STAFF PAPER

IFRS Interpretations Committee Meeting

3 –4 November 2011

[This box can be used to give additional meeting dates]

Project	**IAS 7 *Statement of Cash Flows*—classification of cash payments for deferred and contingent consideration**		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Introduction and purpose of this paper

1. In June 2011, the IFRS Interpretations Committee (the Committee) received a request for guidance on the classification of cash payments for deferred and contingent considerations under IAS 7 *Statement of Cash Flows*. The submitter asked the Committee to clarify:
   (a) whether the settlement of contingent consideration should be classified as an operating, an investing or a financing activity in the statement of cash flows; and
   (b) whether the subsequent settlement of a deferred consideration for a business combination should be classified as an investing or a financing activity in the statement of cash flows.
2. The Committee discussed the issues in the September 2011 meeting, with the September 2011 IFRIC Update reporting that:

   > The Committee noted that the issues are widespread and that divergence in practice exists. Consequently, the Committee directed the staff to do further analysis on these issues with the aim of assessing whether the issues could be solved through the annual improvements process. The staff will present further analysis at a future meeting.

3. We understand that the majority of the Committee members broadly agreed with the staff view[1](ie cash payments for contingent and deferred consideration for which liabilities are recognised at the acquisition date should be classified as investing activities and cash payments for additional contingent and deferred consideration arising after the measurement period should be classified as operating activities). However the Committee asked the staff:

   (a) to perform outreach with users of financial statements in order to verify whether they agree with the staff view;

   (b) to check whether the staff view is consistent with the tentative decisions of the Board regarding the classification of cash payments by a lessee within the leases project; and

   (c) to draft a potential amendment to IAS 7.

4. The purpose of this paper is:

   (a) to provide a summary of the outreach responses received from users of financial statements;

   (b) to provide an updated analysis of the issues within the context of IFRSs;

   (c) to assess the issue against the Annual Improvements criteria;

   (d) to make a recommendation that the Board should amend IAS 7 through Annual Improvements; and

   (e) to ask whether the Committee agrees with our recommendation.

[1] http://www.ifrs.org/NR/rdonlyres/8C6C76CA-6C3F-4BDB-BB3F-9982F969C73B/0/091109AP09IFRS3Cashpaymentsfordeferredandcontingentconsideration.pdf

Outreach activities with users of financial statements

5. We asked the Capital Markets Advisory Committee[2] (CMAC) to provide us with feedback on the classification of cash payment for contingent and deferred consideration.

6. In our request we summarised the different views on the classification of cash payments for contingent and deferred consideration and we attached the Agenda Paper discussed in the September 2011 meeting. We asked the CMAC members the following two questions:

   (a) If the IASB amends the accounting standard on cash flow statements on the basis of the staff's conclusions above (ie cash payments for contingent consideration and deferred consideration that are recognised at the acquisition date should be classified as investing activities; cash payments that are in excess of the amount recognised at acquisition date should be classified as operating activities), would that classification of contingent consideration and deferred consideration in the cash flow statement be appropriate and useful for your analyses?

   (b) If not, how would you classify contingent consideration and deferred consideration in the cash flow statement, and why?

7. We received three responses. All the respondents agreed with the classification proposed by the staff for contingent consideration payments.

8. Two respondents agreed with the classification proposed by the staff for deferred consideration payments. One respondent observed that deferred consideration payments have a closer relationship to financing activities. Although because of boundary issues between investing and financing activities it might be best to consistently classify both types of payments as investing.

9. One respondent noted that the separation between operating, investing and financing is somewhat arbitrary. Accordingly, users should be provided sufficient information in the notes to fully understand the details of the contingent and

[2] Formerly the Analyst Representative Group

deferred payments and, more importantly, the underlying assumptions used to estimate these payments.

Staff analysis

10. Following up the discussion in the September 2011 meeting we think that the main issue is to clarify whether or not cash payments for contingent and deferred consideration arising after the measurement period should be classified as operating activities.

Contingent consideration

11. We think that two views exist on the classification in the statement of cash flows of contingent consideration payments:

    (a) **View 1:** cash payments for the contingent consideration that are recognised at the acquisition date and any adjustment arising during the measurement period (as defined in paragraphs 45-50 of IFRS 3 *Business Combinations*) should be classified as investing activities. Cash payments for increases in fair value of contingent consideration arising after the measurement period (such as additional cash payments due by the acquirer only if the acquiree meets an earnings target) should be classified as operating activities. However when the adjustment reduces the contingent consideration liability the reduced cash payment should be classified as investing activities.

