Financial reporting developments

Statement of cash flows

Accounting Standards Codification 230

Revised July 2010

Ernst & Young

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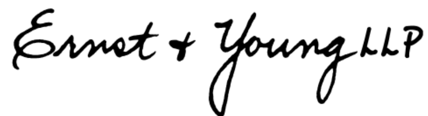
In November 1987, the FASB issued Statement 95 (codified primarily as ASC 230, *Statement of Cash Flows*). This publication was originally issued in January 1994 and was previously updated in December 2006. This edition includes updated guidance to reflect new accounting standards issued since the last update, including Statement 141(R), *Business Combinations* (revised 2007), Statement 160, *Noncontrolling Interests in Consolidated Financial Statements*, Statement 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, and Statement 166, *Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140*.

This publication is designed to assist professionals in understanding the statement of cash flows. This publication reflects our current understanding of this guidance based on our experience with financial statement preparers and related discussions with the staff of the FASB and SEC. Ernst & Young professionals are prepared to help you identify and understand the issues related to the statement of cash flows.



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1 Overview and scope

1.1 Overview

The statement of cash flows is one of the primary financial statements. The objectives of the cash flow statement are to provide relevant information about an entity's cash receipts and cash payments (ASC 230-10-10-1), as well as to assess:

- The entity's ability to generate positive future net cash flows
- The entity's ability to meet its obligations, its ability to pay dividends, and its needs for external financing
- The reasons for differences between net income and associated cash receipts and payments
- The effects on an entity's financial position of both its cash and noncash investing and financing transactions during the period (ASC 230-10-10-2)

The overall requirements for preparing a statement of cash flows are as follows:

Basis of presentation — A focus on cash and cash equivalents is required. A reconciliation of working capital is not permitted.

Classification of cash flows — Cash flows must be classified as operating, investing and financing activities.

Optional presentation of operating cash flows — Entities have the option to present operating cash flows indirectly using a reconciliation format between net income and net cash flow from operating activities, or directly by presenting major classes of operating cash receipts (e.g., from customers) and cash payments (e.g., to suppliers and employees for goods and services). While the guidance encourages use of the direct method, the indirect method dominates current practice. The disclosure requirements vary based on whether the direct or indirect method is used.

Emphasis on gross cash flows — Most investing and financing cash receipts and payments must be presented as gross amounts rather than as net changes in related balance sheet amounts. There are only limited exceptions to this requirement, generally for assets and liabilities with original maturities of three months or less to the reporting entity.

Foreign currency cash flows — Entities with foreign currency transactions or foreign operations must present the reporting currency equivalent of foreign currency cash flows, using the exchange rate at the time of the cash flows. Also, the effect of exchange rate changes on foreign currency cash balances is to be presented as a separate part of the reconciliation of the change in cash and cash equivalents. Generally, entities will have to prepare a separate statement of cash flows in the foreign currency for each foreign operation (or group using the same foreign currency), translate the foreign currency statements to the reporting currency, and consolidate them.

Noncash transactions — Noncash investing and financing transactions (e.g., obtaining an asset by entering into a capital lease) are not included in the statement of cash flows, but must be presented in separate disclosures.

The statement of cash flows should be structured in the following manner (details of operating, investing and financing activities omitted for purposes of this illustration):

Cash provided by (used in)	
Operating activities	$ XXX
Investing activities	XXX
Financing activities	XXX
Effect of exchange rate changes on cash	XXX
Increase (decrease) in cash and cash equivalents	XXX
Cash and cash equivalents — beginning of year	XXX
Cash and cash equivalents — end of year	$ XXX

The statement of cash flows guidance in ASC 230 is principles-based and requires entities to make judgments in some instances about the classification of certain cash receipts and cash payments. To that end, we encourage entities to fully and adequately disclose their policies and related judgments with respect to the statement of cash flows and ensure that their policies are consistently applied. Transparent financial reporting combined with complete disclosure will enhance the understandability of an entity's statement of cash flows for users.

1.2 Scope

All entities, including business entities and not-for-profit entities, other than those specific exceptions noted below, are required to present a statement of cash flows for each period in which results of operations are presented in a complete set of financial statements. A statement of cash flows is not required in the unusual situations in which only a balance sheet or an income statement is presented because such a presentation would not constitute a complete set of financial statements. A US SEC registrant usually will present a statement of cash flows for the three most recent years to correspond with the periods for which an income statement is required. (Note that only the two most recent fiscal years (versus three fiscal years otherwise required) are required of a smaller reporting company as defined in Regulation S-K Item 10(f)(1).)

A statement of cash flows is not required for defined benefit pension plans that present financial information in accordance with the provisions of ASC 960, *Plan Accounting—Defined Benefit Pension Plans*, and certain other employee benefit plans that present financial information similar to that required by ASC 960. Based on a discussion with the FASB staff, we believe the key to deciding whether the defined benefit plan exemption applies to similar

plans is whether the employee benefit plan prepares a statement of changes in net assets that would be substantially similar to a statement of cash flows. For example, the exemption would apply to the typical defined contribution plan or health and welfare plan that does little more than receive cash, invest in highly liquid assets and disburse cash. For such a plan, the statement of changes in net assets would differ so little from a statement of cash flows that presenting both statements would be unnecessary duplication. An example of an employee benefit plan that might not qualify for the exemption would be an ESOP that engaged in complicated stock transactions that departed significantly from cash receipts and disbursements. For such a plan, the statement of changes in net assets and the statement of cash flows would portray significantly different information, and both statements should be presented. However, 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 (ASC 230-10-15-4).

A statement of cash flows is also not required for certain investment companies. This scope exception is further discussed in Chapter 9.

2 Form and content

2.1 Definitions — cash and cash equivalents

Entities commonly invest cash in excess of immediate funding obligations in short-term, highly liquid investments. Whether cash is on hand, on deposit, or invested in a short-term financial instrument that is readily convertible to a known amount of cash is largely irrelevant to financial statement users' assessments of liquidity and future cash flows. Accordingly, ASC 230-10-45-4 requires that a statement of cash flows explain the change during the period in the aggregate of cash and cash equivalents.

2.1.1 Cash

The ASC Master Glossary defines cash as follows:

> "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" (ASC 230-10-20).

Cash is the standard medium of exchange and the basis for measuring and accounting for all other financial statement elements. Cash must be readily available for the payment of an obligation, and it must be free from any contractual restriction that limits its use in satisfying such obligation. In addition to currency on hand and demand deposits with financial institutions, cash also consists of negotiable instruments such as money orders, certified checks, cashier's checks, personal checks and bank drafts. Although a bank has the legal right to demand notice before withdrawal, savings accounts are usually classified as cash because prior notice is rarely demanded by banks.

2.1.2 Cash equivalents

The ASC Master Glossary defines cash equivalents as

> "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 is measured as the period from the holder's date of purchase to the instrument's maturity. For example, both a three-month US Treasury bill and a three-year US Treasury note purchased three months from maturity qualify as cash

equivalents. However, a US 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 US Treasury bills, commercial paper, money market funds, and federal funds sold (for an entity with banking operations)" (ASC 230-10-20).

In developing the definition of a cash equivalent, the FASB noted in its basis for conclusions that "the objective of enterprises' cash management programs generally is to earn interest on temporarily idle funds rather than 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. Although any limit to the maturity of items that can qualify as cash equivalents is somewhat arbitrary, the Board decided to specify a limit of three months or less. The Board believes that that limit will result in treating as cash equivalents only those items that are so near cash that it is appropriate to refer to them as the "equivalent" of cash" (Statement 95, paragraph 53).

Not all investments that meet the definition of cash equivalents are required to be presented as cash equivalents. An entity must establish a policy concerning which short-term, highly liquid investments that meet the definition of cash equivalents are treated as cash equivalents. For example, an entity having banking operations might decide that all investments that meet the definition of cash equivalents, except for those purchased for its trading account, will be treated as cash equivalents. On the other hand, 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.

Banks and other financial institutions commonly carry three-month US Treasury bills, commercial paper and similar short-term financial instruments in their trading and investments accounts, in which they are commingled with longer-term investments. Those institutions generally contend that purchases and sales of those items are part of their trading or investing activities—not part of their cash management program—and they prefer not to treat those items as cash equivalents in a statement of cash flows, which would require segregating them from other items in their trading and investment accounts. Items that meet the definition of cash equivalents that are part of a larger pool of investments properly considered investing activities need not be segregated and treated as cash equivalents. Because entities have the ability to exclude certain qualifying investments from the classification of cash equivalents and that gives rise to differences between entities, entities are required to disclose their accounting policy for determining which items are treated as cash equivalents. Change to that accounting policy is a change in accounting principle that is subject to a preferability assessment and would result in retroactive restatement of prior years' financial statements (ASC 230-10-50-1).

2.2 Application of cash equivalents guidance to certain instruments

2.2.1 Investments in equity securities

Investments in equity securities do not meet the definition of a cash equivalent because equity securities do not have a stated maturity and the issuers are not obligated to redeem the securities. To qualify as a cash equivalent, among other requirements, the investments must have original maturities of three months or less.

2.2.2 Auction rate securities and variable rate demand obligations

See Section C1.0 of the Ernst & Young Accounting Manual for discussion of the classification of auction rate securities (ARSs) and variable rate demand obligations (VRDOs) as cash equivalents or short-term investments.

Since ARSs and VRDOs (collectively, VRNs) typically do not meet the definition of a cash equivalent, presentation of activity related to these instruments in the statement of cash flows should be consistent with their balance sheet classification. Cash flows from purchases, sales and redemptions of VRNs accounted for pursuant to ASC 320, *Investments—Debt and Equity Securities*, and classified in the balance sheet as available-for-sale should be classified as cash flows from investing activities and reported gross in the statement of cash flows. Cash flows from purchases, sales and redemptions of VRNs accounted for pursuant to ASC 320 and classified in the balance sheet as trading securities should be classified based on the nature and purpose for which the securities were acquired. See further discussion of the classification of investments classified as trading securities in Section 3.6.2.

2.2.3 Short-term paper

A variety of "short-term paper" is available for investment, providing investors with an opportunity to earn varying rates of interest. Short-term paper may or may not meet the criteria for classification as a cash equivalent. However, most short-term paper is subject to the accounting and disclosure requirements for investments in marketable debt and equity securities. Common examples of short-term paper include

- Certificates of deposit
- Treasury bills
- Money market savings certificates
- Money market funds
- Commercial paper

See further discussion of these instruments and considerations in classifying them as cash equivalents in Section C1.0 of the Ernst & Young Accounting Manual.

2.3 Statement of cash flows presentation

A statement of cash flows explains the change in cash and cash equivalents during the period. The total amounts of cash and cash equivalents at the beginning and end of the period shown in the statement of cash flows must be the same amounts as similarly titled line items or subtotals shown in the balance sheet as of those dates. Additional disclosures may be necessary with respect to cash flows from discontinued operations if the balance sheet includes a single line for assets of discontinued operations, including cash and cash equivalents. See further discussion of the presentation of discontinued operations in the statement of cash flows in Section 2.5 below.)

2.4 Gross vs. net cash flows

Generally, information about gross amounts of cash receipts and payments during a period is more relevant than information about the net amounts. However, the net amounts do provide sufficient information for activity within cash equivalents as well as certain other classes of cash flows. Details of cash purchases and sales of cash equivalents generally do not need to be reported in a statement of cash flows.

2.4.1 Exceptions to gross presentation of cash flows

In certain circumstances, the net amount of cash receipts and payments provides sufficient information to understand an entity's operating, investing and financing activities. The limited exceptions to gross presentation of cash flows are as follows:

- Investments (other than cash equivalents), loans receivable and debt, when the turnover is quick, the amounts are large and the maturities are short, provided the original maturity of the asset or liability is three months or less
  - 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.
- Items in which an entity is substantively holding or disbursing cash on behalf of its customers; for example, customer demand deposits of a bank and customer accounts payable of a broker-dealer

2.4.2 Revolving lines of credit

Entities presenting changes in borrowings under a revolving line of credit agreement are required to present gross cash borrowed and gross cash repaid unless the borrowing is supported by a note with a maturity of three months or less. Some of these arrangements are structured to require the borrower to sign a series of 90-day notes. In those cases, we believe

presenting the net repayment or borrowing between the beginning and end of the period is appropriate even though the underlying revolving credit agreement has a term of greater than three months. If however, the borrower signs only a single note with a term of more than three months for the maximum amount of the line of credit (sometimes referred to as a master note), presentation of gross borrowings and repayments is required.

2.5 Cash flows from discontinued operations and extraordinary items

Entities are permitted but not required to separately disclose, either in the statement of cash flows or footnotes to the financial statements, cash flows pertaining to extraordinary items or discontinued operations. Entities that do present separate operating cash flows information related to extraordinary items or discontinued operations must do so consistently for all periods presented, which may include periods long after sale or liquidation of the operation (ASC 230-10-45-24). Interpretation of this guidance and the resulting presentation of discontinued operations in the statement of cash flows has varied in practice. Our guidance for presenting discontinued operations and extraordinary items is set forth below in the following sections.

2.5.1 Discontinued operations

Historically, the presentation of discontinued operations in the statement of cash flows has varied in practice. At the 2005 AICPA National Conference on Current PCAOB and SEC Developments, the SEC staff expressed its views as to acceptable presentation and identified certain discontinued operations presentation formats considered inconsistent with the authoritative guidance.

Some of the alternative statement of cash flows presentations that the SEC staff believes are acceptable include:

1. Combine cash flows from discontinued operations with cash flows from continuing operations within each cash flow statement category (i.e., no separate disclosure of cash flows from discontinued operations in the statement of cash flows)
2. Identify cash flows from discontinued operations separately within each statement of cash flows category (i.e., disclose cash flows from discontinued operations as separate line items within operating, investing and financing activities)
3. Identify net cash flows from discontinued operations separately, by category and in total, in the statement of cash flows (i.e., disclose net cash flows from discontinued operations near the bottom of the cash flow statement, before net increase/decrease in cash and cash equivalents, with amounts of cash flows from discontinued operations by the operating, investing and financing categories, and in the aggregate)

If an entity chooses to segregate cash flows provided by continuing operations from cash flows related to discontinued operations, it is **not** appropriate to present cash flows related to discontinued operations in one, net line item of the statement of cash flows.

The following table illustrates some of the presentation of discontinued operations in the statement of cash flows that we believe are consistent with the presentation formats discussed above.

	Alternative 1	Alternative 2a	Alternative 2b	Alternative 3a	Alternative 3b
SCF Categories	No separate disclosure of discontinued operations	Separately disclose cash flows from discontinued operations within the cash flows categories		Separately disclose cash flows from discontinued operations in a separate category at the bottom of the statement of cash flows	
Operating	All operating	Continuing + Discontinued (w/ detail) Total	Continuing + Discontinued (net) Total	Continuing	Continuing
Investing	All investing	Continuing + Discontinued (w/ detail) Total	Continuing + Discontinued (net) Total	Continuing	Continuing
Financing	All financing	Continuing + Discontinued (w/ detail) Total	Continuing + Discontinued (net) Total	Continuing	Continuing
Below Financing				Discontinued: Operating w/ detail Investing w/ detail Financing w/ detail	Discontinued : Operating (net) Investing (net) Financing (net)

The SEC staff also 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, including:

- 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
- 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

In deciding whether to segregate the cash flows related to discontinued operations from the cash flows provided by continuing operations, particularly as it relates to the operating section of the statement of cash flows, entities should consider the long-term reporting implications. If an entity presents cash from continuing and discontinued operations separately, the separate cash flows of the discontinued operation must be presented for all periods affected. This might include periods long after sale or liquidation of the operation (e.g., if the seller agrees to pay for future postretirement health care benefits of retirees of

the discontinued operation). These cash flows could be material for many future years, resulting in a presentation with no discontinued operations reported in the income statements in periods that cash flows from discontinued operations are reported in the statement of cash flows.

