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MFRS Hot Topics

Cash flow statements – common pitfalls and application issues

Part V - Cash flows relating to business combinations and disposals

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Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This is a series of issues that provide guidance on the practical application issues of MFRS 107 Statement of Cash Flows.

Introduction

Part V will be the last section of the series of Cash flow statements – common pitfalls and application issues.

A number of cash flows can arise relating to the acquisition of a business by an entity. Generally, these are expected to be recognised as investing activities because MFRS 107.39 requires that aggregate cash flows arising from obtaining or losing control of a subsidiary are presented separately within investing activities. However, other requirements in MFRS 107 create apparent contradictions that have led to inconsistencies in practice.

This section will address the common cash flow issues in relation to business combinations and disposals.

Part I	**Definition of cash and cash equivalents (August 2015 issue)**
Part II	**Classification of cash flow by activity (September 2015 issue)**
Part III	**Presentation issues (October 2015 issue)**
Part IV	**Foreign currency exchange differences (November 2015 issue)**
Part V	**Cash flows relating to business combinations and disposals**

Consideration transferred in a business combination

Deferred consideration

Normally, cash consideration paid at the time of a business combination will be classified as an investing activity (MFRS 107.39). The acquiring entity will record the fair value of the deferred consideration as a liability at the acquisition date (Paragraph 37 of MFRS 3 Business Combination). This liability will increase as the discount reflecting the time value of money unwinds and is reflected as a finance charge in profit or loss. When the liability is settled at a later date, the payment will reflect both the amount initially recognised as consideration plus the interest element (i.e. the unwinding of the discount). MFRS 107 does not deal directly with how this payment should be classified and so in practice the following alternatives may be observed:

- classify the entire payment as an investing cash flow on the grounds that it is part of the aggregate cash flows arising from obtaining control of the subsidiary (MFRS 107.39)
- classify the entire payment as a financing cash flow on the grounds that the payment of deferred items represent a reduction of a liability; this is consistent with the required treatment of a payment made by a lessee to reduce the outstanding liability relating to a finance lease (MFRS 107.17(e))
- disaggregate the payment into
  a) the amount initially recognised as consideration (and treat as investing or financing as above) and
  b) the interest element resulting from the unwinding of the discount, which should be treated as a financing or operating cash flow according to the entity's policy choice.

This disaggregation approach is consistent with MFRS 107.12, which notes that a single payment may include cash flows that are classified differently and gives the repayment of a loan as an example.

Our preferred view is to disaggregate the payment into the consideration and interest components in accordance with the third approach described above.

Contingent consideration

Similar decisions need to be made for contingent consideration as for deferred consideration (see above) but with an added complication. As with deferred consideration, the amount initially recognised as a liability is the fair value of the contingent consideration (MFRS 3.39). Changes to this fair value that relate to conditions and events after the acquisition date are recognised in profit or loss and do not affect the consideration transferred in exchange for the acquiree (and, consequently, do not affect goodwill (MFRS 3.58)). In addition, the fair value initially recognised will be adjusted to reflect the passage of time and related unwinding of the discount. Again, inconsistency is observed in practice and the subsequent payment of the contingent consideration may be recognised as follows:

- classify the entire payment as an investing cash flow on the grounds that it is part of the aggregate cash flows arising from obtaining control of the subsidiary (MFRS 107.39)
- classify the entire payment as a financing cash flow on the grounds that the payment of contingent consideration recognised as a liability represents a reduction of that liability; consistent with the required treatment of a payment made by a lessee to reduce the outstanding liability relating to a finance lease (MFRS 107.17(e))
- disaggregate the payment in accordance with MFRS 107.12 into:
  a) the principal amount of contingent consideration, including any changes to the amount initially recognised to reflect any changes in the expected outcome of the contingency (classify this principal amount as investing or financing as above) and
  b) the interest element resulting from the unwinding of the discount which should be treated as a financing or operating cash flow according to the entity's policy choice
- disaggregate the payment in accordance with MFRS 107.12 into:
  a) the amount initially recognised as consideration (and treat as investing or financing as above)
  b) the amount of any excess over the amount initially recognised as consideration that reflects conditions and events after the acquisition date and are recognised in profit or loss. Classify this element of the payment as an operating cash flow on the grounds that it does not result in a recognised asset in the statement of financial position (MFRS 107.16)
  c) the interest element resulting from the unwinding of the discount, which should be treated as a financing or operating cash flow according to the entity's policy choice.

Although technical arguments can be made to support the fourth approach (disaggregation into three components), this can be challenging to apply in practice, especially if the amount actually paid is lower than the original estimated amount of contingent consideration. Therefore, our preferred view is to disaggregate at least the interest component in accordance with the third approach.

Cash and cash equivalents acquired

Any cash and cash equivalents acquired in a business combination must be netted against the amount of consideration paid and disclosed under investing activities (MFRS 107.42).

Transaction costs

There is no specific guidance in MFRS 107 regarding transaction costs relating to the acquisition of a subsidiary and some inconsistency is seen in practice. MFRS 107.39 states that the aggregate cash flows arising from obtaining or losing control of a subsidiary shall be presented separately and classified as investing. MFRS 107.16 is amended such that only expenditure that results in a recognised asset in the statement of financial position is eligible for classification as investing activities. This seems to contradict MFRS 107.39 because these transaction costs are expensed to profit or loss in accordance with MFRS 3.53. In our view, classification as operating is preferred but classification as investing is considered acceptable. In either case, clear disclosure will be required.

