Statutory Issue Paper No. 92

Statement of Cash Flow

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 69

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance on the Statement of Cash Flow is contained in the Annual Statement Instructions for Life and Accident and Health Insurance Companies and the Annual Statement Instructions for Property and Casualty Insurance Companies (Annual Statement Instructions).

2. GAAP guidance on the Statement of Cash Flow is primarily contained in *FASB Statement No. 95, Statement of Cash Flows* (FAS 95). Under GAAP, cash receipts and payments are classified according to whether they stem from operating, investing, or financing activities. FAS 95 also requires that investing and financing activities not resulting in cash receipts or payments in the period be disclosed separately.

DISCUSSION

6. This issue paper changes current statutory accounting to require that only cash transactions be included in the Statement of Cash Flow. The current Annual Statement Instructions are unclear and appear to indicate that any amount shown as consideration would be included in the statement.

7. Although the broad categories of cash receipts and disbursements are similar between GAAP and statutory accounting, there are differences in the individual items included in each category. The primary objective of the statutory statement is to enhance the ability to measure and monitor solvency of a reporting entity. The statutory statement is integrated into numerous other exhibits and schedules in the Annual Statement to facilitate preparation of the Statement of Cash Flow and to provide consistent reporting of information.

8. The focus of the GAAP Statement of Cash Flows is on a broad group of users of financial information. Those users include investors and creditors whose focus is assessing financial performance of the company. GAAP also provides for the use of two distinct methods of reporting cash flows known as the direct and indirect methods. Because GAAP is not consistent with the statutory objectives discussed above, FAS 95, *FASB Statement No. 102*, Statement of Cash Flows—*Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale, an amendment of FASB Statement No. 95,* and *FASB Statement No. 104, Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions, an amendment of FASB Statement No. 95,* are rejected in this issue paper.

9. This issue paper adopts *FASB Emerging Issues Task Force Issue No. 95-a0.0009 Tce paper .0014 Tc 0.1256T57*

enterprise's ability to meet its obligations, its ability to pay dividends, and its needs for external financing; (c) assess the reasons for differences between net income and associated cash receipts and payments; and (d) assess the effects on an enterprise's financial position of both its cash and noncash investing and financing transactions during the period.

6. To achieve its purpose of providing information to help investors, creditors, and others in making those assessments, a statement of cash flows should report the cash effects during a period of an enterprise's operations, its investing transactions, and its financing transactions. Related disclosures should report the effects of investing and financing transactions that affect an enterprise's financial position but do not directly affect cash flows during the period. A reconciliation of net income and net cash flow from operating activities, which generally provides information about the net effects of operating transactions and other events that affect net income and operating cash flows in different periods, also should be provided.

<u>Focus on Cash and Cash Equivalents</u>

7. A statement of cash flows shall explain the change during the period in cash and cash equivalents. The statement shall use descriptive terms such as cash or cash and cash equivalents rather than ambiguous terms such as funds. The total amounts of cash and cash equivalents at the beginning and end of the period shown in the statement of cash flows shall be the same amounts as similarly titled line items or subtotals shown in the statements of financial position as of those dates.

8. For purposes of this Statement, cash equivalents are short-term, highly liquid investments that are both:

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.

9. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an enterprise with banking operations). Cash purchases and sales of those investments generally are part of the enterprise's cash management activities rather than part of its operating, investing, and financing activities, and details of those transactions need not be reported in a statement of cash flows.

10. Not all investments that qualify are required to be treated as cash equivalents. An enterprise shall establish a policy concerning which short-term, highly liquid investments that satisfy the definition in paragraph 9 are treated as cash equivalents. For example, an enterprise having banking operations might decide that all investments that qualify except for those purchased for its trading account will be treated as cash equivalents, while an enterprise 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. An enterprise shall disclose its policy for determining which items are treated as cash equivalents. Any change to that policy is a change in accounting principle that shall be effected by restating financial statements for earlier years presented for comparative purposes.

classes of cash flows specified in paragraphs 12, 13, and 28.

12. For certain items, the turnover is quick, the amounts are large, and the maturities are short. For certain other items, such as demand deposits of a bank and customer accounts payable of a broker-dealer, the enterprise is substantively holding or disbursing cash on behalf of its customers. Only the net changes during the period in assets and liabilities with those characteristics need be reported because knowledge of the gross cash receipts and payments related to them may not be necessary to understand the enterprise's operating, investing, and financing activities.

13. Items that qualify for net reporting because their turnover is quick, their amounts are large, and their maturities are short are cash receipts and payments pertaining to (a) investments (other than cash equivalents), (b) loans receivable, and (c) debt, providing that the original maturity of the asset or liability is three months or less.