Operating cash flows of a discontinued operation should be reported as an operating activity up to the date of sale. In addition to net cash flows from "normal" operations, cash flows related to unusual or infrequently occurring transactions of a discontinued operation, such as a reversion of pension plan assets or a payment of severance benefits, also should be reported in the operating activities section of the statement of cash flows. Upon sale of the discontinued operations, the cash received (i.e., proceeds from sale less cash "sold" if any) should be classified as an investing activity. Note that the gain or loss recorded, both when the net assets are designated as held for sale and at the time of sale, should be presented as a reconciling item in the reconciliation of net income and net cash provided by operating activities.

2.5.2 Extraordinary items

The general classification provisions of ASC 230 are relevant to cash flows related to extraordinary items. When an extraordinary item's cash flows are classified only as an investing or financing activity, with no operating cash flow implications, an entity may decide not to present separate reconciliations of income before extraordinary items and of the extraordinary gain or loss. However, when the extraordinary item has operating cash flow implications, separate presentation is more likely.

2.5.3 Income tax effects of discontinued operations and extraordinary items

When cash flows related to discontinued operations are segregated, there is no requirement to allocate income taxes between cash flows from continuing and discontinued operations, although the allocation is required on the income statement in accordance with ASC 205-20-45-3. Likewise, there is no requirement to allocate income taxes paid between operations exclusive of an extraordinary item and the extraordinary gain or loss.

Income tax effects related to cash flows of a discontinued operation or extraordinary item that is classified as an investing or financing activity, even those that are presented net against the related gain or loss in the income statement, are not allocated to investing or financing activities in the statement of cash flows. The Board decided that allocation of income taxes paid to operating, investing, and financing activities would be so complex and arbitrary that the benefits, if any, would not justify the costs involved (Statement 95, paragraph 92). Rather, all income taxes paid should be included in determining net cash flow from operating activities.

3 Classification of cash flows

3.1 Overview

Cash receipts and payments must be classified as operating, investing or financing activities. This chapter discusses these classifications and items that are frequently found in those categories. After discussing the general concepts with respect to classification of cash flows as investing, financing, or operating activities, this chapter discusses common issues with respect to certain types of cash flows.

3.2 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, (i.e., 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 further in Sections 3.6.2 and 3.6.13 (ASC 230-10-20).

Common cash flows from investing activities include:

- Making, collecting or selling loans made by the entity (excludes acquiring and selling loans acquired for resale)
- Acquiring and disposing of:
  - Other entities' debt instruments (other than cash equivalents and certain debt instruments acquired specifically for resale)
  - Other entities' equity instruments (other than certain equity instruments carried in a trading account) and returns of investment in those instruments
  - Cash flows from purchases, sales and maturities of available-for-sale securities are classified as cash flows from investing activities
  - Property, plant and equipment and other long-lived 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 debt to the seller is a financing transaction and subsequent payments of principal on that debt thus are financing cash flows.
- Acquiring a business (net of cash acquired)
- Selling a business unit, such as a subsidiary or division

(ASC 230-10-45-11 through 45-13)

3.3 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; and obtaining and paying for other resources obtained from creditors on long-term credit (ASC 230-10-20).

Common cash flows from financing activities include:

- Proceeds from issuing equity instruments (i.e., such as preferred or common stock) and payments of dividends or other distributions on those instruments, including outlays to reacquire the entity's equity instruments
- Proceeds from borrowings and repayments of amounts borrowed (i.e., issuing bonds, mortgages, notes and from other short- or long-term borrowing and related debt issue costs)
- Principal payments to creditors who have extended long-term credit (including capitalized lease obligations and seller-financed debt)
- Proceeds of and 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)
- Cash retained as a result of excess tax benefits related to share-based payment (reported as a cash inflow)
- Receipts from contributions and investment income that by donor stipulation are restricted for the purposes of acquiring, constructing or improving property, plant or other long-lived assets or establishing or increasing a permanent endowment or term endowment

(ASC 230-10-45-14 through 45-15)

Note that that the structure of a transaction will often affect its presentation in the statement of cash flows. If equipment is purchased via a cash payment, it will result in a cash outflow from investing activities. A capital lease of equipment on the other hand, initially has no statement of cash flow implications. It is disclosed as a noncash investing and financing transaction. As the lease payments are made, they are presented as financing cash outflows. The same cash flow treatment is appropriate for a purchase of equipment that is wholly financed through the seller. However, if only a portion of the purchase is financed through the seller, the amount paid before, at the time of, or soon after the purchase is reported as an investing cash outflow. If the purchase is financed through a third-party (i.e., not the seller), the entire amount of cash paid for purchase of the equipment is an investing activity while the cash received from borrowing and subsequent principal payments are financing activities.

The accounting for leveraged leases results in the investment in the leased asset and the related debt that finances part of the cost of the asset being presented net in the balance sheet. However, the individual cash flows related to the investment, the debt incurred, principal payments received under the lease and principal payments made on the debt are to be presented separately in the investing and financing activities sections of the statement of cash flows.

3.4 Operating activities

Operating activities include all transactions and other events that are not defined as either investing or financing activities. Operating activities generally involve producing and delivering goods and providing services. Cash flows from operating activities generally are the cash effects of transactions and other events that enter into the determination of net income (ASC 230-10-20).

Common cash flows from operating activities include:

- Cash receipts from sales of goods or services, including receipts from collection or sale of trade accounts and short- and long-term notes receivable from customers arising from sales (including sales-type leases)
- Cash payments for acquisitions of materials for manufacture, or goods for resale and to other suppliers and employees for goods and services
- Cash receipts of investment income such as interest and dividends, and cash payments to lenders and other creditors for interest (unless capitalized)
- Cash payments to governments for taxes, duties, fines and other fees or penalties
- Cash retained as a result of excess tax benefits related to share-based payment (reported as a cash outflow)
- Payments made to settle an asset retirement obligation
- All other cash receipts and payments that do not stem from transactions defined as investing or financing activities, including:
    - Amounts received or paid to settle lawsuits
    - Proceeds of insurance settlements not directly related to investing or financing activities
    - Refunds from suppliers and to customers
    - Cash contributions to charities

(ASC 230-10-45-16 and 45-17)

The general rule that cash transactions affecting net income are to be classified as operating activities is overcome if these transactions meet the definitions of financing or investing activities. For example, all cash received from the sale of property, plant and equipment should be classified as an investing activity; all cash paid to satisfy the extinguishment of debt should be classified as a financing activity.

3.5 More than one class of cash flows

Certain cash receipts and payments have characteristics of more than one class of cash flows. If so, the transaction should be classified based on the activity that is likely to be the predominant source of cash flows for the item. For example, the acquisition and sale of equipment either to be used by the entity or rented to others generally is an investing activity. However, if the equipment is acquired or produced to be a direct source of revenue, such as assets to be rented to others for a short period and then sold, the nature of the equipment may be similar to inventory and classification as an operating activity would be appropriate (ASC 230-10-45-22). In such a case, we believe the classification in the statement of cash flows should be consistent with the balance sheet classification of the related asset.

In remarks at the 2006 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff cautioned that if the most appropriate classification is not clear, this does not mean that any classification is appropriate. Rather, registrants must analyze the nature of the activity and the predominant source of the related cash flows. The SEC staff also noted that registrants should provide disclosure sufficient to inform investors of the statement of cash flows classification selected and the alternative classifications considered and rejected. The SEC staff continues to comment when classification of cash flow activities is not clear, correct or consistent. For example, an entity recorded the purchase of an asset as an investing cash flow, the rental proceeds of the asset as an operating cash flow, and the sale of the asset as an operating cash flow. Such presentation of the purchase and sale cash flows is inconsistent. If the asset is an operating asset, all cash flows should have been recorded in the operating section of the statement of cash flows. On the other hand, if the asset is a capital investment, both the sale and purchase of the asset should have been recorded in the investing section of the statement of cash flows.

3.6 Common issues related to classification

Discussed below are several common issues with respect to classification of cash flows as operating, investing or financing cash flows. See Chapter 4 for discussion of issues related to certain financial instruments.

3.6.1 Cash flows related to hedging activities

Generally, each cash receipt or payment should 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 should be classified as a financing activity even if the debt is intended to hedge an investment, and the purchase or sale of a futures contract is an investing activity even if the contract is intended to hedge a firm commitment to purchase inventory. However, an exception exists for a derivative instrument that is accounted for as a fair value hedge or cash flow hedge provided it meets certain criteria (ASC 230-10-45-27). See discussion of cash flows related to certain financial instruments in Chapter 4.

3.6.2 Acquisition and sales of certain securities and loans

Some entities, including banks and broker dealers, may carry securities and other assets in a trading account. Cash flows resulting from purchases, sales and maturities of marketable debt or equity securities classified as trading securities pursuant to ASC 320 should be classified based on the nature and purpose for which the securities were acquired (ASC 230-10-45-19). In other words, an entity must determine whether those securities were acquired and held primarily to be sold in the near team (which would indicate classification as an operating activity), or whether the securities will be held for a longer period (which would indicate classification as an investing activity). However, cash flows resulting from purchases and sales of other securities and other assets are classified as operating cash flows if those assets are acquired specifically for resale and are carried at market value in a trading account (ASC 230-10-45-20).

Some loans are similar to securities in a trading account in that they are originated or purchased specifically for resale and are held for short periods of time. Cash flows resulting from acquisitions and sales of loans also are classified as operating cash flows if those loans are acquired specifically for resale and are carried at market value or lower of cost or market value (ASC 230-10-45-21). Cash flows associated with all other loans are classified as investing cash flows.

Note that the guidance on debt and equity securities requires separate classification of cash flow activity for the held-to-maturity, available-for-sale and trading securities in the statement of cash flows. Cash flows from purchases, sales and maturities of available-for-sale securities and held-to-maturity securities should be classified as cash flows from investing activities and reported gross for each classification. Thus, if an entity has three categories of investments, with purchases, sales and maturities in each category, as applicable, it conceivably could present seven different captions in the statement of cash flows related to investment activity.

Certain sales of debt securities before maturity (e.g., sales within three months of maturity) are deemed to have occurred at maturity (See our Financial reporting developments publication, *Accounting for certain investments in debt and equity securities* — ASC 320). We believe the proceeds received on such sales may be classified as cash received on maturity in the cash flow statement.

Transfers between held-to-maturity or available-for-sale and trading generally result in a non-cash transfer between investing and operating activities. Those activities affect recognized assets, even though they do not result in cash receipts or cash payments in the current period. Therefore, such activity, if significant, should be included in the disclosures of noncash activity.

3.6.3 Distributions received from unconsolidated entities (including joint ventures)

Distributions received from unconsolidated entities that represent returns *on* the investor's investment (i.e., dividends) are reported as cash flows from operating activities in the investor's statement of cash flows, consistent with ASC 230-10-45-16. Cash distributions from unconsolidated entities that represent returns *of* the investor's investment are reported as cash flows from investing activities, consistent with ASC 230-10-45-12. Similarly, proceeds received on the sale by an investor of its interest in an unconsolidated entity are reported as cash flows from investing activities. Accordingly, for those entities with equity method investments, it is important to assess whether a distribution of cash from the unconsolidated investee is a return *on* the investment (i.e., a dividend) or a return *of* the investment, for purposes of appropriately classifying the distribution in the statement of cash flows.

We believe there are two acceptable methods to determine whether distributions received from an unconsolidated investee are returns on, or returns of, the investment.

3.6.3.1 "Cumulative earnings" approach

Under this approach, all distributions received by the investor are deemed to be returns on the investment (and thus classified as operating cash flows) unless the cumulative distributions exceed the cumulative equity in earnings recognized by the investor. The excess distributions are deemed to be returns of the investment and are classified as investing cash flows. Careful consideration should be given to distributions received when the carrying value of the investment is near or below zero to determine whether the return from the investee is a return on, or a return of, the investor's investment.

As discussed in ASC 325-20-35-1, dividends received from a cost method investee in excess of earnings subsequent to the date of the investment are considered a return of an investment. This approach also applies to distributions received from an equity method investee. Accordingly, under the "cumulative earnings" method, the manner in which the cash is generated by the investee to fund the distribution is not considered in assessing the distribution from the investee. In other words, it does not matter whether the cash was

generated through a refinancing, sale of assets or operating results. Rather, the investor need only consider the relationship between the cash received from the investee and its cumulative equity in the undistributed earnings of the investee in assessing whether the distribution from the investee is a return on or return of its investment. Cash received from the unconsolidated entity is presumed to be a return on the investment to the extent that, on a cumulative basis, distributions received by the investor are less than its share of the equity in the undistributed earnings of the entity.

3.6.3.2 "Look-through" approach

Under this approach, a presumption exists that the distributions are reported under the cumulative earnings approach unless the facts and circumstances of a specific distribution clearly indicate that the presumption has been overcome (e.g., a liquidating dividend or distribution of the proceeds from the investee's sale of assets), in which case the specific distribution is deemed to be a return of the investment (investing cash flow).

This approach is consistent with AICPA Technical Practice Aid (TIS Section 1300.18), "Presentation on the Statement of Cash Flows of Distributions From Investees With Operating Losses," as follows:

> "Distributions to investors from investees should be presumed to be returns on investments and be classified by the investor as cash inflows from operating activities, similar to the receipt of dividends. That presumption can be overcome based on the specific facts and circumstances. For example, if the partnership sells assets, the distribution to investors of the proceeds of that sale would be considered a return of investment and be classified by the investor as cash inflows from investing activities."

At times, an unconsolidated entity has operating losses during the year but a positive cash flow allows it to distribute funds to its investors. We believe distributions that are funded by the normal or financing operations of the unconsolidated entity would be a return on investment and presented as an operating cash inflow, provided the distribution did not exceed undistributed earnings from prior periods. If however, the distribution was funded from assets sold by the unconsolidated entity outside of its normal course of business, this distribution would generally be considered a return of the investment, classified by the investor as a cash inflow from investing activities. Likewise, we believe that a liquidating dividend received from an unconsolidated investee should be recognized as a cash inflow from investing activities under the "look-through" approach.

We believe the presumption that distributions to investors are returns on an investment should be overcome only in limited circumstances and only after careful consideration of all relevant facts and circumstances.

The facts and circumstances encompassed in the following example demonstrate the concept of overcoming the presumption that is discussed in TIS Section 1300.18.

Example

Facts:

Real Estate Company A established a 50/50 joint venture (Joint Venture C) with Investor Company B. Real Estate Company A appropriately accounts for its investment in Joint Venture C under the equity method of accounting. Joint Venture C owns one asset, a commercial real estate building. After successful development of the building and leasing 100% of the commercial office space, Joint Venture C sells the asset to an unrelated third-party for cash and distributes all of the proceeds from the sale of the real estate asset to Real Estate Company A and Investor Company B. Joint Venture C as a legal entity and Real Estate Company A's 50% interest remain in existence following the sale and related distribution. During the period from inception of Joint Venture C to the point when the building was sold, Joint Venture C had earnings that were not distributed to Real Estate Company A and Investor Company B.