    (b) **View 2:** any cash payments for contingent consideration (including the payments for additional contingent consideration arising after the measurement period) should be classified as investing activities.

12. Proponents of View 1 note that:

    (a) according to paragraph 16 of IAS 7 only the expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities; and according to paragraph 58 of IFRS 3 changes in fair value of contingent consideration that are not measurement period adjustments do not result in recognised assets in the statement of financial position. Therefore, the additional payments for increases in fair value of contingent consideration arising after the measurement period cannot be classified as investing activities;

(b) paragraph 6 of IAS 7 defines operating activities as '*the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.*'. Usually additional contingent consideration payments are not investing or financing activities because they are linked to the ongoing performance of the acquired business;

(c) View 1 is consistent with the tentative decisions of the Board regarding the lessee's statement of cash flows, because the July 2011 IASB Update reports that [emphasis added]:

> The boards discussed the lessee's statement of cash flows and tentatively decided that a lessee should:
>
> (i) Classify cash paid for lease payments relating to the principal within financing activities. Thirteen IASB members and five FASB members agreed.
>
> (ii) Classify or disclose cash paid for lease payments relating to interest in the statement of cash flows in accordance with applicable IFRSs or US GAAP. Thirteen IASB members and five FASB members agreed.
>
> **(iii) Classify as operating activities cash paid for variable lease payments that are not included in the measurement of the liability to make lease payments. Thirteen IASB members and four FASB members agreed.**
>
> (iv) ...

The rationale[3] behind this tentative decision is that there is no settlement of a financing liability by the lessee when those variable lease payments are made, because the liability to make lease payments does not include other variable lease payments. If there is no financing liability, the leases team thinks it would be inappropriate to include those cash flows in the financing activities.

[3] http://www.ifrs.org/Meetings/IASB+Meeting+July+2011.htm (Agenda Paper 5B)

13. Proponents of View 1 note that paragraph 39 of IAS 7 already provides some guidance on the classification of cash flows related to a business combination; therefore they believe that a paragraph 39A should be added in order to clarify the classification of contingent consideration payments. The proposed amendment is in Appendix A.

14. On the contrary, proponents of View 2 believe that:

    (a) contingent consideration payments are a way to obtain control of a business. The risk-sharing attributes of contingent consideration are necessary, for the acquirer and the vendor to reach agreement on the terms of the acquisition in order that the acquisition takes place and control transfers. Consequently these payments should be classified as an investing activity because paragraph 39 of IAS 7 states that:

    > **39 The aggregate cash flows arising from obtaining or losing control of subsidiaries or other businesses shall be presented separately and classified as investing activities.**

    (b) the splitting of contingent consideration payments into investing and operating activities is not really useful, because users are not interested in the distinction between the initial measurement of the fair value of contingent consideration and the subsequent changes in the fair value of the liability for contingent consideration. Users prefer to see in the same line of the statement of cash flows (ie cash flows from investing activities) the total amount paid in a business combination because the nature of the payments is the same.

15. Proponents of View 2 believe that the Board should amend paragraph 39 of IAS 7 to clarify that contingent consideration payments should be classified as investing activities. The proposed amendment is in Appendix B.

Deferred consideration

16. Following up the discussion in the September 2011 meeting we understand that three views exist on the classification in the statement of cash flows of deferred consideration payments:

(a) **View 1:** cash payments for the deferred consideration for which liabilities are recognised in the statement of financial position at the acquisition date should be classified as investing activities. Cash payments for additional deferred consideration arising after the measurement period should be classified as operating activities.

(b) **View 2:** any cash payments for deferred consideration (including the payments for additional deferred consideration arising after the measurement period) should be classified as investing activities.

(c) **View 3:** any cash payments for deferred consideration (including the payments of amounts for which liabilities are recognised at acquisition date and payments for additional deferred consideration arising after the measurement period) should be classified as financing activities.

17. Proponents of View 1 identify the following differences between contingent and deferred considerations:

(a) a deferred consideration is usually recognised as a liability by the acquirer, whereas a contingent consideration can be classified as either an asset or a liability depending on the terms of the arrangement; and

(b) the amount of a contingent consideration payment is by definition conditional on future events or conditions, whereas the amount of a deferred consideration payment can be fixed at the acquisition date.

