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Ms. Susan M. Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
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June 19, 2018

Re: Agenda Request – Cash Flow & Fair Value Hedges: Hedging Foreign Exchange Risk Associated with Cross-border Business Acquisitions

Dear Ms. Cosper,

The International Swaps and Derivatives Association's ("ISDA")[1] Accounting Committee (the "Committee") appreciates the opportunity to provide an agenda request to the Financial Accounting Standards Board ("FASB"). Collectively, the Committee members have extensive professional expertise and practical experience addressing accounting policy issues related to financial instruments and specifically derivative financial instruments.

The Committee requests that the FASB consider an agenda topic that extends the ability to designate a fair value or cash flow hedge of foreign currency exposure that arises in connection with cross-border business acquisitions. This letter provides the Committee's formal agenda request and overall views on why we believe this topic should be added to the agenda. Overall, the Committee believes this is a practice issue that is pervasive across industries, narrow in nature, and can be resolved in a short-time frame.

We appreciate the Board recently issued Accounting Standards Update ("ASU") 2017-12 – Derivatives and Hedging (Topic 815): *Targeted Improvements to Accounting for Hedging Activities*, which has been well received by stakeholders. This practice issue was outside the scope of the recent hedging project that led to the issuance of ASU 2017-12. Given the FASB commented that issues incremental to the project could be considered by the Board at a subsequent time, we believe the timing of this request is now appropriate.

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[1] Since 1985, the International Swaps and Derivatives Association has worked to make the global derivatives markets safer and more efficient. ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. The Association has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool. Today, ISDA has over 850 member institutions from 67 countries. These members comprise of a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of the Association toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Overview

Companies will from time to time engage in strategic initiatives to grow and expand their businesses through acquisitions – such expansion can focus on both domestic and international footprints. When the purchase price is denominated in a currency other than the purchaser's functional currency, there can be significant economic exposure driven by movements in foreign exchange rates.

To illustrate this point, assume Company ABC, a U.S. dollar ("USD") functional currency entity, enters into a share purchase agreement ("SPA") to acquire Company XYZ for EUR 500 million on January 1, 2017. The purchase price for this acquisition is denominated in euros, the functional currency of the target. Company ABC is exposed to foreign exchange risk driven by changes in the USD/EUR exchange rate between the date both parties agree to the SPA and when the acquisition formally closes. On January 1, 2017 when Company ABC entered into the SPA, the USD/EUR exchange rate was \$1 to €.8 which equates to a purchase price of USD 625 million. Over the course of 2017, the USD continued to weaken to a USD/EUR exchange rate of \$1 to €.75 and as a result of such weakness, the purchase price in USD terms increases to USD 666.67 million during the sign to close period, reflecting an economic loss due to changes in foreign exchange rates. It will now cost Company ABC an incremental USD 41.67 million to acquire the target upon close of the acquisition.

In addition to the foreign exchange exposure to the purchase price, changes in foreign currency exchange rates will affect the value at which identifiable assets and liabilities (and if applicable, goodwill) are recognized by the acquirer. This exposure affects earnings through subsequent amortization expense, impairment charges and gains/losses on any subsequent transfers of the acquired assets or liabilities post consummation of the acquisition.

This foreign exchange purchase price risk is faced by all acquirers, irrespective of industry. To convey a sense of prevalence, in 2017 alone there were over 400 announced transactions where the acquirer was identified as domiciled in the U.S. and where the purchase price was not denominated in USD. Using the foreign exchange spot rate as of each respective deal announcement date, the USD purchase price equivalent for these transactions was in excess of USD 125 billion involving more than 30 foreign currencies[2].

Recent legislative changes may further proliferate this foreign currency exposure. Specifically, in December 2017, H.R. 1, originally known as the Tax Cuts and Jobs Act, was enacted. Under this law, U.S. companies will have access to funds held offshore by their foreign subsidiaries' at a lower tax rate. This incremental liquidity may spur more companies to engage in cross-border activity, further increasing the number of entities with exposure to foreign exchange risk.

Derivatives that hedge the foreign exchange risk associated with forecasted business acquisitions must be marked to market through earnings, as existing GAAP precludes the application of hedge accounting for such forecast transactions. This prohibition causes an income statement mismatch between the hedging derivative, which is immediately recognized in earnings, and the hedged item (i.e., the recognition of the acquired company, which occurs at the closing date).

