

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.
3. The purpose of this issue paper is to establish statutory accounting principles for the Statement of Cash Flow that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. The Statement of Cash Flow shall be prepared using the direct method. Cash from operations shall be reported consistent with the Statement of Income, excluding the effect of current and prior year accruals. Only the cash portion of a transaction shall be reported in the Statement of Cash Flow. For purposes of the Statement of Cash Flow, cash shall include short term investments. Specific instructions for the classification of items are provided in the Annual Statement Instructions.

Disclosures

5. The financial statements shall disclose the following:
 - a. Transactions considered to be investing and financing activities that affect recognized assets or liabilities but do not result in cash receipts or cash payments in the period (in narrative or schedule form);
 - b. The cash and noncash aspects of the above transactions identified as investing or financing activities consistent with the classifications provided by the Annual Statement Instructions. Examples of noncash investing and financing transactions include:
 - i. Converting debt to equity;
 - ii. Acquiring assets by assuming directly related liabilities, such as purchasing a building by incurring a mortgage to the seller;
 - iii. Exchanging noncash assets or liabilities for other noncash assets or liabilities.

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. 95-13, Classification of Debt Issue Costs in the Statement of Cash Flows* which requires that cash payments for debt issue costs shall be classified as a financing activity in the Statement of Cash Flow.

10. Statutory guidance regarding disclosure about noncash investing and financing activities was added to provide users with complete disclosure of the investing and financing activities of a reporting entity.

Drafting Notes/Comments

None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

11. The Annual Statement Instructions for Property and Casualty Insurance Companies include the following guidance for the statement of cash flow. Similar language is provided in the Annual Statement Instructions for Life, Accident and Health Insurance Companies:

The statement of cash flows is prepared using the direct method. Lines one through nine should be prepared in a manner consistent with the Statement of Income, excluding the effect of current and prior year accruals. The following provides the method of preparing the statement. All revenue, expenditures, purchase and sales items should be entered gross.

The remaining portion of the guidance provided by the Annual Statement Instructions is a cross reference schedule which facilitates the preparation of the statement of cash flow by providing a series of calculations using various exhibits and schedules of a reporting entity's Annual Statement.

Generally Accepted Accounting Principles

12. *FASB Statement No. 95, Statement of Cash Flows*, as amended by *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* and *FASB Statement No. 117, Financial Statements of Not-for-Profit Organizations*, contains the following guidance on the accounting and reporting of cash flows:

Introduction

1. This Statement establishes standards for providing a statement of cash flows in general-purpose financial statements. This Statement supersedes *APB Opinion No. 19, Reporting Changes in Financial Position*, and requires a business enterprise to provide a statement of cash flows in place of a statement of changes in financial position. It also requires that specified information about noncash investing and financing transactions and other events be provided separately.

2. Opinion 19 permitted but did not require enterprises to report cash flow information in the statement of changes in financial position. Since that Opinion was issued, the significance of information about an enterprise's cash flows has increasingly been recognized. In *FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 13, the Board says, "A full set of financial statements for a period should show: . . . Cash flows during the period." Moreover, certain problems have been identified in current practice, including the ambiguity of terms such as funds, lack of comparability arising from diversity in the focus of the statement (cash, cash and short-term investments, quick assets, or working capital) and the resulting differences in definitions of funds flows from operating activities (cash or working capital), differences in the format of the statement (sources and uses format or activity format), variations in classifications of specific items in an activity format, and the reporting of net changes in amounts of assets and liabilities rather than gross inflows and outflows. The lack of clear objectives for the statement of changes in financial position has been suggested as a major cause of that diversity.

Scope

3. A business enterprise or not-for-profit organization that provides a set of financial statements that reports both financial position and results of operations shall also provide a statement of cash flows for each period for which results of operations are provided. In this Statement enterprise encompasses both business enterprises and not-for-profit organizations, and the phrase investors, creditors, and others encompasses donors. The terms income statement and net income apply to a business enterprise; the terms statement of activities and change in net assets apply to a not-for-profit organization. A statement of cash flows is not required for defined benefit pension plans and certain other employee benefit plans or for certain investment companies as provided by *FASB Statement No. 102, Statement of Cash Flows--Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale*.