Analysis:

Real Estate Company A, and Investor Company B, alternatively could have sold their interests in the joint venture to the third party that purchased the building and essentially effected the same transaction as the sale of the underlying real estate. Had that transaction occurred, the proceeds from the sale of the interest, including any gain or loss, would have been recognized as a cash inflow from investing activities. Similarly, the cash inflows associated with the sale of real estate 100% owned by an entity, including any gain or loss, would also be reflected as cash flows from investing activities. Accordingly, in this fact pattern, assuming that Real Estate Company A's established accounting policy required it to "look through" the joint venture to evaluate the nature of the distributions received from its unconsolidated entities for purposes of preparing its consolidated statement of cash flows, we believe that the guidance in TIS Section 1300.18 supports Real Estate Company A presenting 100% of the distribution received from Joint Venture C as a cash inflow from investing activities.

On the other hand, if Real Estate Company A has a stated accounting policy of determining the nature of distributions based on the "cumulative earnings" approach, it must consider the relationship between cash received from the joint venture and its cumulative equity in the undistributed earnings of the joint venture. This could result in some of the proceeds classified as operating cash flows (up to the cumulative equity in earnings recognized) and the excess distribution classified as investing cash flows.

The significance of investments in and distributions from unconsolidated investees for both the current and future periods (assuming reasonable expectations) should be considered when evaluating the need for accounting policy disclosures related to unconsolidated investees, including the method for classifying distributions received as operating and investing cash flows.

3.6.4 Transactions with noncontrolling interests (e.g., dividends and purchases/sales of noncontrolling interests while control is maintained)

While ASC 230 does not provide specific guidance on the statement of cash flow presentation for transactions with noncontrolling interest holders, it does state that "proceeds from issuing equity instruments" and "payment of dividends and other distributions to owners, including outlays to reacquire the enterprise's equity instruments" are financing activities (ASC 230-10-45-14 and 45-15). We believe that transactions with noncontrolling interest holders, while control is maintained, should generally be reported as financing activities in the statement of cash flows. This view is consistent with guidance in ASC 810, *Consolidation*, that all residual economic interest holders have an equity interest in the consolidated entity, even if the residual interest is relative to a subsidiary, and the requirement to present noncontrolling interests in the consolidated statement of financial position as a separate component of equity. Further, this view is consistent with its requirement for changes in a parent's ownership interest in a subsidiary, while the parent retains a controlling financial interest, to be accounted for as equity transactions.

3.6.5 Business acquisition or disposition

3.6.5.1 Sale and purchase of productive assets

Cash flows from sales and for purchases of productive assets, including the acquisition or sale of a business, are presented as investing activities. Changes in assets and liabilities that are typically presented in the operating or financing activities sections of the statement of cash flows, but that result from the purchase or sale of a business, are presented as an investing activity. The statement of cash flows should reflect as a single line item cash paid to purchase a business (net of cash acquired) or cash received from the sale of a business (net of cash sold). The non-cash effects of a business combination, including any non-cash consideration included in the purchase consideration and the total effects on the assets and liabilities of the acquirer also are required to be disclosed. However, such disclosures also are required by the guidance in ASC 805, *Business Combinations*, and generally need not be repeated.

Note that subsequent to the acquisition of a business, cash flows of the newly acquired entity are combined with those of the consolidated entity and presented within operating, investing and financing activities as appropriate.

3.6.5.2 Transaction costs

The cash paid for transaction costs incurred in a business combination, we believe, is most appropriately classified in the operating section of the statement of cash flows. ASC 805 requires transaction costs to be expensed as incurred (ASC 805-10-25-23). Classifying the cash flows as an operating activity would be consistent with the requirement to recognize the costs as an expense. In addition, classification of these costs as an operating activity would be

consistent with the guidance that "cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income" (ASC 230-10-20).

3.6.5.3 Contingent consideration

Contingent consideration arrangements will often be settled at an amount different than the amount initially included in measurement of the consideration transferred under ASC 805. Contingent consideration classified as an asset or a liability is remeasured to fair value at each reporting date until the contingency is resolved with the changes in fair value recognized in earnings for changes in the fair value of contingent consideration that are not measurement period adjustments (ASC 805-30-35-1).[1] These subsequent changes in the fair value of the contingent consideration arrangement should be classified as an adjustment to cash flows from operating activities because the change in fair value was an input in determining net income.

When the contingent consideration is paid or settled, we believe that the portion of the contingent consideration arrangement that is included as part of the consideration transferred represents a financing activity as the arrangement is a method of financing the arrangement. This view is consistent with the guidance in ASC 230 that the portion of property, plant and equipment that is not paid for at or soon after the time of acquisition is considered seller financing, and future payments are treated as repayment of debt principal (i.e., a financing activity). Thus, the portion of the payment attributable to the amount included as part of the consideration transferred would be classified as cash flows from financing activities, and the portion recognized in the statement of income (amount above acquisition-date fair value) would be classified as cash flows from operating activities.

3.6.6 Insurance claim proceeds

Proceeds from insurance settlements, except for those directly related to investing or financing activities, such as from destruction of a building, are classified as cash inflows from operating activities (ASC 230-10-45-16(c)). The SEC staff believes that evaluating cash flows from insurance claim proceeds requires careful consideration of the nature of the insurance coverage (i.e., the nature of the loss) and is not dependent on how the entity plans to use the proceeds. If the claim relates partially to business interruption and partially to property, plant, and equipment owned or under capital lease, the presentation of cash flows from proceeds should be allocated between cash flows from operating activities for the business interruption portion of the claim and cash flows from investing activities for the property, plant and equipment portion of the claim. If the claim relates to property, plant and equipment under an operating lease, the presentation of the proceeds should be an operating activity, as should proceeds for a claim related to lost or damaged inventory.

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[1] Unless the arrangement is a hedging instrument for which ASC 815 requires the changes to be initially recognized in other comprehensive income.

The SEC staff believes registrants should consider disclosure of material insurance settlements in MD&A. These disclosures should include a description of how the entity classified the insurance proceeds in the statement of cash flows.

3.6.7 Inventory purchases from a supplier financed by a subsidiary of the supplier (i.e., "floor plan" financing transactions)

Classification in the statement of cash flows by a dealer for its inventory purchases from a supplier that are financed by a subsidiary of the supplier (often referred to as floor plan financing transactions) differs from purchases from a supplier financed by non-supplier affiliated financing sources.

In a financing transaction between a dealer and the subsidiary of the supplier for the purchase of inventory from a supplier, the finance subsidiary typically pays the supplier (its parent) directly, with no actual cash outflow to the dealer (the purchaser of the inventory and borrower). The finance subsidiary then holds a lien on the inventory and will be repaid at a future date by the dealer, typically when the underlying inventory is sold. In this fact pattern, the dealer should present the purchase from the supplier as an increase to inventory and an increase to trade loans within operating activities in the statement of cash flows when presenting operating activities using the indirect method. (Under the direct method, there is no cash flow to report.) The dealer would report the repayment as a reduction of trade loans within operating activities. The net result of these transactions to the dealer is a net operating cash inflow within operating activities equivalent to the gross profit on the sale of the inventory to the end customer. This approach is consistent with the SEC staff's view as discussed at the 2005 AICPA National Conference on Current SEC and PCAOB Developments.

In contrast, a different presentation would be appropriate when the source of financing is unaffiliated with the supplier. In a third-party financing arrangement, the inventory purchase from the supplier by the dealer should be reported as an operating cash outflow, while the loan from the unaffiliated financing source should be reported as a financing inflow to the dealer. The repayment of the loan to the unaffiliated financing source should later be reported as a financing outflow to the dealer. Again, the net result of these transactions to the dealer is a net operating cash inflow within operating activities equivalent to the gross profit on the sale of the inventory to the end customer.

3.6.8 Sale of inventory financed through a captive finance subsidiary

The SEC staff discussed their view related to cash flow reporting by entities providing customers with product purchase financing at the December 2004 AICPA National Conference on Current SEC and PCAOB Developments: when financing the sale of product inventory through a captive finance subsidiary, the cash flow statement should not reflect the payment of the sales consideration by the customer through financing obtained from the captive finance subsidiary as both an operating cash inflow and an investing cash outflow, respectively, when there has not been a cash inflow to the entity on a consolidated basis. On

a consolidated basis, the payment from the finance subsidiary to the parent supplier is eliminated. As a result, no activity should be presented in the consolidated statement of cash flows. Entities may have used the gross presentation because they viewed the manufacturing and finance operations as separate and distinct businesses and believed that the gross presentation was a better depiction of the cash flows of those operations. However, the SEC staff believes that, on a consolidated basis, there has been no cash received or expended by the entity and, as such, gross activity should not be presented in the statement of cash flows.

Note that this view relates only to the financing of sales with an entity's direct customer and not for sales by an entity's customers to end consumers, where such end consumers elect to finance their purchases with the entity's captive finance subsidiary. In those cases, the origination and subsequent collection of financing provided to such end consumers would be properly reflected by the entity as investing activities.

Also, see Section 3.6.13 below regarding classification of loans and trade receivables from customers.

3.6.9 Payment in kind interest (i.e., settlement of interest by issuing additional securities or restructuring debt)

Questions have arisen regarding the classification of paid in kind interest and other similar arrangements (e.g., zero-coupon or deeply-discounted instruments) whereby interest owed on an original principal amount of debt is accrued and added to the original principal amount of debt but is not paid until maturity of the original principal. For the purpose of this discussion, consider a borrowing at a deep discount (receive $75) with maturity at the face amount of the note (assume $100). In the income statement, the $25 difference is accreted through interest expense over the life of the debt.

Under the indirect method, cash flows from operating activities would include a reconciling item to the extent of non-cash expense consistent with the guidance in ASC 230-10-45-28, which notes:

> "Adjustment to net income of a business entity … to determine net cash flow from operating activities shall reflect accruals for interest earned but not received and interest incurred but not paid."

When the interest expense is ultimately settled (e.g., at maturity of the in-kind security), there are two views regarding the classification of the related cash outflow. Under one view, the payment is the payment of the interest initially due and should be reported as an operating activity, because cash outflows for operating activities include "cash payments to lenders and other creditors for interest" (ASC 230-10-45-17). Using the example at the beginning of this section, application of this view would suggest the $25 be classified as an operating cash flow as it exceeds the amount initially borrowed.

Under the other view, the entire amount paid (i.e., $100 in the example above) would be classified as financing. When zero-coupon debt is settled, the amount paid to the borrower on settlement exceeds the amount initially borrowed. That excess amount represents the interest earned by the lender over the time the note was outstanding. While the legal form of a zero-coupon borrowing and a borrowing with in-kind interest is different, the underlying concept is the same. In each case, additional "principal" is added to the initial amount borrowed, then repaid at maturity. Cash outflows for financing activities include "repayments of amounts borrowed" (ASC 230-10-45-15).

We believe that both of these views are acceptable. Because of the diversity in classification, however, we would expect an entity's accounting policy to be applied consistently and disclosed.

3.6.10 Repurchase of shares from an employee to satisfy minimum tax withholding

Some stock option plans allow employees to use shares received from the exercise of an option to satisfy their tax withholding requirement. Similarly, a plan may permit the employee to use vested shares to satisfy a tax withholding obligation. In effect, the employing entity repurchases a portion of the shares at fair value, and uses the cash on behalf of the employee to satisfy the tax withholding requirements. Practice has varied with respect to presentation of cash flows resulting from an employer's repurchase of shares to satisfy minimum tax withholding. While the actual mechanics likely are the issuance of a reduced number of shares and a direct payment of cash by the employer to the taxing authorities, from an accounting standpoint the transaction is recorded as a treasury stock purchase from the employee and, instead of giving the employee the cash for the shares, the cash is remitted to the taxing authorities on the employee's behalf.

Some entities have presented these as an operating cash outflow like the settlement of other current liabilities as the shares are never actually issued and repurchased. However, while this is true, the accounting reflects a share issuance and immediate treasury stock repurchase. Therefore, we believe that the cash outflows should be reflected as a financing activity in the statement of cash flows consistent with other treasury stock repurchases.

3.6.11 Excess tax benefit from share-based payment awards

Generally, the amount of income tax benefit recognized in any period is equal to the amount of compensation cost recognized multiplied by the employer's statutory tax rate. If the tax deduction for an award (generally at option exercise or share vesting) exceeds the cumulative amount of compensation cost recognized in the financial statements for that award, the excess tax benefit (also referred to as the "windfall benefit") is recognized as an increase to additional paid-in capital if it would reduce taxes payable.

The guidance in ASC 230 specifically requires a realized tax benefit related to the excess tax benefit be classified in the statement of cash flows as a cash inflow from financing activities and a cash outflow from operating activities (ASC 230-10-45-14 and 45-17). With respect to the cash outflows in operating activities, we believe it is appropriate to either adjust the change in payables account or segregate the cash outflow in a separate line item in the operating section.

3.6.12 Settlement of pension liabilities

Contributions to pension plans are reported as operating cash outflows because they relate to employee compensation, an item reported as an expense in the income statement. Likewise, with respect to employee benefit pension plans qualifying under the IRS Tax Code, an entity's annual premium contributions to the Pension Benefit Guaranty Corporation ("PBGC") also represent operating cash outflows. Entities that reorganize in bankruptcy often enter into agreements with the PBGC regarding their liability under employee benefit plans that provide for a settlement for the plan liability through an assumption by the PBGC. The agreements with the PBGC typically require that payments be made by the entity at or after (or both) the entity's emergence from bankruptcy for the defined benefit plans that were assumed by the PBGC.

Despite the fact that payments made to the PBGC pursuant to these agreements may extend for several years, the cash outflows should not be classified as financing activities in the statement of cash flows. The form of settlement of the pension liability does not change the substance of the activity for which cash is being paid, and therefore it retains its classification as an operating activity. In addition, the classification of these payments as an operating activity does not change in the event the registrant is required to apply "fresh-start reporting" pursuant to ASC 852, *Reorganizations*, on emergence from bankruptcy.

3.6.13 Loans and trade receivables

The appropriate classification in the statement of cash flows of a commercial entity for cash flows related to loans and trade receivables requires a determination of the source of the loans or receivables. If the loans or receivables result from the sale of the entity's goods or services to its customers, the resulting cash receipts are always operating cash inflows, as cash receipts from "accounts and both short- and long-term notes receivable from customers," whether by collection from the customer or sale of the notes or receivables, are operating cash flows (ASC 230-10-45-16).

However, when the entity originates or purchases loans or trade receivables that do not result directly from the sale of goods or services to its customers, classification is based on management's intent to either hold the loans or trade receivables for sale or for investment. Cash receipts and cash payments resulting from acquisitions and sales of loans should be classified as operating cash flows if those loans are acquired specifically for resale and are carried at market value or at the lower of cost or market value (ASC 230-10-45-21). Cash receipts and cash payments from sales of loans acquired as investments should be classified

as investing cash inflows regardless of a change in the purpose for holding these loans (ASC 230-10-45-12). Thus, if at origination or purchase management initially classifies loans or trade receivables as held for investment, the related cash receipts and payments should be classified as investing cash flows, even if management subsequently decides to sell such loans or trade receivables or subsequently classifies the receivables as held for sale.

3.6.14 Securitized loans or trade receivables

Several cash flow presentation questions arise in transactions involving the securitization of loans or trade receivables, including:

- Whether to gross up the cash flow statement when beneficial interests are received as part of the consideration
- How to present any initial cash receipts from securitizations accounted for as sales
- How to present subsequent cash receipts from beneficial interests

3.6.14.1 Gross versus net presentation

When an entity sells or exchanges loans or trade receivables for consideration that includes a beneficial interest in the securitized assets, the entity should disclose the beneficial interest portion of the transaction as a noncash investing activity. A company should not gross up the cash flow statement by recognizing both a cash inflow for the portion of loans or trade receivables transferred for which it received a beneficial interest, rather than cash, and a cash outflow for the "purchase" of the beneficial interest. For example, if an entity sells receivables with a carrying amount of $100 and receives cash of $80 and a beneficial interest of $20, it should reflect a cash inflow of $80 and disclose an non-cash investing activity of $20, as opposed to a cash inflow of $100 and a cash outflow of $20 to purchase the beneficial interest.

