STAFF PAPER

January 2012

IASB Meeting

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

Project	**Annual improvements 2010–2012 cycle**		
Paper topic	Issue that the Committee recommends should not lead to amendments within the scope of the *Annual Improvements* process		
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Introduction

1. At its meetings in September 2011 and November 2011 the IFRS Interpretations Committee (the Committee) reviewed an issue regarding the request for guidance on the classification of cash payments for deferred and contingent considerations under IAS 7 *Statement of Cash Flows* for potential resolution through the Annual Improvements process for 2010-2012.
2. The Committee tentatively decided to recommend that the Board should not proceed with that issue through the Annual Improvements process.

Purpose of this paper

3. The objective of this paper is to:
   - (a) present background information and give an overview of our analysis;
   - (b) provide a summary of the reasons that led the Committee members to propose that the issue should not be added to the Annual Improvements project; and
   - (c) ask for the Board's agreement with the Committee's recommendation.

Classification of cash payments for deferred and contingent consideration

4. The following is a summary of the analysis presented to the Committee in September 2011 and November 2011. Our full analysis was set out in Agenda Paper 9 (which also includes the text of the original submission) and Agenda Paper 7.

Background information

5. At the September and November 2011 meetings, the Committee discussed a submission requesting guidance on the classification of cash payments for deferred and contingent considerations under IAS 7. The submitter asked the Committee to clarify:

    (a) whether the settlement of 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 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.

6. At the September 2011 meeting, the Committee directed the staff to do further analysis on these issues with the aim of assessing whether the issues could be resolved through the annual improvements process.

7. At the November 2011 meeting, the Committee decided to propose that the Board should not add this issue to the Annual Improvements project.

Issue 1: Classification of contingent consideration cash flows

8. The submitter's request reflects a situation in which an acquirer settles an obligation to pay contingent consideration. We understand that in accordance with paragraphs 39 and 40 in IFRS 3 *Business Combinations*, the acquirer has recognised this contingent consideration as part of the consideration transferred in a business combination.

9. Contingent consideration is defined in Appendix A of IFRS 3 as follows:

Contingent consideration

Usually, an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

10. We identified the following three possibilities for classifying cash flows derived from the settlement of contingent consideration in accordance with IAS 7:

(a) an **investing activity**, because, in accordance with paragraph 39 of IAS 7, cash flows arising from obtaining control of a business shall be classified as investing activities;

(b) a **financing activity**, because the vendor is providing finance to the acquirer; or

(c) an **operating activity**, because it is a payment linked to the performance of the acquired business[1].

Classification as an investing activity

11. Proponents of this view observe that the acquisition-date fair value of contingent consideration is recognised as part of the consideration transferred in exchange for the acquiree in accordance with paragraph 39 in IFRS 3. Because contingent consideration leads to the recognition of the acquiree's net assets, they think that payments of contingent consideration meet the definition of an investing cash flow in accordance with IAS 7.16, because "only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities".

12. They also observed that contingent consideration can be considered to be an investing cash flow in accordance with paragraph 39 of IAS 7, because: "The aggregate cash flows arising from obtaining or losing control of subsidiaries or other businesses shall be presented separately and classified as investing

[1] Paragraph 58(b)(i) of IFRS 3 states that changes in fair value of contingent consideration that are not 'measurement period adjustments' shall be recognised in profit or loss or other comprehensive income.

activities.” They see the payment of contingent consideration as a way to obtain control of a business. Consequently, they think that this payment should be classified as an investing activity.

Classification as a financing activity

13. Proponents of this view see the acquisition-date fair value contingent consideration as a liability incurred by the acquirer to former owners of the acquiree. In particular, they note that according to paragraph 40 of IFRS 3, the acquirer classifies an obligation to pay contingent consideration as a liability or as equity. As a consequence, they claim that the payment of contingent consideration meets the definition of a financing activity because:

    (a) a vendor (seller) is providing finance to the acquirer in the business combination; and

    (b) the payment of contingent consideration represents a repayment of a financial liability by the acquirer.

Classification as an operating activity

14. Proponents of this view note that, in accordance with paragraph 58 of IFRS 3, changes in the fair value of contingent consideration classified as assets or liabilities that are not ‘measurement period adjustments’ should be recognised in profit or loss or in other comprehensive income, because they are not recognised as part of the consideration transferred in a business combination at acquisition date.

15. Consequently, any cash paid by the acquirer for changes in the fair value of contingent consideration that are not measurement period adjustments should be classified as an operating cash flow, because the payment could be seen as being linked to the performance of the acquired business.

Staff analysis and recommendation

16. In our view, 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) should be classified as investing activities, because these cash flows arose from the recognition of the acquiree’s net assets in a business combination.

17. Our reasoning is supported by the fact that 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. We think that guidance in this paragraph (recently introduced as part of the April 2009 *Improvements to IFRS*) for classifying investing activities is meant to reduce diversity in practice for the classification of cash flows.
18. In addition, contingent consideration can be viewed as a way to obtain control of an entity as stated in paragraph 39 of IAS 7, which reinforces the fact that contingent consideration should be classified as an investing activity.
19. In our view, cash payments in excess of the amount recognised at acquisition date of the contingent consideration should be classified as operating activities, because these cash flows do not result in a recognised asset.
20. We also think that cash payments relating to interest resulting from accretion of the discount on the contingent consideration liability balance should be classified as financing or operating cash flows in accordance with other interest expenses, as stated in paragraphs 31–34 of IAS 7.
21. We also performed outreach activities with national standard setters to determine whether the issue on the classification of the cash payments for contingent considerations raised in the submission is widespread and has practical relevance; and whether there are significant divergent interpretations (either emerging or existing in practice). We received eight responses. Five respondents considered this issue to be prevalent and three of them noted divergent interpretations in practice.

