Project	**New items for initial consideration**
Topic	**IFRS 3 *Business Combinations* and IAS 39 *Financial Instruments Recognition and Measurement* – Hedging the foreign exchange risk in a business combination**

Purpose of this agenda paper

1. The IFRS Interpretations Committee received a request to clarify whether gains or losses arising from hedging the risk of changes in the amount of the consideration paid in a business combination, due to movements in foreign exchange rates, would qualify as being part of the consideration transferred in accordance with paragraph 37 of IFRS 3 (revised 2008), *Business Combinations*.
2. The request suggested that clarification be made through *Annual Improvements*. This paper provides a copy of the request in Appendix B and asks the Committee to answer questions raised by the staff.

Background

3. The Committee received a request from a constituent, requesting views of the Committee. The issue regards hedge accounting for an effective hedge of the foreign exchange risk component of consideration paid in a business combination, under the revised version of IFRS 3 (2008), *Business Combinations*.
4. The submitter states that under the previous version of IFRS 3 *Business Combinations* (issued 2004), if the acquisition price of the business combination was hedged, the cost of the acquisition typically included the effect of hedging

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRS Interpretations Committee or the IASB. 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*.

Interpretations are published only after the IFRS Interpretations Committee and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

the risk of movements in foreign exchange rates. The impact of the hedge was typically reflected in goodwill, after the cost was allocated to the fair value of the identifiable assets and liabilities.

5. The submitter claims that in the new version of IFRS 3, *Business Combinations* (as revised in 2008), paragraph 37 does not specifically state whether the consideration transferred in a business combination can include the gain or loss arising from the hedging transaction and thinks it would not be possible to achieve hedge accounting under IFRS 3 (revised 2008) because:

   (a) there is greater focus on the fair value of the **consideration transferred to the selling shareholders**;

   (b) all acquisition-related costs are expensed; and

   (c) the hedge transaction is undertaken with a party other than the selling shareholder.

6. The submitter recommends the Board either to:

   (a) add specific language in paragraph 37 of IFRS 3 (revised 2008) allowing hedging gains and losses to be included in the consideration transferred; and to avoid making basis adjustments to the acquired assets and liabilities; or,

   (b) provide specific guidance on when hedging gains and losses should be recycled from OCI to profit or loss.

Staff analysis

Scope of this analysis

7. The staff observes that the submission relates to the accounting for business combinations under IFRS 3 (revised 2008), and not the purchase of shares in a subsidiary in separate financial statements. Therefore, the staff has not considered as part of its analysis, the purchase of equity instruments (financial assets) in the acquiree that would be recognised in separate financial statements.

Analysis under IFRS 3

Business combinations

8. Under IFRS 3 (revised 2008), a business combination is defined as 'a transaction or other event in which an acquirer obtains control of one or more businesses'. An entity could acquire control in many different ways, for example, by transferring cash, other assets, a business or subsidiary of the acquirer and securities of the acquirer (ordinary shares, preferred shares, options, warrants, etc).

Consideration transferred/cost of the combination

9. Paragraph 37 in IFRS 3 (revised 2008) requires the measurement of the consideration transferred at fair value and comprises the sum of acquisition-date fair values of assets transferred by the acquirer, liabilities incurred by the acquirer to former owners of the acquiree and the equity interests issued by the acquirer.

10. Paragraph 24 in IFRS 3 (issued 2004) has requirements for the measurement of the cost of the business combination. It states that it includes the aggregate of the fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued by the acquirer, in exchange for control of the acquiree, **plus any costs directly attributable to the business combination**.

11. When contrasting the definitions of the 'consideration transferred' and the 'cost of the combination', the staff could not find any indication in IFRS 3 (2008) that could prevent an entity from including the effect of hedging the risk of movements in foreign exchange rates in a business combination within the acquisition cost and reflecting the impact of these hedging effects within goodwill.

12. In addition, the staff thinks that gains and losses arising from hedging the risk of changes in the amount of the consideration paid, due to movements in foreign exchange rates, are not acquisition-related costs that should be expensed as incurred (in accordance with paragraph 53 of IFRS 3), because those gains and losses:

(a) are not costs incurred to effect the business combination

(b) are considered part of the fair value exchange of the consideration transferred between the buyer and seller for the business, rather than separate transactions from the business combination.

13. In paragraphs 15–21 of this paper, the staff is providing an analysis of the requirements in IAS 39 for hedge accounting that shows that gains and losses arising from hedging the risk of changes in the amount of the consideration paid, could adjust the initial cost or other carrying amount of the acquired assets or liabilities in a business combination.

Calculation of goodwill

14. Under paragraph 32 of IFRS 3 (2008), the acquirer shall recognise goodwill as of the acquisition date measured as the aggregate of: the consideration transferred, the amount of any non-controlling interest in the acquiree, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree, less the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this IFRS 3.

Requirements under IAS 39

15. Paragraph AG98 of IAS 39 allows an entity to hedge the movements in foreign currency exchange rates for a hedged item that is a firm commitment to enter into a business combination, as follows:

> AG98 'A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign exchange risk, because the other risks being hedged cannot be specifically identified and measured. These other risks are general business risks.'