[2] Data sourced from Thomson Reuters (thomsonreuters.com)

The inability to achieve hedge accounting has historically factored into a company's decision whether to economically hedge the foreign exchange risk. Specifically, companies may decide not to hedge the exposure because of the aforementioned mismatch in income statement recognition, which results in earnings and earnings per share volatility that would have to be explained to financial statement users. A decision to not hedge this exposure runs counter to a corporate treasury group's general mandate to manage these types of exposures. Thus, companies often make uneconomic decisions because of an undesirable accounting result. For those companies that decide to economically hedge the foreign exchange risk, the income statement volatility that results may have to be explained to users via non-GAAP reporting metrics.

Unlike US GAAP requirements, entities preparing financial statements in accordance with International Financial Reporting Standards ("IFRS") are allowed to designate the foreign exchange risk associated with forecast business combinations in qualifying hedge accounting relationships. See Appendix A for guidance related to hedges of foreign exchange risk in business acquisitions for both IFRS 9 *Financial Instruments* ("IFRS 9") and International Accounting Standard 39 *Financial Instruments: Recognition and Measurement* ("IAS 39")[3]. In addition, Appendix A includes industry guidance that companies have relied upon when applying IFRS. The IFRS literature coupled with well-established industry guidance can readily be leveraged to develop similar guidance within Topic 815.

Committee View

The Committee believes there is a genuine exposure to foreign exchange risk in an anticipated business acquisition, and US GAAP currently inhibits companies from executing valid hedging strategies to mitigate this risk. Companies should be permitted to designate hedges of this foreign exchange risk in either a fair value hedge or cash flow hedge similar to entities reporting under IFRS.

The Committee respectfully disagrees with the previous Board's Basis for Conclusions in Statement of Financial Accounting Standard No. 133, *Accounting for Derivative Instruments and Hedging Activities*, specifically outlined in paragraphs 455 – 456 and 472 – 473.

First, the Committee is not seeking to permit hedge accounting of equity price risk in a forecasted business acquisition. The Committee is seeking for the FASB to consider providing companies the ability to achieve hedge accounting for foreign exchange risk in a forecasted business acquisition.

The Committee believes there is a period of time where a company has a valid expectation that the business acquisition will be completed and as such is deemed probable of occurring in light of any applicable regulatory or shareholder approvals, or other significant considerations specific to the facts and circumstances of a transaction. Such contingencies must be met during the sign to close period in order for the acquisition to be consummated and are germane to any business combination. In order to achieve hedge accounting under IFRS, acquirers are required to support why they believe the acquisition is probable of closing as of the hedging date. Although judgmental, companies have been able to successfully make this assertion with their

[3] At present time, note that companies that apply IFRS still have the option to apply hedge accounting under IAS 39.

auditors and achieve hedge accounting in accordance with international standards. We acknowledge these assertions can be challenging for certain fact patterns and may also occur at different points of the timeline, but we believe US GAAP should not prohibit acquirers and their accounting firms from making those judgements.

In addition, the Committee disagrees with the view that it would be difficult to determine when to reclassify the gain or loss on the hedging derivative to earnings. There is guidance in IFRS and industry guidance that can be leveraged and there are no known pervasive practice issues with applying this hedging strategy.

Industry guidance would generally provide for the gain or loss on the hedge, upon consummation of the business acquisition, to be reclassed as an adjustment to recognized goodwill. In addition to this alternative, which seems a practical application of IFRS, the Committee would also suggest a policy option for target companies that remain a foreign entity subject to foreign exchange translation under Topic 830. Under this policy option, the amount recorded for the hedged item (whether in AOCI for cash flow hedge accounting or as a separate asset or liability under fair value hedge accounting) would be reclassed to the parent's cumulative translation adjustment account ("CTA") in shareholder's equity upon consummation of the business. This amount will then continue to be adjusted for future translation adjustments under Topic 830 for the foreign entity. This alternative, while not applicable to all fact patterns and not similar to IFRS specifically in terms of accounting subsequent to the maturity of the hedging relationship, may result in another practical alternative for how to reclass the gain or loss on the hedging instrument.