Banks, savings institutions, and credit unions are not required to report gross amounts of cash receipts and cash payments for (a) deposits placed with other financial institutions and withdrawals of deposits, (b) time deposits accepted and repayments of deposits, and (c) loans made to customers and principal collections of loans. When those enterprises constitute part of a consolidated enterprise, net amounts of cash receipts and cash payments for deposit or lending activities of those enterprises shall be reported separate from gross amounts of cash receipts and cash payments for other investing and financing activities of the consolidated enterprise, including those of a subsidiary of a bank, savings institution, or credit union that is not itself a bank, savings institution, or credit union.

Classification of Cash Receipts and Cash Payments

b. Payments to acquire equity instruments of other enterprises (other than certain equity instruments carried in a trading account)
c. Payments at the time of purchase or soon before or after purchase to acquire property, plant, and equipment and other productive assets.

Cash Flows from Financing Activities

18. Financing activities include obtaining resources from owners and providing them with a return on, and a return of, their investment; receiving restricted resources that by donor stipulation must be used for long-term purposes; borrowing money and repaying amounts borrowed, or otherwise settling the obligation; and obtaining and paying for other resources obtained from creditors on long-term credit.

19. Cash inflows from financing activities are:

a. Proceeds from issuing equity instruments
b. Proceeds from issuing bonds, mortgages, notes, and from other short- or long-term borrowing.
c. Receipts from contributions and investment income that by donor stipulation are restricted for the purposes of acquiring, constructing, or improving property, plant, equipment, or other long-lived assets or establishing or increasing a permanent endowment or term endowment.

20. Cash outflows for financing activities are:

a. Payments of dividends or other distributions to owners, including outlays to reacquire the enterprise’s equity instruments
b. Repayments of amounts borrowed
c. Other principal payments to creditors who have extended long-term credit.

Cash Flows from Operating Activities

21. Operating activities include all transactions and other events that are not defined as investing or financing activities in paragraphs 15-20. Operating activities generally involve producing and delivering goods and providing services. Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income.

22. Cash inflows from operating activities are:

a. Cash receipts from sales of goods or services, including receipts from collection or sale of accounts and both short- and long-term notes receivable from customers arising from those sales. The term goods includes certain loans and other debt and equity instruments of other enterprises that are acquired specifically for resale, as discussed in Statement 102.
b. Cash receipts from returns on loans, other debt instruments of other entities, and equity securities--interest and dividends
c. All other cash receipts that do not stem from transactions defined as investing or financing activities, such as amounts received to settle lawsuits; proceeds of insurance settlements except for those that are directly related to investing or financing activities, such as from destruction of a building; and refunds from suppliers.

23. Cash outflows for operating activities are:

a. Cash payments to acquire materials for manufacture or goods for resale, including principal payments on accounts and both short- and long-term notes payable to suppliers for those materials or goods. The term goods includes certain loans and other debt and equity instruments of other enterprises that are acquired specifically for resale, as discussed in Statement 102.

b. Cash payments to other suppliers and employees for other goods or services
c. Cash payments to governments for taxes, duties, fines, and other fees or penalties
d. Cash payments to lenders and other creditors for interest
e. All other cash payments that do not stem from transactions defined as investing or financing activities, such as payments to settle lawsuits, cash contributions to charities, and cash refunds to customers.

24. Certain cash receipts and payments may have aspects of more than one class of cash flows. For example, a cash payment may pertain to an item that could be considered either inventory or a productive asset. If so, the appropriate classification shall depend 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 to be used by the enterprise or rented to others generally are investing activities. However, equipment sometimes is acquired or produced to be used by the enterprise or rented to others for a short period and then sold. In those circumstances, the acquisition or production and subsequent sale of those assets shall be considered operating activities.

<u>Foreign Currency Cash Flows</u>

25. A statement of cash flows of an enterprise with foreign currency transactions or foreign operations shall report the reporting currency equivalent of foreign currency cash flows using the exchange rates in effect at the time of the cash flows. An appropriately weighted average exchange rate for the period may be used for translation if the result is substantially the same as if the rates at the dates of the cash flows were used. The statement shall report the effect of exchange rate changes on cash balances held in foreign currencies as a separate part of the reconciliation of the change in cash and cash equivalents during the period.

Content and Form of the Statement of Cash Flows

26. A statement of cash flows for a period shall report net cash provided or used by operating, investing, and financing activities and the net effect of those flows on cash and cash equivalents during the period in a manner that reconciles beginning and ending cash and cash equivalents.

