restricted cash

6.3.80 Stablecoins **

[All content in this section is new.]

[Question](#)

6.2.36 Are funds held for others reported as cash? #

7. Working capital accounts

[Example](#)

7.2.10 Trade accounts receivable and allowance for credit losses #

8. PP&E and other productive assets

Question

- 8.2.17 How are cash flows for the cost of purchasing or developing external-use software classified? #^^

9. Investments

- 9.2.10 Overview **
9.2.20 Debt securities ^^
9.2.30 Equity securities ^^
9.2.40 Other presentation considerations ^^

Question

- 9.2.05 How do investment companies classify purchases and sales of investments? **

12. Debt financing transactions for debtors

Questions

- 12.3.10 How are cash flows for debt restructuring classified? #
12.3.20 How does a nontroubled debt restructuring with no change in principal affect the debtor's statement of cash flows? #
12.3.25 How does an entity determine the cash flow effect of a nontroubled debt restructuring in a loan syndication? **

Example

- 12.3.08 Refinancing in a debt syndication **

13. Derivative instruments

Question

- 13.3.25 How are cash flows from derivatives hedging forecasted debt issuance classified? **

16. Share-based payment arrangements

- 16.5 Tax withholdings on share-based payment awards #

Questions

- 16.5.10 How are taxes paid on a grantee's behalf classified when the grantor withholds shares for tax withholding purposes in a net-share-settled award? #^^
16.5.30 How are cash flows from sell-to-cover transactions classified? **

17. Contingencies and insurance premiums and proceeds

17.1 How the standard works #

[Question](#)

17.4.10 How are cash flows from/for settling a lawsuit and other contingencies classified? #

18. Business combinations

18.1 How the standard works #

18.7 Common control transactions **

[All content in this section is new.]

23. Government grants received by for-profit entities

23.1 How the standard works

Recent ASU affecting this chapter **

23.2 Overview #

24. Crypto intangible assets

24.1 How the standard works

Recent ASU reflected in this chapter #

Appendix: SEC staff guidance #

[Excerpt from Remarks before the 2024 AICPA & CIMA Conference on Current SEC and PCAOB Developments: Accounting Matters (December 9, 2024) is new in this edition]

Moved guidance

The following table lists guidance moved to a new location in this edition.

| Section/Question | Old location | New location |
|--|-----------------|---------------------------------|
| When may cash flows be reported net? | Section 3.5 | Question 3.5.05 |
| How are cash flows for the purchase of software to be sold, leased or marketed classified? [old wording] | Question 8.5.10 | Question 8.2.17 |
| Debt securities | Section 9.2.10 | Section 9.2.20 |
| Equity securities | Section 9.2.20 | Section 9.2.30 |
| Other presentation considerations | Section 9.2.30 | Section 9.2.40 |

| Section/Question | Old location | New location |
|---|------------------|----------------------------------|
| How are taxes withheld upon the vesting of restricted shares classified if these taxes are remitted to the taxing authority after the vesting occurred? [old wording] | Question 16.5.20 | Question 16.5.10 |

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- Contingencies, commitments and guarantees
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- Discontinued operations and held-for-sale disposal groups
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