SEPTEMBER 2016
www.bdo.com

THOUGHT LEADERSHIP FROM THE BDO NATIONAL ASSURANCE AND TAX PRACTICES

BDO KNOWS:
FASB

SUBJECT
FASB ISSUES GUIDANCE ON EIGHT CASH FLOW CLASSIFICATION ISSUES

SUMMARY
The FASB recently issued ASU 2016-15 to clarify whether the following items should be categorized as operating, investing or financing in the statement of cash flows: (i) debt prepayments and extinguishment costs, (ii) settlement of zero-coupon debt, (iii) settlement of contingent consideration, (iv) insurance proceeds, (v) settlement of corporate-owned life insurance (COLI) and bank-owned life insurance (BOLI) policies, (vi) distributions from equity method investees, (vii) beneficial interests in securitization transactions, and (viii) receipts and payments with aspects of more than one class of cash flows.

The new standard takes effect in 2018 for public companies and is available here. If an entity elects early adoption, it must adopt all of the amendments in the same period.

DETAILS
ASU 2016-15[1] (the "Update") includes guidance on eight cash flow issues, which previous GAAP did not specifically address. The absence of such guidance resulted in diversity in practice, which the Update resolves as follows:

TRANSACTION/EVENT	TYPE OF CASH FLOW	CASH FLOW CLASSIFICATION
Prepayment or Extinguishment of Debt	Costs paid to prepay or extinguish the debt	Financing

[1] *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*

CONTACT:

ADAM BROWN
National Director of Accounting
(214) 665-0673
abrown@bdo.com

ANGELA NEWELL
National Assurance Partner
(214) 689-5669
ajnewell@bdo.com

GAUTAM GOSWAMI
National Assurance Partner
(312) 616-4631
ggoswami@bdo.com

TRANSACTION/EVENT	TYPE OF CASH FLOW	CASH FLOW CLASSIFICATION
Settlement of Zero-Coupon Debt or Other Debt with Insignificant Coupon Rate	Payment attributable to the accreted interest related to the debt discount	Operating
	Payment attributable to the principal	Financing
Payment of Contingent Consideration	Payments made soon after the acquisition date	Investing
	Payments up to the amount of the contingent consideration liability recognized at the acquisition date (made not soon after the acquisition date)	Financing
	Payments in excess of the amount of the contingent consideration liability recognized at the acquisition date (made not soon after the acquisition date)	Operating
Settlement of Insurance Claims	Proceeds from settlement of insurance claims	Classify based on nature of the loss
	Lump-sum settlement	Classify based on nature of each loss included in the settlement
Settlement of COLI and BOLI policies	Proceeds from settlement of COLI and BOLI	Investing
	Payments for premiums on COLI and BOLI	Operating, Investing, or mix of both
Distributions from Equity Method Investees: either		
Cumulative earnings approach	Distributions that are returns on investment (up to the amount of cumulative equity in earnings)	Operating
	Distributions that are returns of investment (excess of cumulative distributions, excluding prior distributions determined to be returns of investment, over cumulative equity in earnings)	Investing
Nature of distribution approach	Distributions that are returns on investment (based on the nature of activity that generated the distributions)	Operating
	Distributions that are returns of investment (based on the nature of activity that generated the distributions)	Investing
Beneficial Interests in Securitization Transactions	Beneficial interest obtained by a transferor	Disclose as noncash
	Collections on a transferor's beneficial interests in securitized trade receivables	Investing

TRANSACTION/EVENT	TYPE OF CASH FLOW	CASH FLOW CLASSIFICATION
Cash receipts and payments with aspects of more than one class of cash flows	Each source or use of cash is separately identifiable	Classify each based on its nature
	Each source or use of cash is not separately identifiable	Apply the predominance principle

Debt Prepayment or Debt Extinguishment Costs

Companies often incur costs when paying or settling their borrowings prior to maturity. The Update requires that cash paid for debt prepayment or extinguishment costs, including third-party costs, premiums paid to repurchase debt in an open-market transaction, and other fees paid to lenders (e.g., a prepayment penalty) that are directly related to the debt prepayment or debt extinguishment, should be classified as financing cash outflows.