27. In reporting cash flows from operating activities, enterprises are encouraged to report major classes of gross cash receipts and gross cash payments and their arithmetic sum--the net cash flow from operating activities (the direct method). Enterprises that do so should, at a minimum, separately report the following classes of operating cash receipts and payments:

a. Cash collected from customers, including lessees, licensees, and the like
b. Interest and dividends received. Interest and dividends that are donor restricted for long-term purposes as noted in paragraphs 18 and 19(c) are not part of operating cash receipts.
c. Other operating cash receipts, if any
d. Cash paid to employees and other suppliers of goods or services, including suppliers of insurance, advertising, and the like
e. Interest paid
f. Income taxes paid
g. Other operating cash payments, if any.

Enterprises are encouraged to provide further breakdowns of operating cash receipts and payments that they consider meaningful and feasible. For example, a retailer or manufacturer might decide to further divide cash paid to employees and suppliers (category (d) above) into payments for costs of inventory and payments for selling, general, and administrative expenses.

28. Enterprises that choose not to provide information about major classes of operating cash receipts and payments by the direct method as encouraged in paragraph 27 shall determine and report the same amount for net cash flow from operating activities indirectly by adjusting net income of a business enterprise or change in net assets of a not-for-profit organization to reconcile it to net cash flow from operating activities (the indirect or reconciliation method). That requires adjusting net income of a business enterprise or change in net assets of a not-for-profit organization to remove (a) the effects of all deferrals of past operating cash receipts and payments, such as changes during the period in inventory, deferred income, and the like, and all accruals of expected future operating cash receipts and payments, such as changes during the period in receivables and payables, and (b) the effects of all items whose cash effects are investing or financing cash flows, such as depreciation, amortization of goodwill, and gains or losses on sales of property, plant, and equipment and discontinued operations (which relate to investing activities), and gains or losses on extinguishment of debt (which is a financing activity).

29. The reconciliation of net income of a business enterprise or change in net assets of a not-for-profit organization to net cash flow from operating activities described in paragraph 28 shall be provided regardless of whether the direct or indirect method of reporting net cash flow from operating activities is used. That reconciliation shall separately report all major classes of reconciling items. For example, major classes of deferrals of past operating cash receipts and payments and accruals of expected future operating cash receipts and payments, including at a minimum changes during the period in receivables pertaining to operating activities, in inventory, and in payables pertaining to operating activitiesofulample,006 Tc 0.1587 Tw 2347401 -1.1042f198 T23t timajor cl

purchasing a building by incurring a mortgage to the seller; obtaining an asset by entering into a capital lease; obtaining a building or investment asset by receiving a gift; and exchanging noncash assets or liabilities for other noncash assets or liabilities. Some transactions are part cash and part noncash; only the cash portion shall be reported in the statement of cash flows.

Cash Flow per Share

33. Financial statements shall not report an amount of cash flow per share. Neither cash flow nor any component of it is an alternative to net income as an indicator of an enterprise's performance, as reporting per share amounts might imply.

13. *FASB Emerging Issues Task Force Issue No. 95-13, Classification of Debt Issue Costs in the Statement of Cash Flows* contains the following guidance:

ISSUE
Debt issue costs generally are incurred in connection with the issuance of debt securities or other short- or long-term borrowings. Opinion 21 requires that debt issue costs be reported in the balance sheet as deferred charges. Generally, debt issue costs are capitalized as an asset and amortized over the term of the debt.

Statement 95 requires that cash receipts and payments in a statement of cash flows be classified as operating, investing, or financing activities. However, some believe that Statement 95 does not provide specific guidance on the classification of debt issue costs in the statement of cash flows. Because debt issue costs have aspects of more than one class of cash flows, diversity in practice has arisen. Some companies have reported the cash outflow for debt issue costs as a financing activity, while others have reported the outflow for those costs as an operating activity.

The issue is how cash payments for debt issue costs should be classified in the statement of cash flows.

EITF DISCUSSION
The Task Force reached a consensus that cash payments for debt issue costs should be classified in the statement of cash flows as a financing activity.

RELEVANT LITERATURE

Statutory Accounting
- NAIC *Annual Statement Instructions for Property and Casualty Insurance Companies*
- NAIC *Annual Statement Instructions for Life, Accident and Health Insurance Companies*

Generally Accepted Accounting Principles
- FASB Statement No. 95, *Statement of Cash Flows*
- FASB Statement No. 102, *Statement of Cash Flows--Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale, an amendment of FASB Statement No. 95*
- FASB Statement No. 104, *Statement of Cash Flows--Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions, an amendment of FASB Statement No. 95*
- FASB Emerging Issues Task Force Issue No. 95-13, *Classification of Debt Issue Costs in the Statement of Cash Flows*

State Regulations

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