Purpose of a Statement of Cash Flows

4. The primary purpose of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of an enterprise during a period.

5. The information provided in a statement of cash flows, if used with related disclosures and information in the other financial statements, should help investors, creditors, and others to (a) assess the enterprise's ability to generate positive future net cash flows; (b) assess the

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.

Focus on Cash and Cash Equivalents

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.

Gross and Net Cash Flows

11. Generally, information about the gross amounts of cash receipts and cash payments during a period is more relevant than information about the net amounts of cash receipts and payments. However, the net amount of related receipts and payments provides sufficient information not only for cash equivalents, as noted in paragraph 9, but also for certain other

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

14. A statement of cash flows shall classify cash receipts and cash payments as resulting from investing, financing, or operating activities.

Cash Flows from Investing Activities

15. Investing activities include making and collecting loans and acquiring and disposing of debt or equity instruments and property, plant, and equipment and other productive assets, that is, assets held for or used in the production of goods or services by the enterprise (other than materials that are part of the enterprise's inventory). Investing activities exclude acquiring and disposing of certain loans or other debt or equity instruments that are acquired specifically for resale, as discussed in Statement 102.

16. Cash inflows from investing activities are:

- a. Receipts from collections or sales of loans made by the enterprise and of other entities' debt instruments (other than cash equivalents and certain debt instruments that are acquired specifically for resale) that were purchased by the enterprise
- b. Receipts from sales of equity instruments of other enterprises (other than certain equity instruments carried in a trading account) and from returns of investment in those instruments
- c. Receipts from sales of property, plant, and equipment and other productive assets.

17. Cash outflows for investing activities are:

- a. Disbursements for loans made by the enterprise and payments to acquire debt instruments of other entities (other than cash equivalents and certain debt instruments that are acquired specifically for resale)

- 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.

Foreign Currency Cash Flows

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 activities, shall be separately reported. Enterprises are encouraged to provide further breakdowns of those categories that they consider meaningful. For example, changes in receivables from customers for an enterprise's sale of goods or services might be reported separately from changes in other operating receivables. In addition, if the indirect method is used, amounts of interest paid (net of amounts capitalized) and income taxes paid during the period shall be provided in related disclosures.

30. If the direct method of reporting net cash flow from operating activities is used, 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 shall be provided in a separate schedule. If the indirect method is used, the reconciliation may be either reported within the statement of cash flows or provided in a separate schedule, with the statement of cash flows reporting only the net cash flow from operating activities. If the reconciliation is presented in the statement of cash flows, all adjustments to net income of a business enterprise or change in net assets of a not-for-profit organization to determine net cash flow from operating activities shall be clearly identified as reconciling items.

31. Except for items described in paragraphs 12 and 13, both investing cash inflows and outflows and financing cash inflows and outflows shall be reported separately in a statement of cash flows—for example, outlays for acquisitions of property, plant, and equipment shall be reported separately from proceeds from sales of property, plant, and equipment; proceeds of borrowings shall be reported separately from repayments of debt; and proceeds from issuing stock shall be reported separately from outlays to reacquire the enterprise's stock.

Information about Noncash Investing and Financing Activities

32. Information about all investing and financing activities of an enterprise during a period that affect recognized assets or liabilities but that do not result in cash receipts or cash payments in the period shall be reported in related disclosures. Those disclosures may be either narrative or summarized in a schedule, and they shall clearly relate the cash and noncash aspects of transactions involving similar items. Examples of noncash investing and financing transactions are converting debt to equity; acquiring assets by assuming directly related liabilities, such as

purchasing a building by incurring a mortgage to the seller; obtaining 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

- No additional guidance obtained from state statutes or regulations.

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