Settlement of Zero-Coupon Debt Instruments or Other Debt Instruments with Insignificant Coupon Interest Rates in Relation to their Effective Interest Rate

A deeply discounted debt with a zero or near-zero coupon interest rate effectively includes payment for principal and interest components at settlement. The Update requires the debt issuer to classify the portion of the cash payment attributable to the accreted interest related to the debt discount as an operating cash outflow and the portion of the cash payment attributable to the principal as a financing cash outflow at settlement. This guidance is only applicable to zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing. Therefore, the guidance should not be applied to all other debt instruments.

Contingent Consideration Payments Made after a Business Combination

The Update requires that cash payments to settle a contingent consideration liability made by an acquirer soon after the acquisition date of a business combination be classified as investing cash outflows. While the final amendments do not define the term "soon after," the basis for conclusions indicates this is a relatively short period of time, such as three months or less.

Cash payments to settle a contingent consideration liability made by an acquirer not soon after the acquisition date of a business combination should be separated and classified as follows:

- payments to settle the amount of the contingent consideration liability[2] as financing cash outflows; and
- any payments in excess of the amount of the contingent consideration liability[2] as operating cash outflows.

Proceeds from the Settlement of Insurance Claims

The standard requires proceeds received from the settlement of insurance claims, excluding proceeds received from COLI and BOLI policies, to be classified on the basis of the 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 cash flow classification on the basis of the nature of each loss included in the settlement.

[2] More specifically, this represents the amount of a contingent consideration liability recognized at the acquisition date, including measurement-period adjustments, less any amounts paid soon after the acquisition date that were classified as cash flows for investing activities.

Proceeds from the Settlement of COLI Policies, including BOLI Policies

The Update requires cash proceeds received from the settlement of COLI policies, including BOLI policies, to be classified as investing cash inflows. The Update does not prescribe the cash flow classification for premium payments on these types of policies, therefore they may be classified as cash outflows for investing activities, operating activities, or a combination of investing and operating activities, based on management's judgment.

Distributions Received from Equity Method Investees

Generally, distributions that are considered return of investments are classified as investing inflows and distributions that are considered return on investments are classified as operating inflows. Under the Update, an entity will select one the following approaches to classifying distributions received:

- Cumulative earnings approach—Distributions received are considered returns on investment and classified as operating cash inflows 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. When such an excess occurs, the current-period distribution up to this excess is considered a return of investment and should be classified as an investing cash inflow.
- Nature of the distribution approach—Distributions received should be classified on the basis of the nature of the activity of the investee that generated the distribution as either a return on investment (classified as operating cash inflow) or a return of investment (classified as investing cash inflow) when such information is available.

The Update requires that the same accounting policy election be made for all equity method investments of the reporting entity. However, if an entity elects to apply the nature of the distribution approach and determines that the necessary information for an individual equity method investee is not available, the entity should apply the cumulative earnings approach (and report a change in accounting principle on a retrospective basis) for that investee and the nature of the distribution approach for all other equity method investees. The Update does not address equity method investments measured using the fair value option.

Beneficial Interests in Securitization Transactions

When a transferor sells financial assets (e.g. trade receivables) in a securitization transaction, the transferor, in addition to cash received, typically obtains (or retains) some beneficial interest in the financial assets sold (e.g. right to receive cash from collection of trade receivables). For beneficial interests in a securitization transaction, the Update requires the following cash flow presentation:

- Disclose the beneficial interest obtained by a transferor as noncash activity; and
- Classify the collections on a transferor's beneficial interests in securitized trade receivables as investing cash inflows.

Separately Identifiable Cash Flows and Application of the Predominance Principle

In the absence of specific guidance, certain cash receipts and payments that have aspects of more than one class of cash flows should be separated by their identifiable source (for inflows) or use (for outflows) with each separated element classified based on its nature. In situations in which those aspects cannot be separately identified, the appropriate classification depends on the activity that is likely to be the predominant source or use of cash flows for the item. The entity should apply judgment when necessary to estimate the amount of each separately identifiable source or use within the cash receipts or payments.

EFFECTIVE DATE AND TRANSITION

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

The amendments in this Update should be applied using a retrospective transition method to each period presented. If it is impracticable to apply the amendments retrospectively, the amendments would be applied prospectively as of the earliest date practicable.