Fair Value Hedge of Foreign Currency Risk on Non-Financial Assets (IFRS 9 *Financial Instruments*)—September 2019

The Committee received two requests about fair value hedge accounting applying IFRS 9. Both requests asked whether foreign currency risk can be a separately identifiable and reliably measurable risk component of a non-financial asset held for consumption that an entity can designate as the hedged item in a fair value hedge accounting relationship.

Hedge accounting requirements in IFRS 9

The objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss (or, in some cases, other comprehensive income) (paragraph 6.1.1 of IFRS 9).

If all the qualifying criteria specified in IFRS 9 are met, an entity may choose to designate a hedging relationship between a hedging instrument and a hedged item. One type of hedge accounting relationship is a fair value hedge, in which an entity hedges the exposure to changes in fair value of a hedged item that is attributable to a particular risk and could affect profit or loss.

An entity may designate an item in its entirety, or a component of an item, as a hedged item. A risk component may be designated as the hedged item if, based on an assessment within the context of the particular market structure, that risk component is separately identifiable and reliably measurable.

In considering the request, the Committee assessed the following:

Can an entity have exposure to foreign currency risk on a non-financial asset held for consumption that could affect profit or loss?

Paragraph 6.5.2(a) of IFRS 9 describes a fair value hedge as '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'.

Therefore, in the context of a fair value hedge, foreign currency risk arises when changes in exchange rates result in changes in the fair value of the underlying item that could affect profit or loss.

Depending on the particular facts and circumstances, a non-financial asset might be priced—and its fair value determined—only in one currency at a global level and that currency is not the entity's functional currency. If the fair value of a non-financial asset is determined in a foreign currency, applying IAS 21 *The Effects of Changes in Foreign Exchange Rates*, the measure of fair value that could affect profit or loss is the fair value translated into an entity's functional currency (translated fair value). The translated fair value of such a non-financial asset would change as a result of changes in the applicable exchange rate in a given period, even if the fair value (determined in the foreign currency) were to remain constant. The Committee therefore observed that in such circumstances an entity is exposed to foreign currency risk.

IFRS 9 does not require changes in fair value to be expected to affect profit or loss but, rather, that those changes could affect profit or loss. The Committee observed that changes in fair value of a non-financial asset held for consumption could affect profit or loss if, for example, the entity were to sell the asset before the end of the asset's economic life.

Consequently, the Committee concluded that, depending on the particular facts and circumstances, it is possible for an entity to have exposure to foreign currency risk on a non-financial asset held for consumption that could affect profit or loss. This would be the case when, at a global level, the fair value of a non-financial asset is determined only in one currency and that currency is not the entity's functional currency.

If an entity has exposure to foreign currency risk on a non-financial asset, is it a separately identifiable and reliably measurable risk component?

Paragraph 6.3.7 of IFRS 9 permits an entity to designate a risk component of an item as the hedged item if, 'based on an assessment within the context of the particular market structure, the risk component is separately identifiable and reliably measurable'.

Paragraph 82 of IAS 39 *Financial Instruments: Recognition and Measurement* permits the designation of non-financial items as hedged items only for a) foreign currency risks, or b) in their entirety for all risks, 'because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to specific risks other than foreign currency risks'. Paragraph BC6.176 of IFRS 9 indicates that, in developing the hedge accounting requirements in IFRS 9, the Board did not change its view that there are situations in which foreign currency risk can be separately identified and reliably measured. That paragraph states that the Board 'learned from its outreach activities that there are circumstances in which entities are able to identify and measure many risk components (not only foreign currency risk) of non-financial items with sufficient reliability'.

Consequently, the Committee concluded that foreign currency risk can be a separately identifiable and reliably measurable risk component of a non-financial asset. Whether that is the case will depend on an assessment of the particular facts and circumstances within the context of the particular market structure.

The Committee observed that foreign currency risk is separately identifiable and reliably measurable when the risk being hedged relates to changes in fair value arising from translation into an entity's functional currency of fair value that, based on an assessment within the context of the particular market structure, is determined globally only in one currency and that currency is not the entity's functional currency. The Committee noted, however, that the fact that market transactions are commonly settled in a particular currency does not necessarily mean that this is the currency in which the non-financial asset is priced—and thus the currency in which its fair value is determined.

Can the designation of foreign currency risk on a non-financial asset held for consumption be consistent with an entity's risk management activities?

Paragraph 6.4.1(b) of IFRS 9 requires that, at the inception of a hedging relationship, 'there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge'. Accordingly, the Committee observed that, applying IFRS 9, an entity can apply hedge accounting only if it is consistent with the entity's risk management objective and strategy for managing its exposure. An entity therefore cannot apply hedge accounting solely on the grounds that it identifies items in its statement of financial position that are measured differently but are subject to the same type of risk.

To the extent that an entity intends to consume a non-financial asset (rather than to sell it), the Committee observed that changes in the fair value of the non-financial asset may be of limited significance to the entity. In such cases, an entity is unlikely to be managing and using hedging instruments to hedge risk exposures on the non-financial asset and, in that case, it cannot apply hedge accounting.

The Committee expects that an entity would manage and hedge exposure to foreign currency risk on the fair value of non-financial assets held for consumption only in very limited circumstances—in such circumstances, an entity would use hedging instruments to hedge only foreign currency risk exposure that it expects will affect profit or loss. This may be the case, for example, if (a) the entity expects to sell the non-financial asset (eg an item of property, plant and equipment) part-way through its economic life; (b) the expected residual value of the asset at the date of expected sale is significant; and (c) the entity manages and uses hedging instruments to hedge the foreign currency risk exposure only on the residual value of the asset.

Furthermore, the Committee observed that risk management activities that aim only to reduce foreign exchange volatility arising from translating a financial liability denominated in a foreign currency applying IAS 21 are inconsistent with the designation of foreign exchange risk on a non-financial asset as the hedged item in a fair value hedge accounting relationship. In such circumstances, the entity is managing the foreign currency risk exposure arising on the financial liability, rather than managing the risk exposure arising on the non-financial asset.

Other considerations

An entity applies all other applicable requirements in IFRS 9 in determining whether it can apply fair value hedge accounting in its particular circumstances, including requirements related to the designation of the hedged item and hedging instrument, and hedge effectiveness. For example, an entity would consider how its hedge accounting designation addresses any differences in the size, depreciation/amortisation pattern and expected sale/maturity of the hedged item and the hedging instrument.

For any risk exposure for which an entity elects to apply hedge accounting, the entity also makes the disclosures required by IFRS 7 *Financial Instruments: Disclosures* related to hedge accounting. The Committee noted, in particular, that paragraphs 22A–22C of IFRS 7 require the disclosure of information about an entity's risk management strategy and how it is applied to manage risk.

The Committee concluded that the principles and requirements in IFRS 9 provide an adequate basis for an entity to determine whether foreign currency risk can be a separately identifiable and reliably measurable risk component of a non-financial asset held for consumption that an entity can designate as the hedged item in a fair value hedge accounting relationship. Consequently, the Committee decided not to add the matter to its standard-setting agenda.