3.6.14.2 Initial cash receipts in securitizations accounted for as sales

As noted in Section 3.6.13 above, cash receipts from sale of accounts receivable, including securitization transactions accounted for as sales in accordance with ASC 860, *Transfers and Servicing*, are classified as cash flows from operating activities on the statement of cash flows.

3.6.14.3 Accounting and cash flow presentation considerations for beneficial interests

Questions also have arisen concerning the appropriate classification of the receipt of principal payments on beneficial interests obtained in a securitization transaction. At the 2005 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff expressed a view that the classification of cash received from principal payments on beneficial interests generally depends on how the underlying beneficial interests are accounted for and not the nature of the transaction (e.g., the sale of receivables) that created the beneficial interests.

Cash inflows from investing activities

Beneficial interests represent rights to receive all or portions of specified cash inflows received by a trust or other entity. Often beneficial interests are issued in the form of debt or equity securities. If a beneficial interest can contractually be prepaid or otherwise settled in such a way that the holder (investor) would not recover substantially all of its recorded investment, then the interest should be subsequently measured like an investment in debt securities classified as available for sale or trading under the guidance on investments in debt and equity securities in ASC 320 (ASC 860-20-35-2). It is important to note that such accounting is required even if the legal form of the beneficial interest is not a security or certificated interest (e.g., a note representing a transferable certificate of ownership). Additionally, a beneficial interest that can be contractually prepaid or otherwise settled such that the holder would not recover substantially all of its recorded investment cannot be classified as held-to-maturity even if the investor concludes that prepayment or other forms of settlement are remote (ASC 860-20-35-5). That is, the probability of prepayment or other forms of settlement that would result in the holder not recovering substantially all of its recorded investment is not relevant in deciding whether the provisions of ASC 860-20-35-2 apply to those beneficial interests. See our Financial reporting developments publication, *Transfers and servicing of financial assets (ASC 860)*, for further discussion.

Section 3.6.2 discusses the cash flow classification of certain securities and loans. Based on the guidance above and the guidance in Section 3.6.2, the principal payments on beneficial interests obtained from sales of trade receivables will be presented as cash flows from investing activities (as opposed to operating activities) on the statement of cash flows for most commercial entities, because the beneficial interests obtained are not instruments that commercial entities typically plan to actively trade. Consequently, this treatment could produce net negative cash flows from operations on a cumulative basis when the cash flows from the beneficial interest are reported as an investing activity.

Cash inflows from operating activities

Following the adoption of Statement 166 (codified as ASC 860), many traditional revolving commercial paper programs were modified to comply with the new "participating interest" requirements and to continue to achieve sale accounting for the transferor (seller). The new structures typically involve a "two-step transfer" – designed to achieve the legal isolation and other derecognition requirements of the guidance in ASC 860 - to a multi-seller commercial paper conduit that is typically consolidated by the sponsor of the conduit (i.e., not the seller).

In such transactions, in exchange for a group of trade receivables in their entirety, the seller receives partial cash consideration and a note (i.e., a beneficial interest) for the remainder of the purchase price, which is subordinated to the performance of the receivables transferred. This beneficial interest is commonly referred to as a holdback, deferred purchase price or deferred purchase payment ("DPP"). The DPP typically is not considered either a security or a certificated interest under the Uniform Commercial Code (i.e., a physical financial instrument is not received related to the DPP). Instead, the DPP is simply an element of the receivable purchase agreements and represents a nonrecourse contractual obligation of the commercial paper conduit. The DPP is paid to the seller as amounts are collected by the conduit from the

transferred receivables, but only to the extent that the cash collected by the conduit exceeds the original cash paid by the conduit for those receivables, less the conduit's carrying and servicing costs.

The cash receipts associated with the DPP may be presented as operating cash flows (i.e., in a manner similar to the initial cash receipts from the conduit in a transfer accounted for as a sale) if all of the following conditions are met:

- The DPP is not an actual security or a certificated interest under the Uniform Commercial Code. This condition is a key consideration in the analysis because if the DPP is a security or certificated interest, then it would be a security subject to the provisions of ASC 320 and the related cash flow presentation requirements (i.e., presented within investing activities unless the DPP is held for active trading, which in our experience would be rare for a commercial entity).
- The DPP is solely payable through the collections of the underlying sold trade receivables and is not subject to the credit risk of other assets of the transferee. In other words, repayment is dependent only on the cash flows from the trade receivables transferred by the transferor and not the cash flows received from other financial assets held by the securitization entity (i.e., the conduit).
- The interest rate risk exposure on the DPP is insignificant because the underlying trade receivables have short term maturities. For example, they are generally paid within 60 days.

  As noted above, the DPP absorbs any incremental funding costs incurred by the conduit (i.e., any increase in the weighted average commercial paper rate of the conduit before the conduit recovers 100% of its cash investment). However, because the transferred receivables (which represent the sole source of the DPP repayment) have short maturities, the holder's interest rate risk exposure on its DPP is not significant. Given the significance of this consideration, individual transactions should be carefully evaluated to ensure the interest rate exposure is truly insignificant. This evaluation requires a thorough understanding of the underlying agreements and the conduit's financing arrangements.

We understand that the SEC staff would not object to classifying cash receipts from the DPP as operating cash flows if these criteria are met. In that case, the SEC staff has noted that they expect the following presentation and disclosure:

- SEC registrants should present cash inflows from the DPP as a separate line item within operating cash flows included in annual financial statements included in Form 10-K. For condensed quarterly financial statements included in Form 10-Q, it is acceptable to include the amounts related to the DPP within the asset and liability changes caption rather than as a separate line item on the face of the cash flow statement, due to the condensed presentation permitted in interim financial statements.

- SEC registrants should disclose the total collections from sales of accounts receivable separate from collections of the DPP in both annual and interim financial statements.
- SEC registrants should provide clear disclosure of its policy around the cash flow treatment of its accounts receivable sales programs, including its basis for selecting operating cash flow presentation.

A transferor's accounting policy regarding the classification of cash inflows from a DPP as either operating or investing activities should be consistently applied and, if significant, disclosed as an accounting policy election. Although the presentation requirements above represent the SEC staff's view with respect to SEC registrants, we believe that these presentation requirements are also appropriate for nonpublic entities.

3.6.15 Restricted cash

At the 2006 AICPA National Conference on Current SEC and PCAOB Developments, the SEC staff discussed changes in restricted cash as an area in which more than one cash flow classification might be appropriate depending on the nature of the restriction, while noting that, generally, restricted cash would appear to be an investment, and the related cash flows thus should be classified in investing activities. However, in some situations classification as an operating activity could be supported when the purpose of the restriction on cash is directly related to the operations of an entity's business (e.g., workers' compensation obligations or deposits to be able to do business in certain areas). Classification of restricted cash activity as cash flows from financing activities may be appropriate, for instance, when the primary purpose of the restricted cash is to serve as collateral for borrowings.

In considering the appropriate classification of changes in restricted cash, entities should consider "the activity that is likely to be the predominant source of cash flows for the item" (ASC 230-10-45-22). In addition, the SEC staff has commonly requested that registrants expand their disclosures, at times by including a separate accounting policy in the footnotes for classification of certain items in the statement of cash flows.

Refer to Section C1.0 of the Ernst & Young Accounting Manual for discussion of the balance sheet presentation of restricted cash.

4 Cash flow presentation of certain financial instruments

4.1 Overview

This section discusses the statement of cash flows implications for several types of financial instruments, including derivatives, and related transactions. Some of the discussion pertains to instruments or transactions specific to financial services entities, principally financial institutions, insurance companies and investment companies. Generally, the implications of such instruments or transactions are not directly addressed in ASC 230 or ASC 815, *Derivatives and Hedging*. The presentations we recommend are based on the nature of the transactions and the requirements for cash flow presentation of analogous transactions.

Entities, particularly financial institutions, are engaging in an increasing number of different transactions involving financial instruments. These transactions have various objectives such as transferring risk, reducing the cost of capital or creating liquidity, and the transactions may or may not be recognized on the balance sheet. The cash receipts and payments related to financial instruments should be classified as operating, investing or financing transactions according to their nature, and they should be presented gross in the statement of cash flows unless the cash receipts and payments are eligible for net presentation as discussed in Chapter 2.

4.2 Derivatives

4.2.1 Cash flows related to hedging activities

There is limited guidance in ASC 230-10-45-27 on the presentation of cash flows from derivatives and hedging activities as follows:

> "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 subsequent to the date of discontinuance shall be classified consistent with the nature of the instrument."

4.2.2 Trading derivatives

At acquisition, an entity classifies securities into one of three categories: trading, available-for-sale or held-to-maturity (ASC 320-10-25-1). If a security is acquired and held principally for the purpose of selling in the near term, the security is classified as trading. However, at acquisition, an entity is not precluded from classifying a security as trading it plans to hold for a longer period. Cash flows resulting from purchases and sales of securities classified as trading are classified in the statement of cash flows as operating or investing based on the nature and purpose for which the securities were acquired (ASC 230-10-45-19), which may not necessarily be to sell within hours or days. Cash flows related to securities acquired specifically for resale and carried at market value in a trading account are classified in the statement of cash flows as operating cash flows, whereas cash flows related to other securities classified as trading are not necessarily required to follow that same classification. Likewise, we believe it is appropriate to classify cash flows from derivatives held for trading (i.e., derivatives not in formal accounting hedges or functioning as economic hedges, held for example, as part of its trading portfolio that includes both derivative instruments and nonderivative or cash instruments) as operating cash flows, subject to the additional guidance related to derivatives containing financing elements, as discussed in Section 4.2.3 below.

4.2.3 Derivatives with financing elements

The guidance relative to derivative contracts with financing elements provides that cash flows related to a derivative instrument containing an other-than-insignificant financing element at inception must be reflected in the borrower's statement of cash flows as a financing activity. The FASB did not explicitly address the presentation of cash flows from a derivative containing a financing element for the "lender." We believe classifying those cash flows in investing activities is appropriate, but not required.

The guidance in ASC 815 identifies contracts with financing elements as those contracts that, at inception, contain off-market terms or require an upfront payment, or both. In addition, contracts that are designed to ensure cash inflows for one party in early periods followed by cash outflows to the counterparty in later periods contain a financing element. These are contrasted to instruments that require an upfront payment solely for the time value in an at-the-money or out-of-the-money option contract, or swaps where the general construction of a swap results in expected (but not ensured) cash inflows in early periods followed by cash outflows in later periods. The FASB intended to avoid the possibility that a derivative would be used to hide a borrowing and thus not reflect the true nature of a liability in the financial statements by masking it in an instrument accounted for at fair value. The FASB acknowledges that identifying a contract with a financing element is a matter of judgment. Cash flows of derivatives containing an insignificant financing element, including those that require an upfront payment solely for time value or where the general construction of a swap results in expected cash inflows in early periods followed by cash outflows in later periods, may be reflected in the statement of cash flows based on the item being hedged by the derivative.

4.2.4 Settlement of cash flows for derivatives with no initial investment

The "purchase or sale" of a futures contract is described as an investing activity in ASC 230-10-45-27. This description, written in 1989, seems to conflict with one of the fundamental characteristics of a derivative that such contracts have no initial net investments. Cash flows of non-option derivatives (such as forward contracts or interest rate swaps priced at the market at inception) are unique in that there is not typically an initial cash flow to categorize; all the cash flows are either partial settlements or final settlements. This observation has resulted in practice questions that challenge how settlement cash flows can be investing activities in the statement of cash flows if there was never an initial "investing" cash flow.

For example, futures contracts are not purchased or sold, but are entered into with zero initial investment and no cash flow. Receiving an initial cash flow for entering into an off-market futures contract, unless insignificant, is evidence of a financing activity, not an investing activity. However, paying an initial cash flow for entering into an off-market futures contract does indeed indicate an investing activity. Many believe that the guidance requires the settlement of a derivative contract to be categorized as an investing activity for derivatives not designated as accounting hedges. Others believe that the cash flow settlement could be an operating activity depending on the outcome of the full analysis of the nature of the derivative, and that the reference to "purchase or sale" of a derivative contract is antiquated and inconsistent with other guidance in ASC 815. We understand that the FASB staff has addressed this issue by stating that cash flows from derivatives that are not directly addressed by ASC 815 as financing activities are not necessarily either exclusively investing activities or exclusively operating activities. Rather, the nature of the use of the derivatives must be evaluated to determine the appropriate classification. Accordingly, we believe it is important to understand the nature and purpose of the derivative in determining the appropriate classification.

4.2.5 Termination payment/receipt of forward starting swap hedging forecasted issuance of fixed-rate debt

Hedges of forecasted issuances of fixed-rate debt with forward-starting swaps all require the swap to be terminated on the debt issuance date, when risk of variability ceases. If market interest rates have increased, the hedger will be entitled to a cash receipt on settlement from the swap counterparty. If market interest rates have decreased, the hedger must make a cash payment to the swap counterparty on settlement. We understand the SEC has questioned several registrants who have classified such termination payments as financing cash flows (the rationale for such classification being that debt issuance proceeds together with the cash inflow or outflow from the termination of the hedge should be collectively viewed as financing cash flows — i.e., the registrant is hedging its financing program) rather than operating cash flows (the SEC's rationale being it is based on the item being hedged — i.e., interest which is an operating cash flow).

The guidance in ASC 815-30-55 Example 21, addresses the issue of the impact on accumulated other comprehensive income ("AOCI") of issuing debt at a date that is not the same as originally forecasted, a very common occurrence. The example illustrates via two cases the determination of when an entity should reclassify into earnings the AOCI amount related to the hedging derivative instrument when a delayed issuance of debt occurs under ASC 815-30-40-5. Specifically, it addresses how the "60-day rule" would be applied to two different scenarios:

(1) Entity A plans to issue fixed-rate debt at or near par at the then current market interest rate and will therefore have no variability in debt proceeds, but each of the probable interest payments resulting from the debt is exposed to variability up until the date of issuance

(2) Entity B plans to issue fixed-rate debt at a pre-fixed interest rate, and the proceeds will vary (resulting in either a debt discount or debt premium) as market rates change during the period leading up to actual issuance date. The interest payments are not exposed to variability (as the company has already indicated the coupon rate it intends to pay), but the proceeds are exposed to variability.

The 60-day rule applies separately to each of the periodic interest payments for Entity A, but applies to the entire single receipt of proceeds for Entity B. Accordingly, the impact on AOCI of a delay in the debt issuance date is potentially much more dramatic for Entity B.

Entity A must designate that it is hedging the forecasted interest payments; Entity B must designate that it is hedging the forecasted receipt of debt proceeds. Both Entity A and Entity B would use the *identical* forward-starting interest rate swap as a hedging instrument.

Cash flows from a hedging derivative instrument may be classified in the same category as the cash flows from the items being hedged provided that the derivative does not include an other-than-insignificant financing element at inception and that the accounting policy is disclosed (ASC 230-10-45-27). Therefore Entity A would classify the cash settlement (either inflow or outflow) as "operating" (because it's hedging interest, an operating item) and that Entity B would classify the cash settlement as "financing" (because it's hedging the debt).