Example – Acquisition of subsidiary

Entity D acquired a subsidiary on 1 October 20X1. Consideration of CU1,000,000 recognised at the date of acquisition consisted of:

- cash - CU450,000
- present value of deferred consideration payable in 6 months - CU225,000
- fair value of contingent consideration - CU325,000. The actual amount payable depends on whether certain revenue and profit targets are met over the following year.

In addition, entity D paid CU25,000 acquisition costs. The identifiable net assets of the newly acquired subsidiary included cash and cash equivalents of CU140,000.

How is this acquisition reflected in the statement of cash flows for the year ended 31 December 20X1?

Analysis

- within investing activities, a cash outflow of CU310,000 is reported, being the cash consideration paid of CU450,000 less the cash and cash equivalents acquired of CU140,000
- the deferred and contingent consideration amounts of CU225,000 and CU325,000 are non-cash transactions, as no cash has yet been paid (see below). These amounts are excluded from the statement of cash flows but will be reported as part of the total consideration disclosure required by MFRS 107.40
- our preferred approach is to include the transaction costs of CU25,000 within operating cash flows

Example – Acquisition of subsidiary continued

During 20X2, Entity D

- paid the deferred consideration CU225,000, plus interest of CU5,000
- paid contingent consideration of CU375,000. This was a higher amount than recognised as consideration because the subsidiary's results exceeded expectations and included interest of CU15,000.

How are these payments reflected in the statement of cash flows for the year ended 31 December 20X2?

Analysis

Entity D has to make an accounting policy choice for the classification of each of these payments. If the disaggregation into three components approach is chosen:

- the deferred payment of CU225,000 is classified as investing
- the contingent consideration payment of CU375,000 is broken down into its component parts as follows:
  - CU325,000 initially recognised as consideration is classified as investing
  - CU15,000 interest is classified as below (either operating or financing)
  - the remaining CU35,000 relates to changes in circumstances since acquisition and is classified as operating
- the total interest payment of CU20,000 (5,000+15,000) is classified as either operating or financing in accordance with the entity's normal policy choice.

Changes in non-controlling interests

Changes in ownership interests in a subsidiary that do not result in a loss of control are treated as equity transactions in accordance with MFRS 127 Separate Financial Statements and the cash flows arising from such changes are included within financing activities in accordance with MFRS 107.42A.

Acquisitions and disposals of subsidiaries

When a subsidiary joins or leaves the group, its cash flows should be included in the consolidated statement of cash flows for the same period as the results are reported in the consolidated statement of comprehensive income. As noted previously, an entity presents separately within investing activities the aggregate cash flow arising from obtaining or losing control of a subsidiary (MFRS 107.39). This aggregate cash flow includes any cash consideration paid or received and the amount of cash and cash equivalents in the subsidiary over which control is obtained or lost. MFRS 107.42 requires the net of these two amounts to be included in investing activities.

Recording the cash consideration or proceeds net of any cash and cash equivalent balances transferred means that any property, plant and equipment, intangible assets and working capital (excluding cash and cash equivalents) of the subsidiary at the acquisition or disposal date would need to be eliminated from other cash flow headings so as to avoid double counting because the related amounts are already included within the investing activities figure. For example, when using the indirect method, the adjustments for changes in working capital between the opening and closing consolidated position are adjusted to eliminate the assets and liabilities acquired or disposed of. Any additions to property, plant and equipment and goodwill will not be separately reported within the statement of cash flows.

An example using the indirect method is set out overleaf. This example is intended to demonstrate the mechanics of dealing with an acquisition or disposal of a subsidiary during the year in the statement of cash flows.

Example – Subsidiary acquired in the year

Entity A acquires a subsidiary, entity B, during the year. Summarised information from the consolidated statements of comprehensive income and financial position is provided, together with some supplementary information, to demonstrate how the statement of cash flows under the indirect method is derived. Entity A has chosen to classify interest paid as a financing activity.

Consolidated statement of comprehensive income (extract)	**20X2 CU**
Revenue	1,900
Cost of sales	1,100
Gross profit	800
Depreciation	(150)
Other operating expenses	(280)
Interest cost	(20)
Profit before taxation	**350**
Taxation	(75)
Profit after taxation	**275**

Consolidated statement of financial position (extract)	**20X2**	**20X1**
Assets	**CU**	**CU**
Cash and cash equivalents	40	25
Trade receivables	270	250
Inventories	150	175
Property, plant and equipment	800	400
Goodwill	90	-
Total assets	**1,350**	**850**
Liabilities	**CU**	**CU**
Trade payables	340	300
Income tax payable	60	55
Long term debt	500	320
Total liabilities	900	675
Net assets	450	175

Other information

All of the shares of entity B were acquired for CU370 cash. The fair values of assets acquired and liabilities assumed were:

	CU
Inventories	20
Trade receivables	40
Cash	10
Property, plant and equipment	550
Trade payables	(160)
Long term debt	(180)
Goodwill	90
Cash consideration paid	370

Analysis

This information will be incorporated into the statement of cash flows as follows:

Statement of cash flows for 20X2 (extract)	**CU**	**CU**
Profit before taxation		350
Adjustments for non-cash items		
Depreciation	150	
Decrease in inventories (150-175-20)	45	
Decrease in trade receivables (270-250-40)	20	
Decrease in trade payables (340-300-160)	(120)	
Interest paid included in financing activities	20	
		115
Taxation (60-55-75)		(70)
Net cash inflow from operating activities		**395**
Interest paid	(20)	
Net cash outflow from financing activities		**(20)**
Cash paid to acquire subsidiary (370-10)	(360)	
Net cash outflow from investing activities		**(360)**
Increase in cash and cash equivalents		15
Cash and cash equivalents, beginning of year		25
Cash and cash equivalents, end of year		**40**

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