16. In addition, paragraph 87 allows a hedge of the foreign currency risk of a firm commitment to be accounted for as a fair value hedge or as a cash flow hedge.

17. Paragraph 94 of IAS 39 permits adjustments to the asset or liability that results from the entity meeting the firm commitment in a **fair value hedge**, as shown below:

> 93 When an unrecognised firm commitment is designated as a hedged item, the subsequent cumulative change in the fair value of the firm commitment attributable

> to the hedged risk is recognised as an asset or liability with a corresponding gain or loss recognised in profit or loss (see paragraph 89(b)). The changes in the fair value of the hedging instrument are also recognised in profit or loss.
>
> 94 When an entity enters into a firm commitment to acquire an asset or assume a liability that is a hedged item in a fair value hedge, **the initial carrying amount of the asset or liability that results from the entity meeting the firm commitment is adjusted** to include the cumulative change in the fair value of the firm commitment attributable to the hedged risk that was recognised in the statement of financial position. (emphasis added)

18. The staff notes that the basis adjustment made to the hedged item is after other applicable IFRSs have been applied in accounting for the hedged item. For example, a gold inventory might be the hedged item in a fair value hedge for the exposure to changes in the price of gold. If this is the case, the carrying amount of the gold inventory would be adjusted for changes in the fair value of the firm commitment; the amount of the hedge accounting adjustment will be added to/deducted from the cost of the gold that is recognised in accordance with IAS 2 *Inventories*.

19. In accordance with paragraph 95 of IAS 39, a **cash flow hedge** shall be accounted as follows:

    (a) the **effective portion** of the gain or loss on the hedging instrument (in accordance with paragraph 88) shall be recognised in other comprehensive income (OCI); and

    (b) the **ineffective portion** of the gain or loss on the hedging instrument shall be recognised in profit or loss.

20. In accordance with paragraph 98 of IAS 39, if a hedge of a forecast transaction subsequently results in the recognition of a **non-financial asset or non-financial liability**, as will happen when acquiring a business in a business combination, then the entity would have an accounting policy **option** that must be applied to all such hedges of forecast transactions:

    (a) **same accounting as for recognition of a financial asset or financial liability** (as provided in paragraph 97 of IAS.39) – any gain or loss on the hedging instrument that was previously recognised in OCI is

reclassified into profit or loss in the same period(s) in which the non-financial asset or liability affects profit or loss; or,

(b) **apply a 'basis adjustment'** of the acquired non-financial asset or liability in the business combination – the gain or loss on the hedging instrument that was previously recognised in OCI is removed from equity and is included in the initial cost or other carrying amount of the acquired non-financial asset or liability.

21. From the analysis above we can conclude:

(a) IAS 39's hedge accounting requirements can be applied in addition to IFRS 3's requirements, they are not contradictory.

(b) Paragraph AG98 of IAS 39 allows an entity to hedge the movements in foreign exchange rates for a hedged item that is a firm commitment to enter into a business combination.

(c) IAS 39 provides general guidance for hedge accounting. If a hedge of the foreign currency risk of a firm commitment is accounted for as:

(i) a fair value hedge, the subsequent cumulative change in the fair value of the firm commitment is recognised as an asset or liability with a corresponding gain or loss recognised in profit or loss, followed by an adjustment of the initial carrying amount of the asset or liability that results when meeting the firm commitment; or

(ii) a cash flow hedge, depending on the accounting policy chosen by the entity, the hedging effects can be deferred in OCI and subsequently recycled, or deferred in OCI, followed by a 'basis adjustment'.

(d) The 'basis adjustment' provides for the adjustment of the initial cost or other carrying amount of the acquired asset or liability of the business combination. This adjustment will become part of goodwill in a business combination, after the application of the guidance in IFRS 3 (2008), because goodwill is calculated as a residual, as mentioned in paragraph 14 of this paper.

Annual Improvements *proposed agenda criteria*

22. The staff has analysed this issue using the following four proposed criteria that must all be satisfied for *Annual Improvements:*

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

    (i) **Clarifying:** The proposed amendment improves IFRSs through one or both of the following:

    (a) Clarifying unclear wording in existing IFRSs.

    (b) Providing guidance where a current lack 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 improves IFRSs through one or both of the following:

    (a) Resolving a perceived or actual conflict between existing requirements of IFRSs.

    (b) Addressing an oversight or unintended consequence of the existing requirements of IFRSs.

    A correcting amendment does not propose a new principle or a change to an existing principle. It may create an exception to an existing principle, for example an omitted consequential amendment from a recent change to an IFRS.

    (b) The proposed amendment has a narrow and well-defined purpose, i.e., the consequences of the proposed change have been considered sufficiently and identified.

    (c) It is probable that the IASB will reach agreement on the issue on a timely basis. An inability to reach agreement on a timely basis may indicate that the cause of the issue is more fundamental than can be resolved within **Annual Improvements**.

    (d) If the proposed amendment is to IFRSs that are the subject of a current or planned IASB project, there is a pressing need to make the amendment sooner.