The contra-argument is that Entity A has created synthetic discount debt or synthetic premium debt, while Entity B has created synthetic "at par" debt, and the debt issuance proceeds together with the cash inflow or outflow from hedge termination should be collectively classified as "financing" cash flows. To record Entity A's hedge termination cash flow, a potentially large number, as "operating" before any interest cash flows have begun is misleading to investors, some argue. This contra-argument stresses that ASC 815-30-55, Example 21's designation specificity is addressing the impact of the 60-day rule on AOCI, but in substance and on a higher level, both Entity A and Entity B are using the identical derivative to hedge their financing programs. Entity A and Entity B, accordingly, should not be required to have the cash flow from hedge termination be recorded in different statement of cash flows categories.

We believe that both views are legitimate and that determination should be based upon an accounting policy election which is well disclosed and consistently applied.

4.2.6 Forward placement commitment contracts and when-issued securities

A forward placement commitment contract provides that a seller deliver a specified security to a buyer at a specified future date and price. Forward contracts are not traded on organized exchanges, and the contract generally can be terminated only by agreement of both parties to the contract.

An entity may also commit to purchase securities on a when-issued basis. These securities (e.g., GNMA securities) normally begin trading before the closing date of the offering.

From the buyer's perspective, forward placement commitment contracts and when-issued securities are similar in that cash payment is not required until after the securities are delivered. Gains and losses included in income (whether realized or unrealized) should be treated like gains or losses on other investments; that is, they should be presented as a reconciling item in the reconciliation of net income and net cash flow from operating activities to offset the operating cash flow impact of the gain or loss (when the indirect method is presented). These gains and losses may include the mark to market on any such forward placement contract or when-issued securities that are accounted for as derivatives under ASC 815 (e.g., those that may not receive an exception from derivative accounting).

Upon the settlement of the commitment contract, the buyer makes cash payment at the commitment contract price to purchase the underlying securities. On the balance sheet, it recognizes the securities at the then market price and de-recognizes any asset or liability associated with the forward placement contract or when-issued securities that are accounted for as derivatives. From the buyer's perspective, the actual cash payment represents the:

- Purchase of the securities
- Settlement of the associated derivative asset or liability

In the statement of cash flows, they are presented as two separate transactions although only one net cash flow has actually occurred. As an example, a forward placement commitment contract provides that the buyer purchase a security at $100 in 30 days. The contract is accounted for as a derivative, with an initial fair value of zero. On the 30th day, the market price for the underlying security is $105. The buyer has recognized a derivative asset of $5 for the forward commitment contract. In the statement of cash flows, the buyer would show the settlement of the transaction (including the purchase of the security and the settlement of the forward commitment contract) as the following:

Cash inflows from investing activities:		
Receipts from settlements of derivative contracts	$	5
Cash outflows for investing activities:		
Payments to acquire securities	($	105)

The net cash outflows for investing activities of the statement of cash flows is the actual cash payment of $100 made by the buyer.

The cash flows related to the purchase of the securities and settlement of the commitment contract should be presented as investing activities on the statement of cash flows unless the nature and use of the derivative supports alternative classification. For example, many financial institutions may classify these cash flows as operating because the underlying securities are acquired specifically for resale and carried at market value in a trading account.

4.2.7 Put and call options and standby commitments

An entity receives or pays a fee (premium) in connection with put and call options and standby commitments. The fee compensates the receiving party for assuming the risk of changes in the fair value of the security underlying the option or commitment up to the delivery or expiration date. Option and standby commitments can result in the purchase or sale of the underlying security or they can expire unexercised. In the case of options, a position also can be liquidated by entering into a closing transaction.

By analogy to the FASB's conclusion about presentation of cash flows related to futures contracts, the cash received or paid (including the fee (premium) related to closing a position), should be presented in the investing activities section of the statement of cash flows unless the nature and use of the derivative supports alternative classification. Gains and losses (whether realized or unrealized) should be presented as a reconciling item in the reconciliation of net income and net cash flow from operating activities to offset the operating cash flow impact of the gain or loss (when the indirect method is presented). The guidance above related to derivatives used in hedging transactions or for trading purposes should be considered also.

Cash receipts and payments related to any margin deposit required should be presented in the investing activities section of the statement of cash flows as discussed below.

4.2.8 Commodity and financial futures contracts

An entity may buy or sell futures contracts to hedge an exposure to changes in prices or interest rates, or to speculate on those changes. Futures contracts are traded on various exchanges and represent a firm commitment to buy or sell the item specified in the contract at a specified future date and price. Companies generally close futures positions before the contract matures and, therefore, do not have to buy or deliver the physical item subject to the futures contract.

When a contract position is taken, an entity need only provide to its broker a margin deposit (cash or US Treasury securities). The purpose of the margin account is to ensure contract performance. Margin requirements change daily based on market price fluctuations of the underlying futures contract. Any increase in required margin is paid to the broker, and any decrease is credited to the account of the entity and may be withdrawn. Often entities receive or pay cash daily based on the previous day's net gain or loss from futures positions.

For statement of cash flows presentation, cash receipts from and payments to the margin account should be presented as investing activities. We believe it is appropriate to present the net cash flows related to daily gains or losses that the entity and its broker settle frequently in cash. Gains or losses recognized in the income statement should be presented as a reconciling item in the reconciliation of net income and net cash flow from operating activities to offset the operating cash flow impact of the gain or loss (when the indirect method is presented). The guidance above related to derivatives used in hedging transactions or for trading purposes should be considered also.

4.3 Loan fees and costs

ASC 310-20, *Receivables — Nonrefundable Fees and Other Costs*, requires certain fees and costs associated with lending activities to be deferred and amortized to income over future periods. These fees and costs are integral to lending activities and should be accounted for as components of a loan's origination cost.

For statement of cash flows presentation, the net deferred fee or cost should be presented in investing activities as part of the cash flow related to originating loans or acquiring debt instruments of other entities. The amortization of the net deferred fees or costs should be presented as a noncash income or expense item in the reconciliation of net income and net cash flow from operating activities. As a result, fees and costs associated with a receivable not held-for-sale[2] will never affect net cash flow from operating activities. However, loan fees and costs associated with receivables held-for-sale will be reflected in operating activities.

4.4 Securities lending

Securities lending transactions typically are initiated by securities dealers, broker-dealers, and other financial institutions that need specific securities to make deliveries, either to cover a short sale or a customer's failure to deliver securities sold. Securities lending arrangements are an alternative to purchasing securities in the open market and may be preferred to better manage a dealer's inventory in any number of ways. As viewed by the marketplace, in a typical securities lending transaction, a borrower provides cash or a security (or pool of securities) as collateral for borrowing a specific security or securities.

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[2] Loans and trade receivables that management has the intent and ability to hold for the foreseeable future or until maturity or payoff (i.e. held-for-investment loans)

Securities lending transactions involve transfers of financial assets that must be evaluated for accounting as either sales or secured borrowings. In some securities lending transactions, the criteria for a sale of financial assets are met. During the term of such an agreement, the securities lender or transferor surrenders control over the securities transferred, and the borrower of securities or transferee obtains control over those transferred securities with the ability to sell or transfer them. However, most securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred securities before their maturity. Such transfers are generally accounted for as secured borrowings under ASC 860 because of the transferor's obligation to repurchase or redeem the transferred securities before their maturities.

With respect to the treatment of securities lending arrangements by the securities lender in the statement of cash flows, practice varies in presenting the receipt of cash collateral in exchange for transferred securities accounted for as a secured borrowing and the subsequent reinvestment of that cash. We believe that it is most appropriate to reflect the receipt of cash in exchange for the transferred security as a financing inflow similar to a borrowing arrangement. The subsequent repurchase of the transferred securities would be accounted for as a financing cash outflow (i.e., a repayment of the borrowing). Many entities that engage in securities lending arrangements are broker-dealers or other financial institutions, and they frequently report such activity as an operating activity.

5 Reporting cash flows from operating activities

5.1 Overview

Pursuant to ASC 230, an entity has the option to present operating cash flows using either the direct method, which presents major classes of cash receipts and payments, or the indirect method, which presents a reconciliation of net income and net cash flow from operating activities. Net cash flow from operating activities is the same regardless of the method. Entities using the direct method also must provide the reconciliation of net income and net cash flow from operating activities in a separate schedule. Entities using the indirect method must provide sufficient information, including separate identification of changes in receivables, inventory and payables for operating items (in the reconciliation), and separate disclosure of interest paid and of income taxes paid (outside the statement of cash flows), so users can estimate amounts that would have been presented had the direct method been used.

The guidance in ASC 230 encourages use of the direct method although the indirect method is predominantly used in practice. Conceptually, the direct method is more consistent with the presentation of investing and financing activities as it more clearly presents the actual cash receipts and payments during the period. However, the indirect approach provides a useful link to the income statement and balance sheet, is more familiar to financial statement users, and generally is the less costly approach to prepare.

Changing from one method of presenting operating cash flows to another is not specifically addressed in ASC 230. We believe that the guidance in ASC 250, *Accounting Changes and Error Corrections*, regarding a voluntary change in accounting principle should be followed.

5.2 Direct method

As noted above, the guidance in ASC 230 encourages entities to report net cash flow from operating activities using the direct method (i.e., major classes of gross cash receipts and gross cash payments and their arithmetic sum). Entities using the direct method must, at a minimum, separately report:

- Cash collected from customers (including lessees and licensees)
- Interest and dividends received
- Other operating cash receipts, if any
- Cash paid to employees and other suppliers of goods and services
- Interest paid
- Income taxes paid (and separately, the income taxes that would have been paid if increases in the value of share-based payments that are not recognized for financial statement reporting purposes had not been deductible in determining taxable income)
- Other operating cash payments, if any

Entities are encouraged to provide further breakdowns considered meaningful and feasible. For example, this could include separate presentation of cash paid to employees and cash paid to other suppliers, or separate presentation of payments for costs of inventory and payments for selling, general and administrative expenses (ASC 230-10-45-25).

Entities that present operating cash flows under the direct method must also present a reconciliation of net income to net cash flow from operating activities (i.e., the operating cash flow under the indirect method — see discussion in Section 5.3 below) in a separate schedule in the notes (ASC 230-10-45-30).

5.2.1 Indirectly determining amounts of major classes of cash flows

The presentation of operating cash flows using the direct method does not require separate cash-based accounting systems. 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 flows for receipts from customers often may be determined by adjusting sales for the change during the period in accounts receivable from customers. Similarly, cash paid to suppliers and employees may be determined indirectly by adjusting cost of sales and other expenses (exclusive of depreciation, interest and income taxes) for the change during the period in inventories and payables pertaining to 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 must 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. Likewise, to present separately cash payments for inventory sold and cash payments for selling, general and administrative costs, an entity would have to segregate the change in accounts payable for each of these categories.

5.3 Indirect method

Entities that choose not to present operating cash flows by the direct method must determine and report the same amount for net cash flow from operating activities using the indirect method. The indirect method requires that net income be adjusted to reconcile it to net cash flow from operating activities. The reconciliation adjusts net income by removing:

- The effects of all accruals of expected future operating cash receipts and payments (such as changes during the period in receivables and payables related to operating activities)
  - The effects of accruals related to interest should be included in the reconciliation to net cash flow from operating activities even if the accruals are reflected in assets and liabilities that relate to investing and financing activities, such as loans or deposits.
- The effects of all deferrals of past operating cash receipts and payments (such as changes during the period in deferred income and inventory)
- Noncash expenses (such as depreciation, amortization of goodwill / other intangible assets and provision for bad debts)
- Gains and losses related to transactions that are investing or financing activities (such as gains or losses on sales of property, plant and equipment or on extinguishment of debt)

(ASC 230-10-45-28)

All adjustments to net income should be clearly identified as reconciling items. All major classes of reconciling items must be reported separately, including at a minimum, changes in receivables pertaining to operating activities, in inventory, and in payables pertaining to operating activities. Entities are encouraged to provide further breakdowns they consider meaningful. In addition, the amounts of interest paid (net of amounts capitalized) and income taxes paid during the period must be disclosed.

An entity that uses the indirect method has the option of presenting the reconciliation of net income to net cash flow from operating activities within the statement of cash flows or in a separate schedule (ASC 230-10-45-31). We believe it is acceptable to present the reconciliation in the notes to the financial statements although predominant practice is to present the reconciliation on the face on the statement of cash flows. If presented separately, the net cash flow from operating activities should be presented as a single line item in the statement of cash flows.

6 Disclosures

See our GAAP Disclosure Checklist (EY Form A13) for a summary of disclosure requirements related to the statement of cash flows.

7 Example — statement of cash flows for a commercial company

This Chapter illustrates the application of the guidance in ASC 230 by a US manufacturing entity, LSJU, Inc., with no foreign operations or foreign currency transactions. In the following sections, there are illustrations of statement of cash flow reporting by entities with foreign operations (Chapter 8), by financial institutions (Section 9.1) and by insurance companies (Section 9.2). Note that ASC 230 also contains comprehensive examples of cash flow reporting by a manufacturing entity (ASC 230-10-55), a multinational entity (ASC 830-230-55) and a financial institution (ASC 942-230-55).

7.1 Complete statement of cash flows — indirect method

The following example illustrates the process of analyzing changes in the consolidated balance sheet amounts and demonstrates how certain transactions are to be presented in a statement of cash flows.

Consolidated balance sheets

	December 31	
	20X5	20X4
	(Thousands of dollars)	
Assets		
Cash and cash equivalents	$ 7,500	$ 6,000
Accounts receivable, less allowance of $900 in 20X5 and $500 in 20X4	29,000	20,000
Notes receivable	5,000	12,000
Inventories	53,000	47,000
Prepaid expenses	1,500	500
Property, plant and equipment	100,050	83,050
Accumulated depreciation and amortization	(35,550)	(30,550)
Investment in affiliated entities	6,200	4,100
Finite-lived intangible assets	2,800	1,400
	$ 169,500	$ 143,500
Liabilities and shareholders' equity		
Short-term notes payable to banks	$ 3,000	$ 7,000
Accounts payable and accrued expenses	33,000	27,650
Long-term debt	35,000	21,000
Capital lease obligations	16,500	14,900
Deferred income taxes	3,000	2,000
Common stock	19,000	16,000
Retained earnings	60,000	54,950
	$ 169,500	$ 143,500

Consolidated statement of income

Year ended December 31, 20X5
(Thousands of dollars)

Sales	$ 150,000
Other income	10,000
Cost of sales	(122,000)
Selling and administrative	(15,400)
Depreciation and amortization	(8,600)
Equity in net income of investees	3,000
Gain on sale of equipment	2,500
Interest expense	(5,500)
Income tax expense	(6,000)
Net income	$ 8,000

Assume the following additional information (in thousands):

1. During 20X5, LSJU purchased the common stock of UCB Company for $8,000 cash. The purchase price was allocated based on the following fair values of UCB's assets and liabilities at the date of acquisition:

Cash	$ 300
Accounts receivable	2,000
Inventory	3,000
Property, plant and equipment	10,000
Finite-lived intangible assets	2,000
Accounts payable and accrued expenses	(1,500)
Long-term debt	(7,800)
	$ 8,000

2. LSJU wrote off $350 of bad debts and recognized a provision for losses on receivables (in selling and administrative expense) of $750.

3. Included in accounts payable and accrued expenses are accruals for income taxes payable of $3,500 and $3,000 and for interest payable of $2,300 and $2,000, as of December 31, 20X5 and 20X4, respectively.

