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On the Radar
Statement of Cash Flows

Because ASC 230 is largely principles-based, financial statement preparers must exercise significant judgment when classifying certain cash receipts and payments in their statement of cash flows. Given the lack of prescriptive rules, cash flow presentation continues to challenge financial statement preparers, as noted in recent statements made by regulators.

In addition, while the guidance on cash flow presentation of derivative instruments is not new, an entity's cash flow presentation may be subject to additional scrutiny as a result of rising interest rates. For example, in an increasing interest rate environment, an entity may pay higher costs to acquire an interest rate cap agreement that is intended to limit the entity's exposure to future variability in interest rates.

Further, given the rise in digital asset transactions and lack of explicit guidance in U.S. GAAP on the accounting for digital assets, including classification in the statement of cash flows, entities must use judgment when classifying cash flows associated with transactions involving such assets.

Recent Statements Made by Regulators

Statement Released by SEC Chief Accountant on the Statement of Cash Flows

In December 2023, SEC Chief Accountant Paul Munter released a statement addressing the importance of the statement of cash flows to providing investors with high-quality financial information. Mr. Munter reminded preparers and auditors of their professional responsibilities related to the statement of cash flows, noting the staff's observation that they "may not always apply the same rigor and attention to the statement of cash flows as they do to other financial statements." Key takeaways from Mr. Munter's statement include the following:

- To mitigate the risk of restatements, it is critical for issuers and auditors to perform an objective materiality analysis of "both the financial statement and ICFR impacts [footnote omitted] of an error in the statement of cash flows, including the significance of the statement of cash flows to the investor's complete understanding of the financial condition of the company."
- With respect to disclosures related to the statement of cash flows, issuers should "focus on investor needs when determining how best to communicate relevant cash and noncash information."
- It is essential to have "[a]ppropriate risk assessment processes and controls in place to facilitate risk identification, analysis, and response related to the preparation and presentation of the statement of cash flows."

The SEC staff expects "auditors to design and implement audit procedures that are specifically responsive to [risks of material misstatement] in the statement of cash flows, rather than simply reconciling reported cash flows to the balance sheet or income statement."

Remarks Made at the 2023 AICPA Conference

Mr. Munter also addressed this topic at the 2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments. He referred to his statement (see above) on improving the quality of cash flow information provided to investors and emphasized the following points:

- The statement of cash flows is a primary financial statement, and its importance is equal to that of the other statements; however, the SEC staff has anecdotally observed that the processes and internal controls issuers use to prepare the statement of cash flows are not always as rigorous as they are for the other statements. For example, the staff has seen instances in which issuers and their external auditors have presented errors in the statement of cash flows as simply a matter of classification and, therefore, as an immaterial restatement. Mr. Munter noted that classification is the focus of the statement of cash flows and that all errors in the statement of cash flows should be evaluated in the same manner as other accounting errors, both qualitatively and quantitatively.
- Issuers could consider using the direct method to report operating cash flows or otherwise supplementing their use of the indirect method with disclosures about specific major classes of gross cash receipts and payments (e.g., cash collected from customers).
- Audit committees may, as part of their oversight role, discuss with management and external auditors the potential use of the direct method or whether to provide additional disclosures about gross cash receipts and payments. Emphasis should be on the needs of investors.
- Issuers are encouraged to provide the most transparent and complete information they can to investors regarding cash generation and utilization, provided that such presentation is permissible under the standards.

SEC Deputy Chief Accountant Jonathan Wiggins also observed that diversity in practice may not be a sufficient justification for the acceptability of a certain presentation in the statement of cash flows. However, he acknowledged that there may be limited scenarios in which diversity in practice exists, no classification error is present, and an entity may reasonably conclude that a cash flow belongs in one category or another.

Connecting the Dots

One scenario in which entities should use significant judgment is when the legal terms of the agreement stipulate the allocation of cash flows to a single element in a transaction but the consideration should be allocated to multiple elements for accounting purposes. For example, consider a scenario in which an entity enters into a revenue contract for fixed consideration of $1 million and agrees to give the customer 100 free shares of the entity. In this situation, U.S. GAAP would require the reallocation of part of the contractual consideration received under the revenue contract to the shares issued. In such circumstances, cash receipts would have characteristics of more than one class of cash flows.