The Committee believes that relevant guidance in IFRS that is currently applied by companies should support an opportunity for similar treatment under US GAAP. In addition, an amendment on this specific point will provide the added benefit of US GAAP and IFRS convergence.

Proposed Language

If the Board concludes that this practice issue should be added to the Agenda for further deliberation, and the outcome of such final deliberation were to be consistent with the Committee's view, the Committee believes the amendments to the Codification could be narrow, as demonstrated below (the intent of the below is to demonstrate the amendments are not pervasive in Topic 815).

(added text is <u>underlined</u>; deleted text is ~~struck out~~)

Hedged Transaction Criteria Applicable to Cash Flow Hedges Only

ASC 815-20-25-15 A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following additional criteria are met:

g. <u>If the forecasted transaction involves</u> ~~The forecasted transaction does not involve~~ a business combination subject to the provisions of Topic 805 or a_combination accounted for by an NFP that is subject to the provisions of Subtopic 958-805<u>, the risk being hedged is the risk of changes in foreign exchange risk</u>

Items in Fair Value Hedges of Foreign Exchange Risk

ASC 815-20-25-37 This paragraph identifies possible hedged items in fair value hedges of foreign exchange risk. If every applicable criterion is met, all of the following are eligible for designation as a hedged item in a fair value hedge of foreign exchange risk:

a. Recognized asset or liability. A derivative instrument can be designated as hedging the changes in the fair value of a recognized asset or liability (or a specific portion thereof) for which a foreign currency transaction gain or loss is recognized in earnings under the provisions of paragraph 830- 20-35-1. All recognized foreign-currency-denominated assets or liabilities for which a foreign currency transaction gain or loss is recorded in earnings shall qualify for the accounting specified in Subtopic 815-25 if all the fair value hedge criteria in this Section (including the conditions in paragraph 815-20-25-30(a) through (b)) are met.
b. Available-for-sale debt security. A derivative instrument can be designated as hedging the changes in the fair value of an available-for sale debt security (or a specific portion thereof) attributable to changes in foreign currency exchange rates. The designated hedging relationship qualifies for the accounting specified in Subtopic 815-25 if all the fair value hedge criteria in this Section (including the conditions in paragraph 815-20-25-30(a) through (b)) are met.
c. Subparagraph superseded by Accounting Standards Update No. 2016-01.
d. Unrecognized firm commitment. Paragraph 815-20-25-58 states that a derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Topic 830 can be designated as hedging changes in the fair value of an unrecognized firm commitment, or a specific portion thereof, attributable to foreign currency exchange rates.
e. An unrecognized firm commitment to acquire a business in a business combination

Items and Transactions in Cash Flow Hedges of Foreign Exchange Risk

ASC 815-20-25-38 The conditions in the following paragraph relate to a derivative instrument designated as hedging the foreign currency exposure to variability in the functional-currency-equivalent cash flows associated with any of the following:

a. A forecasted transaction (for example, a forecasted exposure sale to an unaffiliated entity with the price to be denominated in a foreign currency)
b. A recognized asset or liability
c. An unrecognized firm commitment
d. A forecasted intra-entity transaction (for example, a forecasted sale to a foreign subsidiary or a forecasted royalty from a foreign subsidiary)
e. A forecasted transaction that involves a business combination or an unrecognized firm commitment to acquire a business in a business combination

Items Specifically Ineligible for Designation as a Hedged Item or Transaction

ASC 815-20-25-43 Besides those hedged items and transactions that fail to meet the specified eligibility criteria, none of the following shall be designated as a hedged item or transaction in the respective hedges:

c. With respect to fair value hedges only:
   5. A firm commitment either to ~~enter into a business combination or to~~ acquire or dispose of a subsidiary, a noncontrolling interest, or an equity method investee

Please see Appendix A for relevant guidance in IFRS 9 and IAS 39, along with relevant industry guidance that may be useful to add as potential Implementation Guidance for this hedging strategy.

Conclusion

In light of the above considerations, the Committee recommends that the FASB revisit the current US GAAP guidance that precludes the application of fair value and cash flow hedge accounting to the foreign exchange risk associated with business acquisitions. The Committee believes there is much merit to aligning the economic risk management objectives of hedging foreign exchange risk with the accounting for qualifying hedge relationships in a company's financial statements. Additionally, this change would be in line with the broad objective of ASU 2017-12 which is to better align hedge accounting with a company's risk management activities.