4. LSJU collected principal of $2,500 on an installment note receivable related to a sale of product, and $4,500 on a note receivable from the sale of a plant consummated in the prior year.
5. LSJU entered into a capital lease for equipment with a fair value of $2,000. Principal payments on this and other lease obligations amounted to $400 during the year.
6. LSJU borrowed $9,000 on a long-term basis during the year and made payments of $1,800 on long-term debt.
7. LSJU borrowed $5,500 and repaid $9,500 under a revolving credit agreement with an original maturity of one year. LSJU signed a single note with a one-year term when the agreement occurred for the maximum amount available under the line of credit.
8. LSJU received a dividend of $900 from an affiliate accounted for under the equity method of accounting.
9. LSJU received $6,500 from the sale of equipment with a book value of $4,000 and an original cost of $7,000.
10. LSJU constructed a new warehouse for its use for $12,000 including capitalized interest of $300.
11. LSJU's depreciation expense, amortization of intangibles and provision for deferred taxes were $8,000, $600 and $1,000, respectively.
12. LSJU issued $3,000 of additional common stock, $2,000 for cash, and $1,000 upon the conversion of long-term debt.
13. LSJU paid dividends of $2,950 to shareholders.

The next page illustrates a worksheet technique many preparers use to identify information to be reported in a statement of cash flows using the changes in consolidated balance sheet amounts and the other financial information provided in this example. Numerical references in parentheses on the worksheet map to the presentation of information in the statement of cash flows and related disclosures.

Statement of cash flows worksheet

	Consolidated increase/ (decrease)	Purchase of UCB company	Increase/ (decrease) after removing effect of UCB purchase			
Assets						
Cash and cash equivalents	$ 1,500	$ 300 (1)	$ 1,200 (4)			
Accounts receivable, less allowance of $900 in 20X5 and $500 in 20X4	9,000	2,000	7,000 (5)	Provision for bad debts	$ (750)	(6)
				Increase before provision for bad debts	7,750	(7)
					7,000	
Notes receivable	(7,000)		(7,000)	Payment received on installment sale of product	(2,500)	(8)
				Payment received on note for sale of plant	(4,500)	(9)
					(7,000)	
Inventories	6,000	3,000	3,000 (10)			
Prepaid expenses	1,000		1,000 (11)			
Property, plant and equipment	17,000	10,000	7,000	Purchase of property, plant, and equipment	12,000	(12)
				Original cost of equipment sold	(7,000)	(13)
				Acquisition of equipment under capital lease	2,000	(14)
					7,000	
Accumulated depreciation and amortization	(5,000)		(5,000)	Depreciation expense	(8,000)	(15)
				Accumulated depreciation of equipment sold	3,000	(16)
					(5,000)	
Investment in affiliated entities	2,100		2,100	Equity in net income of investees	3,000	(17)
				Dividend received from equity investee	(900)	(18)
					2,100	
Intangible assets	1,400	2,000	(600)(19)	All amortization		
	$ 26,000	$ 17,300(2)	$ 8,700			
Liabilities and shareholders' equity						
Short-term notes payable to banks	$ (4,000)		$ (4,000)	Proceeds from borrowing under revolving line of credit	$ 5,500	(20)
				Repayments of borrowings under revolving line of credit	(9,500)	(21)
					(4,000)	
Accounts payable and accrued expenses	5,350	$ 1,500	3,850	Increase in accrued income tax	500	(22)
				Increase in accrued interest	300	(23)
				Increase in accounts payable and other accrued expenses	3,050	(24)
					3,850	
Long-term debt	14,000	7,800	6,200	New long-term borrowings	9,000	(25)
				Repayment of long-term borrowings	(1,800)	(26)
				Conversion of long-term debt to common stock	(1,000)	(27)
					6,200	
Capital lease obligations	1,600		1,600	New capital lease	2,000	(28)
				Principal payments on capital lease obligations	(400)	(29)
					1,600	
Deferred income taxes	1,000		1,000 (30)			
Common stock	3,000		3,000	Sale of common stock for cash	2,000	(31)
				Issuance of common stock upon conversion of long-term debt	1,000	(32)
					3,000	
Retained earnings	5,050		5,050	Details of Net Income:		
				Sales	150,000	(33)
				Other income	10,000	(34)
				Cost of sales	(122,000)	(35)
				Selling administrative	(15,400)	(36)
				Depreciation & amortization	(8,600)	(37)
				Equity in net income of investees	3,000	(38)
				Gain on sale of equipment	2,500	(39)
				Interest expense	(5,500)	(40)
				Income tax expense	(6,000)	(41)
				NET INCOME	8,000	(42)
				Dividends Paid to Shareholders	(2,950)	(43)
	$ 26,000	$ 9,300(3)	$ 16,700		$ 5,050	

Example statement of cash flows — Indirect method

Consolidated statement of cash flows

LSJU, Inc. and subsidiaries

Year ended December 31, 20X5
(Thousands of dollars)

Operating activities		
Net income	$ 8,000	(42)
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	8,600	(15) + (19)
Provision for losses on accounts receivable	750	(6)
Provision for deferred income taxes	1,000	(30)
Undistributed earnings of affiliate	(2,100)	(17) + (18)
Gain on sale of equipment	(2,500)	(39)
Payment received on installment sale of product	2,500	(8)
Changes in operating assets and liabilities net of effects from purchase of UCB Company:		
Increase in accounts receivable	(7,750)	(7)
Increase in inventories and prepaid expenses	(4,000)	(10) + (11)
Increase in accounts payable and accrued expenses	3,850	(22) + (23) + (24)
Net cash provided by operating activities	8,350	
Investing activities		
Purchases of property, plant and equipment	(12,000)	(12)
Purchase of UCB Company, net of cash acquired	(7,700)	(2) − (3) − (1)
Proceeds from sale of equipment	6,500	(13) − (16) + (39)
Payment received on note for sale of plant	4,500	(9)
Net cash used in investing activities	(8,700)	
Financing activities		
Proceeds from revolving line of credit and long-term borrowings	14,500	(20) + (25)
Principal payments on revolving line of credit, long-term debt and capital lease obligations	(11,700)	(21) + (26) + (29)
Proceeds from sale of common stock	2,000	(31)
Dividends paid	(2,950)	(43)
Net cash provided by financing activities	1,850	
Increase in cash and cash equivalents	1,500	(1) + (4)
Cash and cash equivalents at beginning of year	6,000	
Cash and cash equivalents at end of year	$ 7,500	

Note: Separate presentation of changes in inventory, receivables and payables relating to operating activities is required (ASC 230-10-45-29). The purpose of this requirement is to allow users to estimate amounts that would be reported when using the direct method of reporting net cash flow from operating activities. We believe it is acceptable to present line items that include other reconciling items (in this case the changes in prepaid expenses and accrued expenses) as long as all the items combined would affect a single line item under a direct method presentation.

Supplemental Disclosures:

Accounting Policies note: Cash Equivalents — The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

Debt or Property, Plant and Equipment note: During 20X5, the Company incurred interest cost of $5,800 ((40) + $300 capitalized), including $300 capitalized. Interest paid was $5,200 ($5,500 – (23)) during 20X5.

Income Taxes note: The Company made income tax payments of $4,500 ((41) – (30) – (22)) during 20X5.

Acquisitions note: In connection with the acquisition of all of the common stock of UCB Company for $8,000 ((2) – (3)), the Company acquired assets with a fair value of $17,300 (2) and assumed liabilities of $9,300 (3).

Leases note: During 20X5, the Company incurred a capital lease obligation of $2,000 (28) in connection with lease agreements to acquire equipment.

Shareholders' Equity note: On 11 June 20X5, the Company called for redemption all 5.75% convertible debentures outstanding. Debenture holders of securities with a carrying amount of $1,000 ((27), (32)) elected to convert the debentures to 20,000 shares of common stock.

The locations of the disclosures above are merely suggestions. They also may be presented in a separate note specific to the statement of cash flows, or another appropriate location. As discussed in Section 5.3, the reconciliation of net income and cash provided by operating activities may be presented in a separate schedule (e.g., immediately following the statement of cash flows) or in the notes, rather than in the statement of cash flows. Using this approach, the statement of cash flows illustrated on the previous page would report only a single line item for cash provided by operating activities.

7.2 Operating cash flows using the direct method

Following is the presentation of cash provided by operating activities of LSJU, Inc. using the direct method. When net cash flow from operating activities is presented using the direct method, the reconciliation of net income and net cash flow from operating activities must be presented elsewhere in the financial statements.

Operating activities		
Cash received from customers	$144,750	(See below)
Dividend received from equity investee	900	(18)
Other operating cash receipts	10,000	(34)
Cash paid to suppliers and employees	(137,600)	(See below)
Interest paid	(5,200)	(40) – (23)
Income taxes paid	(4,500)	(41) – (30) – (22)
	$ 8,350	

The following calculations illustrate a method of determining cash received from customers and cash paid to suppliers and employees when operating cash flows are presented using the direct method (See 5.2.1 above for a discussion of this method).

Cash received from customers during the year		
Sales		$ 150,000(33)
Collection of installment payment for sale of product		2,500(8)
Gross accounts receivable at beginning of year	$ 20,500	
Accounts receivable acquired in purchase of UCB Company	2,000	
Accounts receivable written off	(350)	
Gross accounts receivable at end of year	(29,900)	
Excess of new accounts receivable over collections from customers		(7,750)(7)
		$ 144,750
Cash paid to suppliers and employees during the year		
Cost of sales		$ 122,000(35)
Selling and administrative expenses	$ 15,400(36)	
Expenses not requiring cash outlay (provision for uncollectible accounts payable)	(750)(6)	
Net expenses requiring cash payments		14,650
Inventory at beginning of year	(47,000)	
Inventory acquired in purchase of UCB Company	(3,000)	
Inventory at end of year	53,000	
Net increase in inventory from LSJU's operations		3,000(10)
Increase in prepaid expenses		1,000(11)
Adjustments for changes in accounts payable and accrued expenses:		
Balance at beginning	27,650	
Amounts related to income taxes and interest at beginning of year	(5,000)	
Accounts payable and accrued expenses assumed in purchase of UCB Company	1,500	
Balance at end of year	(33,000)	
Amounts related to income taxes and interest at end of year	5,800	
Amounts charged to expense but not paid during year		(3,050)(24)
		$ 137,600

8 Foreign currency cash flows

8.1 Overview

Entities with foreign operations or foreign currency transactions are required to include the reporting currency equivalent of foreign currency cash flows in the cash flow statement using the exchange rate in effect at the time of the cash flows (ASC 830-230-45-1). In order to meet that requirement, entities with foreign operations or foreign currency transactions generally will have to prepare a separate statement of cash flows in the foreign currency, translate these statements to the reporting currency and then consolidate them along with the cash flow statement for domestic operations.

These requirements apply regardless of whether the functional currency (as determined under ASC 830, *Foreign Currency Matters*) is the foreign currency or the reporting currency. In either case, the foreign currency cash flows are translated to reporting currency using the exchange rate in effect at the time of the cash flows. It is acceptable to use an appropriately weighted average exchange rate for the period in translating a statement of cash flows from the foreign currency if the result is substantially the same as using the rates in effect at the dates of the cash flows. This accommodation is consistent with an acceptable methodology used to translate foreign currency denominated revenues, expenses and other items in the income statement.

8.2 Presenting the effects of exchange rate changes

The effect of exchange rate changes on cash balances held in foreign currencies should be presented as a separate line item as part of the reconciliation of the change in cash and cash equivalents during the period (ASC 830-230-45-1). Because this amount is not a cash receipt or payment, it is not included as an operating, investing or financing activity. The effects of exchange rate changes on foreign-denominated monetary assets and liabilities are recognized in the income statement or as an adjustment to other comprehensive income, and may affect the ultimate amount of a cash receipt or payment. However, the exchange rate changes themselves do not give rise to cash flows.

8.3 Foreign currency transactions

The requirements to present the reporting currency equivalent of foreign currency cash flows also apply to the cash flows of foreign currency transactions. For example, a German subsidiary may collect British pounds related to a sale denominated in pounds or a US parent may repay Japanese yen for a loan denominated in yen.

The reporting currency equivalent of foreign currency cash flows should be classified in the statement of cash flows according to the nature of the transaction. For example, the reporting currency equivalent of cash collected on a foreign currency denominated trade account receivable is reported in operating cash flows regardless of the classification and amount of any related exchange gain or loss.

Depending on the timing of when the underlying transaction is recorded and settled, entities will have to determine whether foreign currency transaction gains and losses should be presented as reconciling items in the reconciliation of net income and net cash flow from operating activities. Consider the following example:

Example

Assume Company A (US company with US dollar functional currency) makes a sale denominated in Yen in the amount of 10,000 Yen on 5 January 20X0. The exchange rate at the time is $1 to 100 Yen.

Dr. Receivable	$ 100	
Cr. Revenue		$ 100

To record the sale based on the exchange rate in effect at the time of the transaction.

On 31 March 20X0, the exchange rate is $1 to 80 Yen.

Dr. Receivable	$ 25	
Cr. FX Gain		$ 25

To record the change in exchange rate as of the end of the period. Calculated as the difference between (10,000 Yen / 80) and (10,000 Yen / 100).

On 31 March 20X0, the transaction is settled.

Dr. Cash	$ 125	
Cr. Receivables		$ 125

To record the settlement of the transaction.

If the sale and collection of the receivable occur in the same period, there would be no reconciling item between net income and net cash flow from operating activities. In the example above, the total net income recorded and the net cash flow from operating activities are both $125. However, if the receivable is collected after the balance sheet date (e.g., 15 April 2010), the unrealized foreign exchange gain accrued as of 31 March 2010 by increasing accounts receivable at the balance sheet date ($25) would be included with changes in the accounts receivable balance. Therefore, the unrealized foreign exchange gain would be a noncash reconciling item to offset this change in accounts receivable under the indirect method. Under the direct method, a company that determines cash received from customers by adjusting sales by the change in receivables during the period (i.e., the indirect-direct method) also will have to consider the change in receivables resulting from an unrealized exchange gain or loss.

Unrealized exchange gains or losses recognized in the income statement and not relating to cash flows for that period (i.e., from remeasurement of amounts denominated or stated in another currency) are presented as a reconciling item in the reconciliation of net income and net cash flow from operating activities, similar to the presentation of depreciation and other noncash income and expense items.

If the exchange gain or loss in the income statement relates to an investing or financing transaction (e.g., repayment of foreign currency denominated debt), a realized exchange gain or loss would be a reconciling item in the reconciliation of net income and net cash flow from operating activities, and the cash receipt or payment would be presented as an investing or financing activity. If the transaction was not settled at the balance sheet date, a reconciling item also results because the exchange gain or loss included in the determination of net income is a noncash item.

Example

Assume Company A (US company with US dollar functional currency) enters into a foreigncurrency denominated borrowing agreement with a German bank in the amount of €10,000 on 9 January 20X0. The exchange rate at the time is $1 to €0.80.

Dr. Cash	$ 12,500	
Cr. Loan payable		$ 12,500

To record the borrowing based on the exchange rate in effect at the time of the transaction.

On 31 March 20X0, the exchange rate is $1 to €0.75.

Dr. FX Loss	$ 833	
Cr. Loan payable		$ 833

To record the change in exchange rate as of the end of the period. Calculated as the difference between (€10,000 / 0.80) and (€10,000 / 0.75).

On 31 March 20X0, Company A repays the borrowing.

Dr. Loan payable	$ 13,333	
Cr. Cash		$ 13,333

To record the repayment of the borrowing.

In the above scenario, a realized exchange loss of $833 would be a reconciling item in the reconciliation of net income and net cash flow from operating activities, and the cash payment of $13,333 would be presented as a financing activity. Even if the transaction was not settled on 31 March 2010, an exchange loss of $833 would still be a reconciling item in the reconciliation of net income and net cash flow from operating activities because the exchange gain or loss included in the determination of net income is a noncash item.

Cash payments and cash receipts related to foreign currency hedging transactions follow the guidance in ASC 230-10-45-27. See discussion above in Section 3.6.1.