Interpretations Committee's recommendation to the Board

22. At the September 2011 Committee members noted that the issue raised is widespread and that divergence in practice exists.
23. A majority of the Committee members broadly agreed with the staff view (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 consideration arising after the measurement period should be classified as operating activities) but 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.

24. Committee members also requested the staff to ask the Capital Markets Advisory Committee[2] (CMAC) if they agreed with the proposed classification of cash payment for contingent and deferred considerations.

25. At the November 2011 meeting, the staff discussed with Committee members the results of the outreach performed with the CMAC. Those few members of CMAC who replied to the staff's request agreed with the staff's proposed classification.

26. The Committee members determined that the outreach performed showed inconclusive results. Some members also noted that business combinations and related cash flows are usually large transactions and their significance generally results in clear disclosure of the cash effect regardless of any judgement as to the appropriate classification of the cash flows. Few others thought that a single consistent classification of all cash flows as part of investing activities (supplemented by transparent disclosure) may be the best way to achieve the desired level of consistency. Other members noted that that the matters involved in this submission might be relevant to circumstances other than business combinations (for example, consistency with the classification of contingent payments in financial liabilities has not been sufficiently discussed).

27. A majority of Committee members determined that the issue raised by the submitter is too broad to be resolved through the annual improvements process and decided to propose that the Board should not add this issue to the Annual Improvements project.

Issue 2—classification of the cash flows derived from the settlement of deferred consideration

28. The submitter asks whether, in accordance with IAS 7, the subsequent settlement of deferred consideration for a business combination should be classified as an investing or as a financing activity in the statement of cash flows.

29. We observe that the term 'deferred consideration' is not referred to or used in IFRS 3 (issued in 2008). However, this term had been referred to in IFRS 3 issued in 2004, in particular in paragraph 26 as follows (emphasis added):

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[2] Formerly the Analyst Representative Group

> 26 Assets given and liabilities incurred or assumed by the acquirer in exchange for control of the acquiree are required by paragraph 24 to be measured at their fair values at the date of exchange. **Therefore, when settlement of all or any part of the cost of a business combination is deferred, the fair value of that deferred component shall be determined by discounting the amounts payable to their present value at the date of exchange**, taking into account any premium or discount likely to be incurred in settlement.

30. We identified two possibilities for classifying cash flows derived from deferred consideration.

View 1—Classification within investing activities

31. Proponents of View 1 think that cash payments to settle a deferred consideration for a business combination should be classified as investing activities, because:
    (a) according to paragraph 39 of IAS 7, cash flows arising from obtaining control of a business shall be classified as investing activities; and
    (b) deferred considerations for business combinations result in recognised assets (ie the net assets of the business acquired) and 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.

View 2—classification within financing activities

32. Proponents of View 2 support the classification of payments of deferred consideration as financing activities for two main reasons:
    (a) payments of deferred items represent a reduction of a liability incurred by the acquirer to former owners of the acquiree; and
    (b) if the deferral period between the acquisition date and payment date of the deferred consideration is significant, the cash payment should be classified as financing.

33. Proponents of this view observe that the guidance in in US GAAP in paragraph–10–45–13 of Topic 230 *Statement of Cash Flows* in the *FASB Accounting Standards Codification*® could be used to support their conclusions. This paragraph 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**.

34. They think that the guidance in Topic 230–10–45–13 (shown above) is implicit in IAS 7, because according to paragraph 17 of IAS 7, cash payments by a lessee for the reduction of the outstanding liability relating to finance lease are cash flows arising from financing activities. Consequently, proponents of this view would consider:

(a) the deferred consideration to be a provision of finance by the vendor; and

(b) that the payment is a financing cash flow.

Staff view

35. We agree with View 1, because we think that the subsequent settlement of a deferred consideration for a business combination should be classified as an investing activity.

36. In addition, we think that cash payments in excess of the amount recognised at acquisition date resulting from adjustments to the amount payable (which in our view would be unusual because we think that deferred consideration is usually fixed at acquisition date) should be classified as operating activities because those cash flows do not result in a recognised asset. Likewise, cash payments relating

to interest resulting from accretion of the discount on the deferred consideration liability balance should be classified in financing or operating cash flows in accordance with other interest expenses as stated in paragraphs 31–34 of IAS 7.

37. We think that View 2 has some merit, because we agree that when the period between the acquisition date and the payment date of the deferred consideration is significant (ie more than one year), the payment could represent a provision of finance by the vendor, and as a consequence it could be classified as a financing activity. However, in accordance with the current requirements of IAS 7, View 1 is our preferred view. We also think that View 1 for deferred consideration is consistent with our view on the classification of cash flows for contingent consideration.

38. We also performed outreach activities with national standard setters to determine whether this issue on the classification of the cash payments for deferred consideration is widespread and has practical relevance; and whether there are significant divergent interpretations (either emerging or existing in practice). We received eight responses. Only two respondents considered this issue to be prevalent and noted divergent interpretations in practice.

Interpretations Committee's recommendation to the Board

39. At the November 2011 meeting, the Committee made a similar observation to Issue 1 above. The Committee noted that determining the classification of the cash flows derived from the settlement of deferred consideration is too broad to be resolved through the annual improvements process. Consequently, the Committee decided to propose that the Board should not add this issue to the Annual Improvements project.

Question to the Board

Question 1–classification of contingent consideration cash flows and deferred consideration cash flows
1. Does the Board agree with the Committee's recommendation not to propose an amendment through Annual Improvements for these issues because the issues are too broad?