18. They think that these differences are not sufficient to justify a different classification between contingent and deferred consideration; in addition sometimes it is difficult to distinguish contingent from deferred consideration. Consequently cash payments for additional deferred consideration arising after the measurement period should be classified as operating activities for the reasons mentioned in paragraph 12 (ie paragraph 16 of IAS 7 and the Board tentative decision on the classification in the statement of cash flows of variable lease payments). The amendment proposed by the advocates of View 1 is in Appendix A.

19. Proponents of View 2 agree that contingent and deferred consideration are quite similar; however they believe that cash payments for deferred consideration should be classified as investing activities for the reasons mentioned in paragraph 14 (ie paragraph 39 of IAS 7 and the splitting into investing and operating activities does not provide users with useful information). The amendment proposed by the advocates of View 2 is in Appendix B.

20. Proponents of View 3 believe that deferred consideration is significantly different from contingent considerations, because they consider deferred consideration to be a provision of finance by the vendor. In their view cash payments for deferred consideration should be classified as financing activities for the following reasons:

    (a) these payments represent a reduction of a liability incurred by the acquirer to former owners of the acquiree;

    (b) deferred consideration payments are conceptually similar to cash payments made by a lessee for the reduction of the outstanding liability relating to finance lease. These lease payments are cash flows arising from financing activities according to paragraph 17 of IAS 7;

    (c) the classification as financing cash flows is consistent with the guidance in US GAAP. Paragraph–10–45–13 of Topic 230 *Statement of Cash Flows* in the *FASB Accounting Standards Codification*® states that (emphasis added):

    > Payments at the time of purchase or soon before or after purchase to acquire property, plant, and equipment and other 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 directly related debt to the seller is a financing transaction (see paragraphs 230-10-45-14 through 45-15), and subsequent payments of principal on that debt thus are financing cash outflows**.

21. Proponents of View 3 believe that the Board should amend paragraph 39 of IAS 7 to clarify that deferred consideration payments should be classified as financing activities. The proposed amendment is in Appendix C.

Assessment against the annual improvements criteria

22. We have assessed a potential amendment to IAS 7 against the enhanced annual improvements criteria to clarify the classification of cash payments for deferred and contingent consideration, which are reproduced in full below:

In planning whether an issue should be addressed by amending IFRSs within the annual improvements project, the IASB assesses the issue against the following criteria. All criteria (a)–(d) must be met to qualify for inclusion in annual improvements.

(a) The proposed amendment has one or both of the following characteristics:

(i) clarifying–the proposed amendment would improve IFRSs by:

- clarifying unclear wording in existing IFRSs, or providing guidance where an absence of guidance is causing concern.
- A clarifying amendment maintains consistency with the existing principles within the applicable IFRSs. It does not propose a new principle, or a change to an existing principle.

(ii) correcting–the proposed amendment would improve IFRSs by:

- resolving a conflict between existing requirements of IFRSs and providing a straightforward rationale for which existing requirement should be applied, or.
- addressing an oversight or relatively minor unintended consequence of the existing requirements of IFRSs.

A correcting amendment does not propose a new principle or a change to an existing principle.

[Staff analysis—this criterion is satisfied. The proposed amendment clarifies the classification in statement of cash flows of cash payments for deferred and contingent consideration where the absence of explicit guidance is causing significant diversity in practice. The proposed amendment maintains consistency with the existing principles in IAS 7 for the presentation of a statement of cash flows.]

(b) The proposed amendment is well-defined and sufficiently narrow in scope such that the consequences of the proposed change have been considered.

[Staff analysis— this criterion is satisfied. The issue is sufficiently narrow in scope to ensure that the proposed change has been considered sufficiently and identified.]

(c) It is probable that the IASB will reach conclusion on the issue on a timely basis. Inability to reach a conclusion on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within annual improvements.

[Staff analysis—this criterion is satisfied. We think that the Committee will be able to address these issues on a timely basis and we think that the Board should be in a position to also reach a conclusion on a timely basis.]

(d) If the proposed amendment would amend IFRSs that are the subject of a current or planned IASB project, there must be a need to make the amendment sooner than the project would.

[Staff analysis—this criterion is satisfied. There is no current IASB project on IAS 7.]

Staff view and recommendation

23. On the basis of our analysis and the assessment under the annual improvements criteria, we think that the Committee should recommend to the Board to amend IAS 7 to clarify the classification in the statement of cash flows of contingent and deferred consideration payments. This amendment should be included in the 2010-2012 AIP cycle.