8.4 Alternatives to the consolidating approach

Although many companies use the consolidating approach, many others look for other ways of preparing the consolidated statement of cash flows. Alternatives to the consolidating approach may be particularly appealing to companies with many foreign operations, most of which are individually insignificant to the consolidated financial statements.

Many companies consider the effects of exchange rate fluctuations on changes in the balance sheet amounts in which gross cash receipts and payments must be presented on the statement of cash flows (e.g., fixed assets, long-term borrowings). However, few companies analyze the effects of exchange rate changes for items presented net in the statement of cash flows (e.g., accounts receivable, inventories, accounts payable).

Companies can approximate the effects of exchange rate changes by making detailed calculations only for selected subsidiaries or even selected cash receipts or payments of those subsidiaries that will significantly affect the consolidated statement of cash flows. The effects of exchange rate changes will be significant only if both the following conditions are present.

- The cash receipt or payment is significant relative to the statement of cash flows line item in which it will be presented in the consolidated statement of cash flows.
- The change in the exchange rates between the date of the cash flow and the end of the period is significant.

Preparers will have to use judgment in determining how large the cash flows have to be and how much the exchange rates have to change before the effects will be significant. The effects of exchange rate changes for individual transactions can be determined using the mathematical concepts illustrated in the example and proof on the following pages.

8.5 Example — Preparing and translating a foreign currency statement of cash flows

The following example illustrates how to prepare a local currency statement of cash flows and translates it to the reporting currency equivalent of the local currency cash flows.

Assume the following financial information for Overseas Company, a wholly owned foreign subsidiary of a US company with cash flows in FC (foreign currency).

Balance sheets

Overseas company

		December				Increase/
		20X9		20X8		(decrease)
Assets						
Current assets						
Cash and equivalents	FC	752,222	FC	535,784	FC	216,438
Accounts receivable		1,400,000		1,685,000		(285,000)
Inventories		1,500,000		1,600,000		(100,000)
Prepaid expenses		75,000		-		75,000
		3,727,222		3,820,784		(93,562)
Property and Equipment		2,400,000		2,250,000		150,000
Accumulated depreciation		(410,000)		(260,000)		(150,000)
		1,990,000		1,990,000		-
	FC	5,717,222	FC	5,810,784	FC	(93,562)
Liabilities and shareholder's equity						
Current liabilities						
Accounts payable and accrued expenses	FC	2,036,281	FC	1,740,429	FC	295,852
Due to parent		867,052		946,372		(79,320)
		2,903,333		2,686,801		216,532
Long-term debt		1,600,000		2,000,000		(400,000)
Deferred income taxes		60,000		45,000		15,000
Shareholder's Equity						
Capital stock		600,000		600,000		-
Paid-in capital		200,000		200,000		-
Retained earnings		353,889		278,983		74,906
		1,153,889		1,078,983		74,906
	FC	5,717,222	FC	5,810,784	FC	(93,562)

Statement of income and retained earnings

Overseas company

Year ended December 31, 20X9		
Sales	FC	7,800,000
Other income		31,211
		7,831,211
Cost and expenses		
Cost of goods sold		6,410,000
General and administrative		650,000
Depreciation		150,000
Interest		220,000
		7,430,000
		401,211
Foreign currency transaction gain		79,320
Income before income taxes		480,531
Income taxes		
Current		290,625
Deferred		15,000
		305,625
Net income		174,906
Retained earnings at beginning of year		278,983
		453,889
Less dividends paid		100,000
Retained earnings at end of year	FC	353,889

Assume the following additional information.

The exchange rate of FC to US dollars was .317 at 31 December 20X8, .406 at 31 December 20X9, and the weighted average rate for 20X9 was .346.

The only change in property and equipment was a purchase at the beginning of the year; the decrease in the amount due to parent was because of changes in exchange rates for US dollar denominated intercompany debt; the decrease in long-term debt was because of repayments during the year; and the dividends of FC 100,000 were paid at year end. Changes in all other balances occurred ratably during the year.

8.6 Foreign currency as functional currency

Assuming the functional currency is the FC, the statement of cash flows using the indirect approach would appear as follows in FC and US dollars (Note: exchange rates do not represent current market rates):

Statement of cash flows

Overseas company

Year ended December 31, 20X9

		Local Currency	Exchange Rate	Reporting Currency
Operating activities				
Net income	FC	174,906	.346[1]	$ 60,517
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation		150,000	.346[1]	51,900
Deferred taxes		15,000	.346[1]	5,190
Decrease in accounts receivable		285,000	.346[1]	98,610
Decrease in inventories and pre-paid expenses		25,000	.346[1]	8,650
Increase in accounts payable and accrued expenses		295,852	.346[1]	102,365
Foreign currency transaction gain		(79,320)	.346[1]	(27,445)
Net cash provided by operating activities		866,438		299,787
Investing activities				
Purchases of property and equipment		(150,000)	.317[2]	(47,550)
Net cash used by investing activities		(150,000)		(47,550)
Financing activities				
Repayment of long-term debt		(400,000)	.346[1]	(138,400)
Cash dividends to parent		(100,000)	.406[2]	(40,600)
Net cash used by financing activities		(500,000)		(179,000)
Effect of exchange rate changes on cash		N/A		62,321[3]
Increase in cash and equivalents		216,438		135,558
Cash and cash equivalents at beginning of year		535,784	.317[4]	169,844
Cash and cash equivalents at end of year	FC	752,222	.406[4]	$ 305,402

[1] Weighted average rate.

[2] Rate at time of transaction. Note: This example assumes all purchases of property and equipment were made at the beginning of the year to demonstrate the statement of cash flow implications. More commonly, companies will purchase property and equipment throughout the year and will translate these purchases using a weighted average rate.

[3] See the table below on how this balance is computed.
[4] Rate at respective period end.

The amount reported as the effect of exchange rate changes on cash and cash equivalents is often viewed as a "plug" figure in the statement but it can be proved this way:

Effect on beginning cash balance			
Beginning cash balance in local currency	FC	535,784	
Net change in exchange rate during year (.406 -.317)		.089	$ 47,684
Effect from operating activities			
Cash provided in local currency		866,438	
Year-end exchange rate		.406	351,774
Less: US dollar operating cash flows reported			(299,787)
			51,987
Effect from investing activities			
Cash used in local currency		(150,000)	
Year-end exchange rate		.406	(60,900)
Less: US dollar investing cash flows reported			(47,550)
			(13,350)
Effect from financing activities			
Cash used in local currency		(500,000)	
Year-end exchange rate		.406	(203,000)
Less: US dollar financing cash flows reported			(179,000)
			(24,000)
Effect of exchange rate changes on cash			$ 62,321

Cash provided by operating activities using the direct method would be presented this way:

		Local Currency	Exchange Rate	Reporting Currency
Cash received from customers	FC	8,085,000[1]	.346[2]	$2,797,410
Other cash received		31,211	.346[2]	10,799
Cash paid to suppliers and employees		(6,744,773)[1]	.346[2]	(2,333,692)
Interest paid		(230,000)[3]	.346[2]	(79,580)
Income taxes paid		(275,000)[3]	.346[2]	(95,150)
	FC	866,438		$ 299,787

[1] This amount could be derived — see 7.2.
[2] Weighted average exchange rate during the year.
[3] Difference between these amounts and corresponding amounts reported as expenses in the statement of income are due to changes in beginning and end of year interest and income tax accruals included in accounts payable and accrued expenses.

8.7 US dollar as functional currency

When the reporting currency is the US Dollar (USD) and the functional currency of a foreign operation is also the US dollar, nonmonetary balance sheet items and related income statement amounts expressed in the foreign currency must be remeasured to US dollars using historical exchange rates in accordance with ASC 830-10-45-18. This remeasurement process does not affect cash flows. However, the amounts of specific line items presented in the reconciliation between net income and net cash flow from operating activities will be different for nonmonetary items if the functional currency is the US dollar rather than the local foreign currency. This result occurs because nonmonetary items expressed in the local foreign currency would be *remeasured* into US dollar at the historical exchange rates if US dollar is the functional currency of a foreign operation while they would be *translated* into US dollar at the current exchange rates if the functional currency of the foreign operation is the local foreign currency. Furthermore, if US dollar is the functional currency of a foreign operation, unrealized exchange gains or losses may be recorded for foreign currency denominated transactions which would be presented as a reconciling item in the reconciliation of net income and net cash flow from operating activities.

Nevertheless, regardless of the foreign operation's functional currency, the net cash flow from operating activities in the reporting currency is the same.

The following illustration shows how the presentation of Overseas Company's cash flows from operating activities would be affected if the US dollar, rather than the local foreign currency, was the functional currency. Amounts from the previous example are used for the local foreign currency amounts. For purposes of comparison, this illustration shows both the translated-into-USD amounts when the FC is the functional currency of the subsidiary (from the previous example) and the remeasured-into-USD amounts for FC-denominated balances when the US dollar is the functional currency of the foreign subsidiary.

Nonmonetary items requiring remeasurement into US dollars:

		Functional Currency		
		Local Currency (Remeasured into USD)	US Dollar (Translated into USD)	FC
Inventories and prepaid expenses				
20X9	FC	1,575,000	$ 598,500[1]	$ 639,450[2]
20X8		1,600,000	481,600[1]	507,200[2]
Cost of goods sold — 20X9		6,410,000	2,092,310[3]	2,217,860[4]
Depreciation expensed — 20X9		150,000	45,000[3]	51,900[4]
Transaction (gain) loss		(79,320)	188,417[5]	(27,445)[4]
Net income (loss)		174,906	(22,895)	60,517[4]

[1] At average exchange rate for production period using first-in, first-out method.

[2] At respective year-end exchange rates (20X9 — .406; 20X8 — .317).
[3] On a historical cost basis.
[4] At average exchange rate of .346.
[5] The change from a translation gain when the FC is the functional currency to a transaction loss when the US dollar is the functional currency occurs because Overseas Company is in a net monetary liability position. See our Financial Reporting Developments on Foreign Currency Translation for an illustration of how the transaction gain or loss reported in the income statement is developed for a foreign entity whose functional currency is the US dollar.

Net cash provided by operating activities presented using the indirect method would be as follows:

		Functional Currency		
		Local Currency	US Dollar	FC
		(Remeasured into USD)	(Translated into USD)	
Operating activities				
Net income (loss)	FC	174,906	$ (22,895)	$ 60,517
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation		150,000	45,000	51,900
Deferred taxes		15,000	5,190	5,190
Decrease in accounts receivable		285,000	98,610	98,610
Decrease (increase) in inventories and prepaid expenses		25,000	(116,900)	8,650
Increase in accounts payable and accrued expenses		295,852	102,365	102,365
Foreign currency transaction (gain) loss		(79,320)	188,417	(27,445)
	FC	866,438	$ 299,787	$ 299,787

Using the direct method, the net cash provided by operating activities would be the same regardless of whether the functional currency is the foreign currency or US dollar, although proving the amounts would differ. For example, cash paid to suppliers and employees of $2,333,692 in our previous example by Overseas Company would be proved this way:

		Functional Currency		
		Local Currency (Remeasured into USD)	US Dollar (Translated into USD)	FC
Cost of goods sold	FC	6,410,000	$2,092,310	$2,217,860
General and administrative expense		650,000	224,900	224,900
(Decrease) increase in inventories and prepaid expenses		(25,000)	116,900	(8,650)
(Increase) in accounts payable and accrued expenses		(290,227)[1]	(100,418)	(100,418)
	FC	6,744,773	$2,333,692	$2,333,692

[1] Differs from increase of $295,852 reported above because of the exclusion of changes in interest and income tax accruals which are reported separately under the direct method.

9 Industry considerations

9.1 Financial institutions

A cash flow statement must be presented by all business entities, including commercial banks, savings and loan associations and other financial institutions. Although the cash flows of a financial institution may be larger (because cash is the "product" of its business), the turnover faster, and the reliance on borrowed funds greater than for a nonfinancial business, a financial institution needs cash for essentially the same reasons as any business entity — to invest in its operations, to pay its obligations and to provide returns to its investors.

9.1.1 Gross vs. net cash flows

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. Because of the difficulty in capturing cash flow information separately for short-term and longer-term assets, some banks, savings institutions and credit unions present gross cash flows for assets with maturities of three months or less. Further, for certain items, the turnover is quick, the amounts are large and the maturities are short. Net presentation is appropriate when a financial institution is substantively holding or disbursing cash on behalf of its customers, such as demand deposits of a bank.

ASC 230 generally requires information about gross cash flows rather than the net change in balance sheet amounts between the beginning and end of a period. However, it does allow the reporting of net cash receipts and payments by banks, savings institutions and credit unions for:

- Deposits placed with other financial institutions and withdrawals of deposits
- Time deposits accepted and repayments of deposits
- Loans made to customers and principal collections of loans

Investments — Cash flows resulting from purchases, sales and maturities of securities classified as available-for-sale and held-to-maturity pursuant to ASC 320 should be classified as investing activities and reported gross for each security classification in the statement of cash flows. Cash flows resulting from purchases, sales and maturities of trading securities (pursuant to ASC 320) should be classified based on the nature and purpose for which the securities were acquired. However, cash flows resulting from purchases and sales of other securities and other assets are classified as operating cash flows if those assets are acquired specifically for resale and are carried at market value in a trading account (ASC 230-10-45-20).

Loans — Some loans are similar to securities in a trading account in that they are originated or purchased specifically for resale and are held for short periods of time. Cash flows resulting from acquisitions and sales of loans are classified as operating cash flows if those loans are acquired specifically for resale and are carried at market value or lower of cost or market value. Cash flows associated with all other loans are classified as investing cash flows.

9.1.2 Interest credited directly to deposit accounts

Interest credited directly to deposit accounts having the general characteristics of demand deposit accounts (i.e., the depositor may deposit additional funds at any time and effectively withdraw funds at any time without prior notice or penalty, such as for checking, NOW and passbook savings accounts) are cash payments of the financial institution. The related interest expense is treated like other cash expenses in the operating activities section of a cash flow statement (i.e., the interest represents a cash outflow, and there is no reconciling item in the reconciliation of net income to net cash flow from operating activities). The net change in the deposit account during a period is reported in the financing activities section.

Although ASC 230 does not specifically address statement of cash flow presentation for interest credited to deposit accounts not having the general characteristics of demand deposit accounts, such as certificates of deposit, such interest credits should be reflected as operating cash payments in the statement of cash flows.

9.1.3 Interest accruals

Changes in accrued interest receivable or payable must be treated as a reconciling item between net income and net cash flow from operating activities, regardless of whether the accrued amount is classified with loans or deposits on the balance sheet.

9.1.4 Commercial letters of credit

Banks may facilitate the trading activities of customers through issuance of commercial letters of credit. These transactions involve a cash payment to satisfy the customer's obligation (assumed by the bank) and a cash receipt from the customer for the obligation satisfied and for the fee to compensate the bank for the service performed.

A bank may recognize liabilities (acceptances outstanding) and corresponding assets (customers' acceptance liability) on its balance sheet in connection with these transactions (e.g., when a bank receives a draft obligating it to satisfy a customer transaction at some future date). Regardless of whether assets and liabilities are recognized, we believe the bank is substantively disbursing cash on behalf of its customer when performing under a commercial letter of credit. As such, we do not believe presentation of gross cash flow information is required.

9.1.5 Renewals of loans and deposits

Banks may "rollover" commercial loans and certificates of deposit at maturity. We do not believe these rollovers should be reported in the statement of cash flows because there is no cash receipt or payment by the bank (other than the cash receipt or payment, if any, related to interest). Further, these rollovers do not generally affect recognized assets or liabilities, and therefore, there is no change in financial position to be disclosed as a noncash investing or financing activity.