The Committee members appreciate the Board's consideration of this issue and would welcome the opportunity to discuss it further. Should you have any questions or desire further clarification on any of the matters discussed in this letter, please do not hesitate to contact Matt Esposito at (212) 816 - 5371.

Matthew Esposito
Citigroup Inc
Chair, North America Accounting Committee

Antonio Corbi
ISDA, Inc
Director, Risk and Capital

<u>Appendix A</u>
Relevant guidance in IFRS 9 and IAS 39, along with pertinent industry guidance

IFRS 9

6.5.2 There are three types of hedging relationships:

a. fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.
b. cash flow hedge: a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable-rate debt) or a highly probable forecast transaction, and could affect profit or loss.
c. hedge of a net investment in a foreign operation as defined in IAS 21.

6.5.4 A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or a cash flow hedge.

6.5.8 As long as a fair value hedge meets the qualifying criteria in paragraph 6.4.1, the hedging relationship shall be accounted for as follows:

a. the gain or loss on the hedging instrument shall be recognised in profit or loss (or other comprehensive income, if the hedging instrument hedges an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5).
b. the hedging gain or loss on the hedged item shall adjust the carrying amount of the hedged item (if applicable) and be recognised in profit or loss. If the hedged item is a financial asset (or a component thereof) that is measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A, the hedging gain or loss on the hedged item shall be recognised in profit or loss. However, if the hedged item is an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income in accordance with paragraph 5.7.5, those amounts shall remain in other comprehensive income. When a hedged item is an unrecognised firm commitment (or a component thereof), the cumulative change in the fair value of the hedged item subsequent to its designation is recognised as an asset or a liability with a corresponding gain or loss recognised in profit or loss.

6.5.9 When a hedged item in a fair value hedge is a firm commitment (or a component thereof) to acquire an asset or assume a liability, the initial carrying amount of the asset or the liability that results from the entity meeting the firm commitment is adjusted to include the cumulative change in the fair value of the hedged item that was recognised in the statement of financial position.

6.5.11 As long as a cash flow hedge meets the qualifying criteria in paragraph 6.4.1, the hedging relationship shall be accounted for as follows:

d. the amount that has been accumulated in the cash flow hedge reserve in accordance with (a) shall be accounted for as follows:
   i. if a hedged forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a hedged forecast transaction for a

non-financial asset or a non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, the entity shall remove that amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or the liability. This is not a reclassification adjustment (see IAS 1) and hence it does not affect other comprehensive income.

ii. for cash flow hedges other than those covered by (i), that amount shall be reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment (see IAS 1) in the same period or periods during which the hedged expected future cash flows affect profit or loss (for example, in the periods that interest income or interest expense is recognised or when a forecast sale occurs).

iii. however, if that amount is a loss and an entity expects that all or a portion of that loss will not be recovered in one or more future periods, it shall immediately reclassify the amount that is not expected to be recovered into profit or loss as a reclassification adjustment (see IAS 1).

B6.3.1 A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign currency risk, because the other risks being hedged cannot be specifically identified and measured. Those other risks are general business risks.

IAS 39

78 A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be (a) a single asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation, (b) a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics or (c) in a portfolio hedge of interest rate risk only, a portion of the portfolio of financial assets or financial liabilities that share the risk being hedged.

86 Hedging relationships are of three types:

a. *fair value hedge*: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss.
b. *cash flow hedge*: a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss.
c. *hedge of a net investment in a foreign operation* as defined in IAS 21.

87 A hedge of the foreign currency risk of a firm commitment may be accounted for as a fair value hedge or as a cash flow hedge.

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.

97 If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or a financial liability, the associated gains or losses that were recognised in other comprehensive income in accordance with paragraph 95 shall be reclassified from equity to profit or loss as a reclassification adjustment (see IAS 1 (as revised in 2007)) in the same period or periods during which the hedged forecast cash flows affect profit or loss (such as in the periods that interest income or interest expense is recognised). However, if an entity expects that all or a portion of a loss recognised in other comprehensive income will not be recovered in one or more future periods, it shall reclassify into profit or loss as a reclassification adjustment the amount that is not expected to be recovered.

