Mergers & acquisitions — a snapshot
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Financial risk management considerations in an acquisition

The acquisition of a business can have a significant impact on both the risk exposures and risk management strategies of the combined entity. In many cases, an acquirer’s financial risk exposure will increase as a result of the acquisition. However, there may be situations in which the acquiree’s operations reduce the acquirer’s current risk exposure. In any event, identifying potential changes in enterprise risks, creating an action plan to address them, and managing changes to risk management strategies post-acquisition are critical to developing short- and long-term solutions for integrating financial risk management considerations in an acquisition.

This edition of Mergers & acquisitions — a snapshot, provides insight on financial risk management considerations an acquirer should evaluate prior to the acquisition as well as steps to consider in developing a financial risk management plan post-acquisition.

¹ Accounting Standards Codification 805 is the US standard on business combinations, and Accounting Standards Codification 810 is the US standard on noncontrolling interests (collectively the “M&A standards”).
What is the new risk exposure?

An acquiree’s financial risk exposure often adds to the acquirer’s risk, creating the new risk exposure of the combined entity. New financial risks can arise from expanding the geographic reach of the combined entity, broadening its customer base through acquired product lines or new services, and inheriting new or unique contract terms. New exposures to foreign currencies and government policies can be particularly challenging.

Another source of financial risk exposure is acquired financial instruments. For instance, variable rate liabilities can change the interest rate risk profile of the combined entity. Other financial instruments, such as investments and derivatives, can introduce credit risk, liquidity risk, and other additional risks at the combined entity that did not previously exist at the acquirer.

Additionally, an acquisition may result in the acquirer being exposed to a greater concentration of counterparty credit risk that did not previously exist. For example, if both the acquirer and the acquiree had executed derivatives with one bank, the acquisition will result in the combined entity being exposed to an elevated level of counterparty credit risk with that bank.

In some cases, the potential acquiree’s risk exposure may reduce current risk exposure of the acquirer. For example, an aluminum manufacturer that purchases aluminum based on fixed price contracts and sells its aluminum products at market rates may acquire a company that purchases its aluminum at current market rates but enters into fixed price forward sales contracts. The risk exposure created by the acquirer’s fixed price purchase contracts and the acquiree’s fixed price sales contracts will provide an economic hedge of the price risk of aluminum at the combined entity. If the level of fixed price purchase contracts approximates the level of fixed price sales contracts, the new financial risk exposure of the combined entity will be largely offset.

Determining whether new financial risks are added or existing financial risks are reduced starts with gaining a thorough understanding of the acquiree’s financial risk exposure. There are many variations on how an acquiree’s operations can increase or decrease the financial risk exposure of the combined entity. An acquirer will want to understand these acquired financial risk exposures and their impact on the combined entity.

Risk management strategies and policies

Once the inventory of new risk exposures has been developed, an important next step is an acquirer’s evaluation of its current risk management strategy, taking into account new risk exposures, as well as any reduced risk exposures. An acquirer may be willing to accept a heightened level of risk, depending on its magnitude and the acquirer’s risk tolerance. Or, the acquirer may decide to manage its overall risk exposure by entering into derivative instruments or through its natural operations.

If new instruments are contemplated for managing the combined risks, a review of banking relationships and company policies (including approval to use derivatives at the combined entity) will be a necessary part of the action plan. For example, the acquiree’s policies may allow it to trade certain types of derivatives (such as option contracts) that are not approved by the acquirer’s risk management committee, to trade with bank counterparties not previously approved by the acquirer, or to set different volume or notional limits that are not aligned with the acquirer’s policies. In such a case, the combined entity will need to establish new policies, or update existing policies, to execute derivatives, which can be a complex and time consuming exercise. If not properly planned in advance of the acquisition, an acquirer could be exposed to unwanted risk for a period of time.

An acquirer may decide to manage its overall risk exposure through its natural operations (i.e., in situations in which the new financial risk exposure of the combined entity will be reduced). In these cases, management may decide to revise its risk management strategy to manage its risk without the use of derivatives for the combined entity.

The acquirer will need to determine if there are differences between its risk management strategies and those of the acquiree. The example below illustrates a scenario in which the acquirer manages its risk centrally through a treasury center, while the acquiree does not.
Example – Integrating risk management strategies

Facts: Company A acquires Company T. Company T is exposed to foreign currency risk, and it executes forward currency derivative contracts to hedge its risk exposure. Company A is a multi-national corporation that manages the foreign currency risk of all of its entities through its central treasury center (i.e., using internal derivatives to shift foreign currency risk from the subsidiary to the central treasury center).

Analysis: Company A should evaluate how to integrate the risk management strategy of Company T into its current centralized risk management strategy. Company A will want to develop a plan to centralize Company T’s foreign currency risk exposure. Post-acquisition, Company A may consider having Company T terminate its existing derivatives and have its central treasury center execute new derivatives with third party banks. Alternatively, Company A may consider having Company T enter into internal derivatives with Company A’s central treasury center to shift the foreign currency risk from Company T to Company A’s central treasury center. Either way, this will entail changing processes in place at Company T and should be planned in advance to allow for a smooth transition upon completion of the acquisition.