23. In the staff's opinion, the issue in the request does not satisfy the above proposed *Annual Improvements* criteria, because the requirements in IAS 39 provide sufficient guidance and this guidance should be applied in addition to

the guidance in IFRS 3 for determining the initial amount of the consideration transferred (that will subsequently be adjusted by IAS 39).

24. In addition, the hedge accounting 'basis adjustment' permitted in IAS 39 is not exclusive to IFRS 3. Hedging effects of any non-financial item would follow the same treatment under IAS 39, for example, in the determination of the cost basis for inventories in accordance with IAS 2, or for a machinery in IAS 16 *Property, Plant and Equipment.* The staff thinks that the guidance in IAS 39 for hedge accounting is sufficient, and that additional guidance does not need to be included in IFRS 3 or any other Standard.

Staff recommendation

25. The staff thinks that the draft criteria for *Annual Improvements* are not satisfied, therefore, this issue should not be recommended to the Board for addition to *Annual Improvements*.

26. Appendix A to this paper includes a staff prepared draft of proposed Agenda Decision consistent with the above staff recommendations.

Questions for the Committee

27. The staff requests the Committee answer the following questions:

Question 1 – Not to recommend addition to *Annual Improvements*
Does the Committee agree with the staff recommendation not to recommend to the Board to add this issue to *Annual Improvements*?

Question 2 – Tentative Agenda Decision drafting
Does the Committee agree with the staff prepared draft of the Agenda Decision included in Appendix A to this paper?

Appendix A – Staff draft of proposed Agenda Decision

A1. Below is a staff prepared draft of the Agenda Decision consistent with the staff recommendations included in this paper.

> **IFRS 3 *Business Combinations* – Hedging the foreign exchange risk of consideration paid in a business combination**
>
> The IFRS Interpretations Committee received a request to clarify how the effective hedge of foreign exchange risk of consideration paid in a business combination should be accounted for in respect of business combinations to which IFRS 3 (revised 2008), *Business Combinations* applies.
>
> The Committee noted that IAS 39 *Financial Instruments: Recognition and Measurement* provides sufficient guidance on the accounting for hedging transactions and it does not expect diversity in practice.
>
> The Committee noted that when an entity chooses to remove the gain or loss on the hedging instrument from other comprehensive income and adjust the initial cost or other carrying amount of the acquired asset or liability of the business combination, that adjustment should be made after applying other applicable IFRSs to the non-financial asset or non-financial liability.
>
> Therefore, the Committee proposes that the issue should not be included in Annual Improvements.

Appendix B – Request for views

A2. The staff received the following request. All information has been copied without modification, except for details that would identify the submitter of the request and details that are subject to confidentiality.

Hedging the foreign exchange risk of consideration paid in a business combination

IAS 39.AG98 allows an entity to hedge the risk of changes in the amount of the consideration paid in a business combination due to movements in foreign currency exchange rates. The hedge may be designated as a fair value hedge or a cash flow hedge. If the hedge proves to be effective, the accounting consequences are summarised as follows:

- Assets acquired and/or liabilities assumed are adjusted (basis adjustment) to include the gain or loss arising from the hedging transaction (fair value or cash flow hedge); or
- The gain or loss arising from the hedging transaction is recognised in other comprehensive income and transferred to profit or loss when the hedged asset or liability affects profit or loss (cash flow hedge).

IAS 39.AG98 co-existed with the previous version of IFRS 3 (2004). Under that standard business combinations were measured by reference to the cost of the acquisition. If the acquisition price of the business was hedged, the cost of the acquisition typically included the effect of the hedging transaction. This meant that the impact of the hedge was typically reflected in goodwill being the residual amount after the cost was allocated to the fair value of the identifiable assets and liabilities. This was the common approach under IFRS 3 (2004). Further, the specific measurement requirements to fair value assets acquired and liabilities assumed under IFRS 3 (2004) didn’t seem to allow for the basis adjustment referred to above.

Under the revised version of IFRS 3, the specific measurement requirements of net assets acquired has been retained. There is also greater focus on the fair value of the consideration transferred to the selling shareholders. As the hedge transaction is undertaken with a party other than the selling shareholder, any gain or loss from the hedging transaction might not qualify as being part of consideration transferred (IFRS 3R.37) and might need to be recorded separately (i.e. expensed). These factors essentially mean that there may not be an ability to achieve hedge accounting for an effective hedge of the foreign exchange risk component of consideration paid in a business combination.

We suggest the Board clarify that hedge accounting may continue under IFRS 3R by taking one of the following approaches:

1.) Add specific language that allows the hedging gains & losses to be included in consideration transferred. This approach essentially results in the amount being part of goodwill; however, we believe IFRS 3.37 would need to be clarified in order for the hedging gains & losses to form part of consideration transferred. This approach would allow entities to avoid making basis adjustments to the acquired assets and liabilities and to avoid detailed tracking to identify when hedging gains & losses should be released from OCI.

2.) Provide specific guidance on when hedging gains & losses should be recycled from OCI to profit or loss.