98 If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, then the entity shall adopt (a) or (b) below:

a. It reclassifies the associated gains and losses that were recognised in other comprehensive income in accordance with paragraph 95 to profit or loss as a reclassification adjustment (see IAS 1 (revised 2007)) in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that depreciation expense or cost of sales is recognised). However, if an entity expects that all or a portion of a loss recognised in other comprehensive income will not be recovered in one or more future periods, it shall reclassify from equity to profit or loss as a reclassification adjustment the amount that is not expected to be recovered.
b. It removes the associated gains and losses that were recognised in other comprehensive income in accordance with paragraph 95, and includes them in the initial cost or other carrying amount of the asset or liability.

99 An entity shall adopt either (a) or (b) in paragraph 98 as its accounting policy and shall apply it consistently to all hedges to which paragraph 98 relates.

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.

Industry Guidance

PricewaterhouseCoopers (PwC)
December 2017
In depth: Achieving hedge accounting in practice under IFRS 9

1.14 Cash flow hedge of the foreign currency risk of a forecast business combination

Question
Can a hedge of the foreign currency risk on a forecast business combination be accounted for as a cash flow hedge?

Illustration
Entity A, whose functional currency is the Euro, on 1 March 20X1 started negotiations with entity B (an overseas entity) in order to take control of entity B and gain access to the overseas market. On 1 August 20X1, entity A and entity B agree the key terms of the transaction, including the purchase price which will be denominated in a fixed amount of the overseas currency. However, entity A has not yet received a required approval from the overseas authorities. On 29 March 20X2, entity A and entity B agree the full terms of the transaction and the overseas authorities have granted their approval. At this point, there are no significant uncertainties that could affect the completion of the business combination. Entity A's risk management strategy is to hedge forecast transactions in a foreign currency as soon as they are highly probable. The entity intends to use a forward contract to hedge the payment in the overseas currency.

Can hedge accounting be achieved in this scenario?

Solution
Yes. However, the forecast business combination must be highly probable in order to be an eligible hedged item.

- Could entity A apply hedge accounting to the forecast transaction at 1 August 20X1?

  It depends. In order to apply hedge accounting to a forecast transaction, this transaction must be highly probable. Whether this is the case will depend on the specific facts and circumstances and the significance of the outstanding contingencies affecting the completion of the transaction. In some territories, a regulatory process could be considered perfunctory or 'rubber stamping' of the agreement and so the transaction can be considered highly probable before receiving the formal approval. However, in other cases the regulatory approval process will be more substantive and there will be significant uncertainty over whether it will be received, such that the transaction can be considered highly probable only once the formal approval is received.

- Can entity A designate only the spot component of the forward contract as the hedging instrument?

  Yes. Once the hedge accounting criteria are met, the entity can choose either to designate the full fair value of the forward contract as a hedging instrument or to separate the forward element and to designate only the spot component of the hedging instrument (on a discounted basis). Similarly, the entity may choose to separate the foreign currency basis spread and exclude it from the designated hedge. Changes in the value of the forward element / foreign currency basis spread are either taken to P&L or to OCI if the cost of hedging approach is applied as explained further in FAQ 3.7 and section 4.5-6 of Section 1.

KPMG's Insights into IFRS 2017/2018
Practical Guide to International Financial Reporting Standards
14th Edition

7A.9.470 Cash flow hedges and business combinations

7A.9.470.10 A firm commitment to acquire a business in a business combination can be a hedged item only for foreign exchange risk because other risks cannot be specifically identified and measured. In our view, an entity may also hedge the foreign exchange risk of a highly probable forecast business combination. In our view, in the consolidated financial statements a cash flow hedge of the foreign exchange risk of a firm commitment to acquire a business or a forecast business combination relates to the foreign currency equivalent of the consideration paid. [IFRS 9.B6.3.1]

7A.9.470.20 In a cash flow hedge designation, the effective portion of the gain or loss arising from the hedging instrument is recognised in OCI. However, an issue arises about when and how this amount accumulated in equity is reclassified to profit or loss. The answer depends on whether the hedge represents a hedge of non-financial item or a financial item. [IFRS 9.6.5.11]

7A.9.470.30 In our view, because a hedge of a firm commitment to acquire a business or forecast business combination relates to the foreign currency equivalent of the consideration paid, the acquisition of an equity interest in the entity may be viewed as either a hedge of the purchase of shares of an entity or a hedge of the purchase of a business. A hedge of the purchase of shares represents a hedge of a financial item, whereas a hedge of the purchase of a business represents a hedge of a non-financial item. Therefore, we believe that an entity should choose an accounting policy, to be applied consistently, on whether such hedges are considered hedges of a financial item or non-financial item.