Treasury systems (e.g., trading platforms) the acquiree uses to execute derivatives or administer hedging programs (e.g., software to assess effectiveness or measure ineffectiveness) may not align with those used by the acquirer. The acquirer will need to evaluate whether separate systems will be maintained or whether the systems will be transitioned to the combined entity, and what the process will be to ensure the data is transferred accurately and there are no gaps in managing the financial risk post-acquisition.

Additionally, policy elections related to financial instruments will need to be synchronized post-acquisition. For instance, the classification of investments as trading or available for sale, and the policy for recognizing derivative gains/losses in earnings may need to be aligned with the policies that will be carried out at the combined entity.

Don’t forget the accounting

While the economics of various risk management alternatives should be carefully considered, the financial statement presentation ramifications and accounting complexities should not be underestimated. For example, an acquirer may have a policy of designating derivatives as hedges to achieve a desired accounting result. If the acquiree executes derivatives to manage its risks, the acquirer will need to determine whether these acquired derivatives can be designated as a hedge post-acquisition.

Any hedging relationships the acquiree has in place will need to be re-designated as hedges if the acquirer intends to maintain them post-acquisition. Under the M&A rules, these hedges are deemed to be new hedges to the acquirer. Any re-designated hedging relationships will require new hedge documentation at the date of re-designation. Additionally, the acquirer will need to determine whether the acquired derivatives will be considered “highly effective” in order to satisfy the requirements of hedge accounting. Acquired off-market derivatives will not qualify for any of the easier to apply “qualitative” methods for assessing the effectiveness of the hedging relationships, and any re-designated off-market derivatives will often result in at least some amount of ineffectiveness, introducing earnings volatility.

If the requirements to achieve hedge accounting cannot be satisfied, the acquirer will need to weigh the alternatives of accepting the earnings volatility from non-designated derivatives against the cost of terminating the derivatives early. If stand-alone reporting continues to be required at the acquiree level, what and how hedging relationships will continue at the acquiree level should also be considered.

Given all these complexities, a plan to address the business and accounting implications for derivatives should be developed prior to acquisition. Questions to consider may include:

- Will terminating the acquired derivatives result in a cash cost?
- What are the tax implications of early termination?
- Can hedge accounting be elected on acquired derivatives?
- What are the financial reporting impacts of not designating derivatives in a hedging relationship?
- How difficult will it be to achieve a highly effective relationship?
- Does the acquirer have the resources necessary to administer hedge accounting for re-designated hedges?

Of course, this list is not all-inclusive and the weighting of factors to consider is an important part of the assessment. However, the key to success is proper planning.

Develop a plan

The foundation of a good action plan is a thorough understanding of the economic and financial reporting impacts of the various alternatives that are available to address the new risk exposures. Once a solid foundation is in place, an action plan can be developed that incorporates pre-acquisition considerations along with post-acquisition planning to ensure a smooth transition to manage the risk exposure of the combined entity.
The following table provides a summary of pre-close action items that an acquirer might consider prior to the acquisition.

<table>
<thead>
<tr>
<th>Pre-close action items</th>
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<tbody>
<tr>
<td>1) Identify the new post-combination risk exposure profile</td>
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<tr>
<td>2) Develop a plan to address the new risk management strategy (i.e., hedge risk or tolerate risk exposure)</td>
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<td>3) Communicate and train employees on any new or revised risk management strategies</td>
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<td>4) Discuss alternatives with counterparties for early termination and/or execution of new derivatives; establish new banking relationships if necessary to implement risk management strategy</td>
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<td>5) Determine if hedge accounting will/or can be elected; evaluate financial reporting impact of applying hedge accounting</td>
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<td>6) Complete hedge documentation for new or re-designated hedges</td>
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<td>7) Consider any changes to systems and personnel, including transition of employees from acquiree</td>
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<td>8) Identify new controls or changes to the existing control structure</td>
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<tr>
<td>9) Identify and communicate the financial reporting, tax, and systems implications of the proposed plan</td>
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<tr>
<td>10) Draft disclosures for the reporting period post-acquisition early to provide time for review and updates based on new risks, strategies and policies</td>
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</table>

The following table provides a summary of post-close action items that an acquirer might consider after the acquisition.

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>1) Execute new and/or terminate old derivatives necessary to manage the new risk exposure</td>
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<tr>
<td>2) Issue hedge documentation for new or re-designated hedges</td>
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<tr>
<td>3) Converge accounting policy elections for consistent application</td>
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<tr>
<td>4) Implement new systems and/or converge existing systems used in managing the new risk exposure</td>
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<tr>
<td>5) Identify ways to streamline and optimize the overall risk management process once it has been implemented</td>
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<tr>
<td>6) Implement new controls to address new or revised risk management processes</td>
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**Conclusion**

Combining risk management activities is a complex process with economic, business, and financial reporting considerations. Significant planning is needed prior to the acquisition to (1) identify the risk management strategies of the acquired entity, (2) assess the impact of the acquisition on the combined entity’s risks, (3) determine how the combined entity will manage changes to its risk profile, and (4) assess what changes to risk management strategies, accounting elections, systems, and personnel will be required. While the decisions about financial risk management can be difficult, a well thought out plan can smooth the transition and limit unexpected risks or accounting surprises.

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