9.1.6 Fee-based financial services

Many fee-based services provided by financial institutions may have cash flow implications beyond the fee received. For example, collection of items for a customer represents a cash receipt when the item is collected and a cash payment when the customer's demand deposit account is credited. Additionally, a financial institution servicing mortgage loans for others accepts cash from the debtors and tenders that cash (less the servicing fee) to the investor.

We do not believe the gross cash flows (other than the fee received) from transactions such as these should be presented in the statement of cash flows because the financial institution is substantively holding, receiving or disbursing cash on behalf of its customer.

9.1.7 Example statement of cash flows

Indirect method

Following is an example of a statement of cash flows of a commercial bank using the indirect method. It illustrates certain common line items of operating, investing and financing activities many financial institutions could expect to present in a statement of cash flows.

Consolidated statement of cash flows

Fourth Bank Corporation and Subsidiaries

Year ended December 31, 20X9
(Thousands of dollars)

Operating activities	
Net income	$ 20,022
Adjustments to reconcile net income to net cash provided by operating activities:	
Provision for loan losses	14,425
Provision for losses on other real estate	935
Provision for depreciation and amortization	3,766
Amortization of investment security discounts	(1,436)
Deferred income taxes	6,500
Investment security gains	(178)
Gains on sales of loans	(100)
Loans originated and purchased for sale	(1,500)
Proceeds from sales of loans originated for sale	1,750
Increase in interest receivable	(5,345)
Increase in interest payable	3,995
Excess tax benefit from exercise of stock options	(80)
Net cash provided by operating activities	42,754

Investing activities	
Proceeds from sales of investment securities	60,742
Proceeds from maturities of investment securities	20,005
Purchases of investment securities	(40,338)
Net decrease in short-term investments	3,566
Net decrease in credit card receivables and other short-term loans	17,587
Principal collected on loans held for investment	288,668
Loans held for investment originated or acquired	(488,985)
Purchases of assets to be leased	(30,157)
Principal payments received under leases	7,695
Purchases of premises and equipment	(4,515)
Net cash used by investing activities	(165,732)
Financing activities	
Net increase in demand deposits, NOW accounts and savings accounts	116,785
Proceeds from sales of certificates of deposit	612,857
Payments for maturing certificates of deposit	(567,932)
Net increase in short-term borrowings	2,635
Acquisition of treasury stock	(5,551)
Cash dividends	(9,934)
Proceeds from exercise of stock options	738
Excess tax benefit from exercise of stock options	80
Net cash provided by financing activities	149,678
Effect of exchange rate changes on cash	250
Increase in cash and cash equivalents	26,950
Cash and cash equivalents at beginning of year	130,879
Cash and cash equivalents at end of year	$ 157,829

Accounting Policies note: Cash Equivalents — Cash equivalents include amounts due from banks and federal funds sold. Generally, federal funds are purchased and sold for one-day periods.

Income Taxes note: The Company made income tax payments of $11,219 during 20X5.

Deposits note: The Company paid $181,540 in interest on deposits and other borrowings during 20X5.

Shareholders' Equity note: During 20X5, the Company called for redemption all 5.75% convertible debentures outstanding. Debenture holders of securities with a carrying amount of $5,829 elected to convert the debentures to 120,000 shares of common stock.

Optional direct method presentation

Cash flows from operating activities for Fourth Bank Corporation and subsidiaries could have been presented using the direct method. When net cash flow from operating activities is presented using this method, the reconciliation of net income and net cash flow from operating activities must be disclosed elsewhere in the financial statements. The following is a direct method presentation.

Operating activities	
Interest and fees received on loans, leases and investments	$ 295,787
Loans originated and purchased for sale	(1,500)
Proceeds from sales of loans originated for sale	1,750
Other fees and commissions received	17,500
Interest paid	(181,540)
Cash paid to suppliers and employees	(78,024)
Income taxes paid	(11,219)
Cash provided by operating activities	$ 42,754

9.2 Insurance companies

Insurance companies typically capture information about the cost of investments acquired and the proceeds from sales, maturities and repayments of investments to prepare a statement of cash flows for the Annual Statement they file with state regulatory authorities. As a result, information about the gross cash receipts and payments from these activities is readily available.

9.2.1 Cash and cash equivalents

Insurance companies generally present short-term investments, including those that meet the definition of a cash equivalent, in the balance sheet with investments rather than with cash. As the statement of cash flows must reconcile to similarly titled line items or subtotals of cash or cash and cash equivalents in the balance sheet, most insurance companies will reconcile to cash rather than cash and cash equivalents in the statement of cash flows.

9.2.2 Presenting cash flow from operating activities

The Annual Statement filed with state regulatory authorities requires the presentation of gross cash receipts and payments for transactions classified as operating activities (e.g., premiums received, benefits paid), so information necessary to present cash flows from operating activities using the direct method generally will be available.

9.2.3 Separate accounts

Assets held in separate accounts that meet the conditions in ASC 944-80, *Financial Services-Insurance — Separate Accounts,* should be measured at fair value and reported in summary total with an equivalent summary total reported for related liabilities. The related investment performance (including interest, dividends, realized gains and losses and changes in unrealized gains and losses) and the corresponding amounts credited to the separate account holder should be offset within the same statement of operations line item netting to zero. As a result, an insurance entity does not present in its statement of cash flows the cash flows of the separate accounts. The financial statements of the separate account itself should present the cash flows related to its operating, investing and financing transactions.

9.2.4 Presenting investing activities

Insurance companies hold a variety of investments, including stocks, bonds, mortgage loans and real estate. ASC 230 requires separate presentation of cash receipts and cash payments related to investing activities, but it does not provide guidance on the level of detail to be presented for the various types of investments.

Although insurance companies provide cash flow information by type of investment in the Annual Statement filed with state regulatory authorities, and detailed information is available, we do not believe that this level of detail is required by ASC 230, and as such, companies should use their judgment about the level of detail they provide.

9.2.5 Universal life insurance

Universal life insurance (also known as flexible premium life insurance and interest sensitive life insurance) is addressed in ASC 944-20, *Financial Services-Insurance — Insurance Activities*. A universal life-type contract is characterized by

1. Assessments by the insurer against the policyholder account balance for mortality coverage and contract administration that are not fixed and guaranteed by the contract

2. Interest credited to the policyholder account balance (not fixed or guaranteed)

   Or

3. Variable payment of premiums by the policyholder.

Insurance companies account for universal life-type contracts by establishing a liability for the policyholder account balance. The following shows the various transactions that affect the liability on all universal life policies during a period.

	Liability — Beginning of Year	$	XXX
+	Cash receipts from policyholders		XXX
-	Charges for mortality/administration		(XXX)
+	Interest credited		XXX
-	Cash payments for return of account balance (e.g., upon surrender of policy or for mortality events)		(XXX)
	Liability — End of year	$	XXX

Universal life-type contracts are similar to certain deposits of a financial institution so the statement of cash flow presentation would show cash receipts from policyholders and payments representing a return of policyholder balances as financing activities, similar to the presentation by a financial institution of sales and maturities of certificates of deposit. Interest credited to policyholder accounts would be treated as an operating cash payment for statement of cash flow presentation. This presentation is consistent with the way financial institutions present interest credited on certificates of deposit.

Charges for mortality, administration and similar items that are recognized as revenue in the insurance company's income statement should be treated as operating cash inflows for statement of cash flow presentation.

9.2.6 Policy acquisition costs

Insurance companies defer policy acquisition costs and amortize these costs to expense over the policy term. These costs should be presented as an operating cash flow. Acquisition costs usually are inseparable from policy liability determinations, and the change in policy liabilities is presented as a reconciling item in the reconciliation of net income and net cash flow from operating activities.

9.2.7 Fund withheld coinsurance

Reinsurance arrangements such as fund withheld coinsurance and similar arrangements involving modified coinsurance, contain an embedded derivative that must be bifurcated and accounted for separately (refer to ASC 815-15-25, *Derivatives and Hedging — Embedded Derivatives — Recognition* and ASC 815-15-55-107 through 55-109). In such arrangements, for example, an insurance company and a reinsurer enter into a coinsurance arrangement; next, the reinsurer extends a hypothetical collateralized loan of an underlying pool of assets supporting the reinsurance arrangement back to the insurance company; finally, the companies enter into a derivative — in this example, a total return swap — in which the return on the underlying pool of assets is paid by the insurance company in satisfaction of the insurance company's obligation to pay off the hypothetical collateralized loan from the reinsurer.

The SEC staff has commented on the cash flow treatment of the hypothetical loans in these arrangements. Some insurance companies have classified the hypothetical loans as a cash inflow from the reinsurer although no cash is actually received/paid to the reinsurer until settlement at the end of the arrangement. However, since cash does not change hands in those arrangements until settlement, the hypothetical collateralized loan is a noncash transaction which the SEC staff believes should be excluded from the statement of cash flows but disclosed as a noncash activity.

9.2.8 Example statement of cash flows

Indirect method

The following example of a statement of cash flows of a multiline insurance company illustrates certain of the typical line items of operating, investing and financing activities an insurance company may present in its statement of cash flows.

Consolidated statement of cash flows
Multiline insurance holding company and subsidiaries
Year Ended December 31, 20X5

(Thousands of dollars)	
Operating activities	
Net Income	$ 185,000
Adjustments to reconcile net income to net cash provided by operating activities:	
Change in accounts receivable, unearned premiums and policyholders' funds	296,900
Increase in accrued investment income	(16,400)
Change in accrued policy benefits, losses, claims and loss adjustment expenses, and reinsurance recoverable	212,300
Change in other assets, other liabilities and accrued income taxes	(49,900)
Amortization of policy acquisition costs	252,400
Policy acquisition cost deferred	(313,400)
Provision for depreciation	18,700
Provision for deferred income taxes	40,900
Net realized gains on investments	(40,100)
Net cash provided by operating activities	586,400
Investing activities	
Purchases of investments and loans made	(1,181,800)
Sales or maturities of investments and receipts from repayment of loans	608,600
Purchase of property and equipment	(96,300)
Net cash used by investing activities	(669,500)
Financing activities	
Increase in short-term debt	100,400
Repayment of long-term debt	(5,400)
Receipts from universal life policies credited to policy holder account balances	68,000
Return of policyholder account balances on universal life policies	(10,000)
Dividends paid	(72,700)
Acquisition of treasury stock	(100)
Net cash provided by financing activities	80,200
Decrease in cash	(2,900)
Cash at beginning of year	123,200
Cash at end of year	$120,300

Debt note: During 20X5, the Company paid $36,300 for interest.

Income Taxes note: The Company made income tax payments of $43,300 during 20X5.

Optional direct method presentation

Cash flows from operating activities for Multiline Insurance Company could have been presented using the direct method. When net cash flow from operating activities is presented using this method, the reconciliation of net income and net cash flow from operating activities must be disclosed elsewhere in the financial statements. Following is a direct method presentation:

Operating activities

Insurance premiums received	2,779,000
Investment income received, net of investment expenses paid	621,200
Other operating receipts	57,700
Insurance claims and policyholder's benefit paid	(1,806,700)
Underwriting, acquisition and insurance operating costs paid	(985,200)
Interest paid	(36,300)
Income taxes paid	(43,300)
Cash provided by operating activities	$ 586,400

9.3 Investment companies

ASC 230-10-15-4 specifies conditions under which an investment company is exempt from the requirements to provide a statement of cash flows. Provided that these conditions are met, a statement of cash flows is **not** required to be provided by:

- An investment company subject to the registration and regulatory requirements of the Investment Company Act of 1940 ("1940 Act")
- An investment company that has essentially the same characteristics as those subject to the 1940 Act
- A common trust fund, variable annuity account, or similar fund maintained by a bank, insurance company or other entity in its capacity as a trustee, administrator or guardian for the collective investment and reinvestment of moneys

For an investment company specified above to be exempt from the requirement to provide a statement of cash flows, all of the following conditions must be met:

- During the period, substantially all of the entity's investments were highly liquid (for example, marketable securities, and other assets for which a market is readily available)

- Substantially all of the entity's investments are carried at market value[3]
- The entity had little or no debt, based on the average debt outstanding[4] during the period, in relation to average total assets
- The entity provides a statement of changes in net assets

9.4 Not-for-profit entities

A not-for-profit entity (NFP) that provides a set of financial statements that reports both financial condition and results of operations must provide a statement of cash flows for each period for which results of operations are provided.

9.4.1 Cash and cash equivalents

Some assets of NFPs that would otherwise meet the definition of cash equivalents have restrictions that can prevent them from being included as cash equivalents for purposes of the statements of financial position and cash flows. For example, short-term highly liquid investments that are purchased with resources that have donor-imposed restrictions that limit their use to long-term investment are not cash equivalents.

9.4.2 Cash received with a donor-imposed restriction that limits its use to long-term purposes

Cash received with a donor-imposed restriction that limits its use to long-term purposes is not classified in the statement of financial position with cash that is unrestricted and available for current use (ASC 958-210-45-6). An adjustment is thus necessary for the statement of cash flows to reconcile beginning and ending cash and cash equivalents. To report in conformity with ASC 230, the receipt of a cash contribution that is restricted for the purchase of equipment is reported as a cash flow from financing activities (using a caption such as contributions restricted for purchasing equipment), and simultaneously reported as a cash outflow from investing activities (using a caption such as purchase of assets restricted to investment in property and equipment or, if the equipment was purchased in the same period, purchase of equipment). An adjustment to reconcile the change in net assets to net cash used or provided by operating activities would also be needed if the contributed asset is not classified as cash or cash equivalents on the statement of financial position.

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[3] Securities for which market value is determined using matrix pricing techniques would meet this condition. However, other securities for which market value is not readily determinable and for which fair value must be determined in good faith by the board of directors would not.

[4] 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 should be included in average debt outstanding.

Note that when the equipment is purchased in a subsequent period, both the proceeds from the sale of assets restricted to investment in the equipment and the purchase of the equipment are reported as cash flows from investing activities.

9.4.3 Agency transactions

At times, NFPs act as an agent, trustee or intermediary for another party that may be a donor or donee. Cash received and paid in these agency transactions is classified as an operating activity in the statement of cash flows and may be presented net.

9.4.4 Collections

An NFP that holds works of art, historical treasures and similar items that meet the definition of a collection may choose not to capitalize the collection in accordance with ASC 958-360-25-3. Cash flows from the purchase, sale or insurance recoveries of the unrecognized, noncapitalized collection items are reported as investing activities in the statement of cash flows.

9.5 Real estate entities

A cash flow statement must be presented by all business entities, including real estate entities.

9.5.1 Classification of cash flows related to certain assets

The definitions of operating and investing activities in ASC 230 provide flexibility for the appropriate classification of cash flows for assets that generally are productive assets but in certain cases may be inventory. Real estate generally is considered a productive asset, with related cash flows (i.e., the purchase or sale of real estate) classified as an investing activity. However, real estate may be acquired by a real estate developer to be subdivided, improved and sold in individual lots. As the real estate is acquired specifically for resale and is similar to inventory in other businesses, the cash payment to purchase (and cash received from the sale of) that real estate would be classified as an operating cash flow.

9.5.2 Financing provided by a captive finance subsidiary

Many real estate entities (e.g., homebuilders) include a wholly owned subsidiary whose purpose is to provide financing to the entity's customers (i.e., a captive finance subsidiary). These financing arrangements are similar in nature to the product purchase financing provided to customers in other industries. See Section 3.6.8 above for considerations related to cash flows classifications in these circumstances.

9.5.3 Distributions received from equity method investees

Many real estate entities have investments accounted for under the equity method. See Section 3.6.3 above for the cash flow considerations of distributions received from unconsolidated entities.

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