7A.9.470.40 For hedges of a financial item, the accounting for the reclassification from equity to profit or loss is complicated by the fact that the shares acquired are not recognised in the consolidated financial statements and therefore will never directly impact profit or loss. However, for hedges of financial and non-financial items, the effective portion of the gain or loss arising from the hedging instrument relates to the foreign currency equivalent of the consideration paid. Therefore, recognition of the effective portion of the gain or loss arising from the hedging instrument in profit or loss occurs when the residual (i.e., goodwill) arising from the business combination affects profit or loss.

7A.9.470.60 In our view, if the hedge is a hedge of a non-financial item, then the entity should recognise the gain or loss from the hedging instrument recognised in OCI as an adjustment to goodwill when the business combination occurs.

7A.9.470.70 In our view, a hedge of a firm commitment to acquire a business or a forecast business combination that will be effected through the acquisition of the assets and liabilities that comprise the business – rather than the acquisition of an equity interest in the entity –

should be accounted for as a hedge of a non-financial item because the legal form of the transaction does not involve the acquisition of a financial asset.

Ernst & Young LLP
International GAAP 2018

4.4 Hedges of a firm commitment to acquire a business

A firm commitment to acquire a business in a business combination cannot be a hedged item, except for foreign exchange risk (see 2.2.5 above).

Consider the situation where an entity with euro as its functional currency enters into a binding agreement to purchase a subsidiary in six months. The subsidiary's functional currency is the US dollar. The consideration is denominated in US dollars and is payable in cash. The entity decides to enter into a forward contract to buy US dollars for euros to hedge its foreign currency risk on the firm commitment. The following options exist and the entity may choose the most appropriate accounting treatment:

- Because the hedge is a *purchase* of US dollars, it is, arguably, not a fair value hedge of the acquisition, since the acquisition is itself naturally hedged for changes in the fair value in the US dollar – that is, the entity is committed to buy a group of US dollar denominated assets and liabilities for a price denominated in US dollars. Nevertheless, the entity may still designate the transaction as the hedged item in a fair value hedge relationship, [IAS 39.87], although this may not make intuitive sense.
- The entity could instead designate the forward contract as a hedge of the cash flows associated with the committed purchase, which is a cash flow hedge. [IAS 39.87]
- If the anticipated business combination in this example is only a highly probable forecast transaction and not a firm commitment, then the entity can only apply cash flow hedging.

If the transaction is a fair value hedge, then the carrying amount of the hedged item is adjusted for the gain or loss attributable to the hedged risk. Since separately identifiable assets acquired and liabilities assumed must be recognised on initial consolidation at fair value in the consolidated financial statements of the acquirer, it follows that the gain or loss attributable to the hedged risk must be included in the consideration paid. In other words, the impact of the hedge affects the calculation of goodwill, that is otherwise determined by the application of IFRS 3 – Business Combinations – see Chapter 9 at 6.[13]

During the hedging period, the effective portion of the gain or loss on a hedging instrument in a cash flow hedge is recognised in other comprehensive income. Upon initial recognition of the acquisition, gains or losses recognised in other comprehensive income may be:

- Deferred in other comprehensive income until the goodwill acquired affects profit or loss; or
- Included in the consideration paid for the business combination that is designated as the hedged item. [IAS 39.98].

The adjusted carrying amount of goodwill, including the gain or loss from hedge accounting, will then be subject to the normal requirements to test for annual impairment (see Chapter 20 at 5).

Once the purchase price is paid and the transaction is completed, the entity is 'long' US dollars as a result of recognising the US Dollar net assets of the acquired entity. Those net assets would then be eligible for net investment hedging which would require selling US dollars to create an eligible hedging instrument, for example by entering into a foreign currency forward (see 3.3 and 4.3 above).