24. We support View 1 for the reasons mentioned in paragraph 12. The proposed amendment is in Appendix A of this paper.

Questions to the Interpretations Committee

Questions
1. Does the Committee agree with the staff recommendation to amend IAS 7 to clarify the classification in the statement of cash flows of contingent and deferred consideration payments? 2. Does the Committee agree with the staff view (ie View 1)? If not, what is the Committee view? 3. Does the Committee agree with the proposed amendments to paragraph 39 of IAS 7 in Appendix A?

Appendix A—proposed changes (View 1)

A1. The proposed amendment to IAS 7 is presented below.

Amendment to IAS 7 *Statement of Cash Flows*

Paragraph 39A is added as follows:

39A Cash payments for deferred and contingent consideration related to business combinations shall be classified as investing activities to the extent that the amount was recognised as a financial liability (or financial asset), at the acquisition date. However cash payments for increases in the fair value of contingent consideration that, in accordance with IFRS 3 *Business Combinations,* are not measurement period adjustments and are recognised in profit or loss, shall be classified as operating activities.

Basis for Conclusions on proposed amendments to IAS 7 *Statement of Cash Flows*

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Cash payments for contingent and deferred considerations

BC1 The Board received a request to clarify:

(a) whether the settlement of a contingent consideration for a business combination should be classified as an operating, an investing or a financing activity in the statement of cash flows; and

(b) whether the settlement of a deferred consideration for a business combination should be classified as an investing or a financing activity in the statement of cash flows.

The Board observes that paragraph 16 of IAS 7 requires that only the expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities. Consequently, the Board proposes to make an amendment to IAS 7 to clarify that cash payments for contingent and deferred consideration should be classified as investing activities to the extent that a liability was recognised at the acquisition date and for any measurement period adjustments (as defined in paragraphs 45-50 of IFRS 3 *Business Combinations*). Cash payments for additional contingent consideration, ie for adjustments that are made to the liability for contingent consideration and are recognised in profit or loss, should be classified as operating activities.

Appendix B—proposed changes (View 2)

B1 The proposed amendment to paragraph 39 in IAS 7 is presented below.

Amendment to IAS 7 *Statement of Cash Flows*

Paragraph 39 is amended as follows: (new text is underlined)

<u>Changes in ownership interests in subsidiaries and other businesses</u>

39 The aggregate cash flows<u>, including cash payments for contingent and deferred consideration,</u> arising from obtaining or losing control of subsidiaries or other businesses shall be presented separately and classified as investing activities.

Basis for Conclusions on proposed amendments to IAS 7 *Statement of Cash Flows*

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Cash payments for contingent and deferred considerations

BC1 The Board received a request to clarify:

(a) whether the settlement of contingent consideration should be classified as an operating, an investing or a financing activity in the statement of cash flows; and

(b) whether the subsequent settlement of a deferred consideration for a business combination should be classified as an investing or a financing activity in the statement of cash flows.

The Board observes that contingent and deferred consideration payments related to business combinations are a way to obtain control of a business. Consequently, the Board proposes to make an amendment to paragraph 39 in IAS 7 to clarify that cash payments for the contingent and deferred consideration shall be classified in the statement of cash flows as investing activities.

Appendix C—proposed changes (View 3)

C1 The proposed amendment to paragraph 39 in IAS 7 is presented below.

Amendment to IAS 7 *Statement of Cash Flows*

Paragraph 39 is amended as follows: (new text is underlined)

<u>Changes in ownership interests in subsidiaries and other businesses</u>

39 The aggregate cash flows<u>, including cash payments for contingent consideration,</u> arising from obtaining or losing control of subsidiaries or other businesses shall be presented separately and classified as investing activities. <u>However, when the settlement of all or part of the consideration for a business combination is deferred, the cash payments shall be classified as financing activities</u>

Basis for Conclusions on proposed amendments to IAS 7 *Statement of Cash Flows*

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Cash payments for contingent and deferred considerations

BC1 The Board received a request to clarify:

(c) whether the settlement of contingent consideration should be classified as an operating, an investing or a financing activity in the statement of cash flows; and

(d) whether the subsequent settlement of a deferred consideration for a business combination should be classified as an investing or a financing activity in the statement of cash flows.

The Board observes that contingent consideration payments related to business combinations are a central part of the negotiation to obtain control of a business. The Board also notes that when the settlement of all or part of the consideration for a business combination is deferred the former owner of the acquiree is providing finance to the acquirer. Consequently, the Board proposes to make an amendment to paragraph 39 in IAS 7 to clarify that cash payments for contingent consideration shall be classified as investing activities, and that cash payments for deferred consideration shall be classified as investing activities.