Examples of SEC Comments

Examples of SEC Comments[1]

Category Classification

- Please tell us your basis for classifying the capitalization of contract costs as an investing cash flow activity as opposed to an operating activity.
- We note that you present increases and decreases in book overdrafts as cash flows from financing activities. In this regard, please provide us with your basis for reporting changes in book overdrafts as cash flows from financing activities instead of cash flows from operating activities. Also, clarify whether the overdraft is with a bank.
- Please explain why you classified your short-term investments as trading and why the corresponding cash flows have been classified as investing instead of as operating in your Statements of Cash Flows. See ASC 320 and ASC 230-10-45-20.

ASC 230 requires entities to classify cash receipts and cash payments as operating, investing, or financing activities on the basis of the nature of the cash flow. Many of the SEC staff's comments are related to understanding the classification or potential misclassification among these three cash flow categories. In some cases, the SEC staff has raised questions about the presentation of cash inflows resulting from a transaction in a manner inconsistent with the underlying balance sheet classification.

Examples of SEC Comments

Gross Versus Net Classification

- Please revise the other assets and liabilities, net line item to present changes in other assets separately from other liabilities and further breakout any material components. Refer to ASC paragraphs 230-10-45-7 and 45-29.
- We note that you present the caption Investments in property and equipment, net. Please revise future filings to separately present the cash inflows and cash outflows for property and equipment on a gross basis as discussed in ASC 230-10-45-26.

[1] These examples of SEC comments have been reproduced from the SEC's Web site. Dollar amounts and information identifying registrants or their businesses have been redacted from the comments.

The SEC staff may challenge whether it is appropriate to report the net amount of certain cash receipts and cash payments on the face of the statement of cash flows. Generally, cash payments should not be presented net of cash receipts in the statement of cash flows. However, ASC 230-10-45-7 through 45-9 state that although reporting gross cash receipts and gross cash payments provides more relevant information, financial statement users sometimes may not need gross reporting to understand certain activities. Further, the netting criteria in ASC 230-10-45-8 (turnover is quick, the amounts are large, and the maturities are short) must be met for an entity to present investing and financing activity on a net basis. Accordingly, the SEC staff may ask a registrant to revise the presentation or to explain (in accordance with ASC 230) why it is appropriate to report certain cash flows on a net basis rather than on a gross basis.

Example of an SEC Comment

Extended Vendor Payable Arrangements

We note your "Accounts Payable days" are [X] days as of [the fiscal year-end]. We further note your Accounts Payable days [have] increased substantially over the past ten years . . . . Please tell us if you are engaging in supply chain finance operations and mechanisms, such as reverse factoring or similar methods to increase your Accounts Payable days. Otherwise, please explain how you have been able to achieve such extended accounts payable terms with your suppliers.

The SEC staff has recently issued comments to registrants that use extended vendor payable arrangements involving the participation of a paying agent or other financial institution. Under such programs, the paying agent or financial institution may settle the payment obligation directly with the registrant's supplier, for a fee, earlier than the extended payment term. Because there is no explicit authoritative guidance on these arrangements, the SEC staff has challenged registrants' determinations of whether the payments (1) constitute trade payables, which would represent operating activities, or (2) are more akin to debt, which would represent financing activities. Before the issuance of ASU 2022-04, which requires enhanced disclosures about supplier finance programs, there were no explicit disclosure requirements for such programs. Therefore, the staff has encouraged registrants to provide enhanced disclosures in MD&A about their extended vendor payable arrangements, such as the following:

- A description of the program; the material and relevant terms of the program, including the risks along with the general benefits.
- Amounts settled through the program; and impacts of the program on the registrant's payment terms to suppliers, days payable outstanding, working capital, liquidity, and capital resources.
- Amounts remaining in trade payables at year-end for which the registrant's supplier has elected early payment (i.e., the balance sheet impact).

For a discussion of SEC comment letters to registrants on additional topics, see Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

Increasing Interest Rates

As a result of rising interest rates in the current economic environment, entities may have entered into, amended, or terminated interest rate derivative contracts (such as interest rate swaps and interest rate caps). The table below summarizes common cash flow classifications for various derivative transactions. The classifications are discussed in more detail in Deloitte's Roadmap *Statement of Cash Flows*.

Derivative Instrument	Classification of the Derivative's Cash Flows
Derivatives with an other-than-insignificant financing element at inception	Financing activities (for the deemed borrower[2]) and generally investing activities (for the deemed lender)
Derivatives acquired or originated for trading purposes	Operating activities
Hedging derivatives	Investing activities **or** In the same category as the cash flows from the item being hedged
Nonhedging derivatives	Investing activities **or** In accordance with the nature of the derivative instrument as it is used in the context of the entity's business (if an economic hedge)

Digital Assets

Other than the guidance in ASU 2023-08 (discussed below), there is no explicit guidance in U.S. GAAP on the accounting for digital assets, including how an entity classifies its receipts of and payments for such assets in the statement of cash flows. As a result, an entity must apply judgment when classifying cash flows associated with transactions involving such assets. These transactions commonly include purchases and sales of crypto assets, crypto asset safeguarding, and crypto asset lending.

Changing Lanes

In December 2023, the FASB issued ASU 2023-08, which addresses the accounting and disclosure requirements for certain crypto assets. The ASU provides guidance on, among other topics, cash flow presentation related to the sale of crypto assets received as noncash consideration in the ordinary course of business. For all entities, the ASU's amendments are effective for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years. Early adoption is permitted. If an entity adopts the amendments in an interim period, it must adopt them as of the beginning of the fiscal year that includes that interim period.

Constructive Receipt and Disbursement

An entity may enter into arrangements in which cash is received by or disbursed to another party on behalf of the entity. Although these arrangements may not result in a direct exchange of cash to or from the entity, the same economic result is achieved if cash is received by or disbursed to the entity directly (i.e., constructive receipt and constructive disbursement, respectively). Because ASC 230 does not address constructive receipt and disbursement, an entity will need to use judgment when determining the substance of the arrangement to presenting the cash flows of the arrangement.

For example, a company may purchase real estate by taking out a mortgage with a third-party financing entity. In some cases, the third-party lender will not deposit cash into the company's bank account but will electronically wire cash directly to an escrow account at the closing of the transaction, which in turn is wired directly to the seller. Since the third-party lender is acting as the buyer's agent and transfers the proceeds of the mortgage directly to the escrow agent on behalf of the buyer, the substance of the transaction is that the buyer received the proceeds of the mortgage as a financing cash inflow and disbursed the purchase price of the real estate as an investing cash outflow. Accordingly, the transaction should be presented in such a manner in the company's statement of cash flows.

[2] The "deemed borrower" refers to the party that benefits from a financing element in a derivative instrument in early periods of the instrument's term. For example, a party that receives a premium upon entering into an arrangement because of the arrangement's off-market terms is considered to be the deemed borrower.

Looking Ahead

In November 2023, the FASB added to its technical agenda a project on the statement of cash flows in response to feedback indicating that improvements to financial institutions' statement of cash flows are needed to provide investors with more decision-useful information. For example, users of financial institutions' financial statements indicated that the existing framework that outlines operating, investing, and financing cash flows fails to effectively reflect the complexities of such institutions' operations. Other commenters expressed a desire for improved disclosures related to changes in working capital. Further, the project is aimed at reorganizing and disaggregating the information on the statement of cash flows for financial institutions (e.g., a requirement for such entities to separately disclose the amount of cash interest income received). In addition to this project on the statement of cash flows, the FASB is exploring improvements to the statement of cash flows more broadly in a project on its research agenda.

Deloitte's Roadmap *Statement of Cash Flows* comprehensively discusses the accounting guidance on the statement of cash flows, primarily that in ASC 230.

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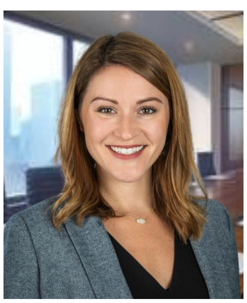

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