STAFF PAPER

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Project	**Fair value hedge of foreign currency risk on non-financial assets (IFRS 9)**
Paper topic	Initial consideration

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Introduction

1. The IFRS Interpretations Committee (Committee) received two submissions about fair value hedge accounting applying IFRS 9 *Financial Instruments*. Both submissions 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.

2. The objective of this paper is to:

   (a) provide the Committee with a summary of the matter;

   (b) present our research and analysis; and

   (c) ask the Committee whether it agrees with our recommendation not to add this matter to its standard-setting agenda.

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Structure of the paper

3. This paper includes:
   (a) background information;
   (b) summary of outreach;
   (c) staff analysis; and
   (d) staff recommendation.

4. There are two appendices to the paper:
   (a) Appendix A—proposed wording of the tentative agenda decision; and
   (b) Appendix B—submissions.

Background information

Summary of IFRS 9 hedge accounting requirements

5. The objective of the hedge accounting requirements in IFRS 9 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 other comprehensive income). This approach aims to convey the context of hedging instruments for which hedge accounting is applied in order to allow insight into their purpose and effect.

6. In addition to this objective, an entity must meet the other specific hedge accounting requirements in IFRS 9 in order to qualify for hedge accounting. If those requirements are met, an entity may choose to designate a hedging relationship between a hedging instrument and a hedged item and apply hedge accounting. 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.

7. An entity may designate an item in its entirety, or a component of an item, as a hedged item. Such a component may comprise only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component). Applying paragraph 6.3.7 of IFRS 9, an entity may designate a risk component 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.

Background to the submissions

8. The submissions consider the application of the hedge accounting requirements in IFRS 9 to foreign currency risk exposures that might arise on non-financial assets in particular situations. The submitters provided two examples of fact patterns, which we summarise in the following paragraphs.

Example 1—Property, Plant and Equipment

9. Purchases and sales of some non-financial assets—such as some kinds of aircraft, ships and heavy machinery—are routinely denominated in a particular currency (in this fact pattern, USD). Entity A has a non-USD functional currency and owns such an asset for use in its operations. The entity applies IAS 16 *Property, Plant and Equipment* and measures the asset (PPE asset) using the cost model.

10. Although the PPE asset is measured at cost, changes in its fair value could affect profit or loss if (a) the entity sells the asset part way through its economic life, or (b) the asset becomes impaired and the resulting impairment loss reflects a reduction in the asset's carrying amount to its fair value less costs of disposal.

11. Entity A considers whether it could designate a foreign currency risk component of the PPE asset as the hedged item in a fair value hedge accounting relationship. The hedging instrument could be a financial liability denominated in USD—for example, a loan or a lease liability—which may be unrelated to the purchase of the PPE asset.

Example 2—Commodity inventory

12. Entity B has a non-USD functional currency and holds commodity inventory (in this fact pattern, copper) that it has purchased in an established market in USD. The entity consumes the copper inventory as part of its production process by incorporating it into its products, which are then sold in the entity's functional currency.

13. There is no established market where copper is traded in Entity B's functional currency and the entity has access only to a market in which copper is bought and sold in USD. Although the entity does not expect to sell any of its copper inventory, changes in the fair value of the inventory could affect profit or loss if it decides to do so.

14. Entity B considers whether it could designate a foreign currency risk component of the copper inventory as the hedged item in a fair value hedge accounting relationship during a period of time before it consumes the inventory. Entity B would designate a forward contract that pays USD and receives Entity B's functional currency as the hedging instrument.

Additional background—lease liabilities denominated in a foreign currency

15. One submitter said, because IFRS 16 *Leases* results in the recognition of additional lease liabilities in a lessee's balance sheet, entities with significant foreign currency leases are concerned about foreign currency volatility that will arise from translating these liabilities into their functional currency applying IAS 21 *The Effects of Changes in Foreign Exchange Rates*. Those entities are seeking to mitigate that volatility in different ways.

16. The submitter said they are aware of several entities looking to designate lease liabilities denominated in a foreign currency as the hedging instrument in a fair value hedge accounting relationship, such as the one described above in paragraphs 9–11 of this paper. If fair value hedge accounting is achieved, the entity would adjust the carrying amount of the hedged non-financial asset for the hedged USD risk to the extent that the non-financial asset has been hedged and the hedge is effective. The entity would recognise the resulting hedging gain or loss on the hedged item in profit or loss where it

would offset the effects of the gain or loss on translating foreign currency lease liabilities applying IAS 21.

The question in the submissions

17. The questions in the submissions can be summarised as whether an entity can designate a fair value hedge accounting relationship applying IFRS 9 in fact patterns such as those illustrated above. More specifically, can an entity designate foreign currency risk as a separately identifiable and reliably measurable risk component of a non-financial asset as the hedged item, even though the asset is held for consumption?

18. The submitters describe two views on the matter, which are reproduced in Appendix B to this paper.

Summary of outreach

19. We sent information requests to members of the International Forum of Accounting Standard-Setters, securities regulators, and large accounting firms.

20. The request asked those participating to provide information about whether, based on their experience:

    (a) fact patterns such as those described in the submissions are common and, if so, in which industries and for which types of non-financial assets they are common; and

    (b) if the fact patterns are common, how do entities demonstrate that the hedge accounting requirements in IFRS 9 are met.

21. We received 11 responses—five from national standard-setters, four from large accounting firms and two from organisations representing groups of regulators. The views received represent informal opinions and do not reflect the official views of those respondents or their organisations. We also received an unsolicited response from a trade organisation representing the airline industry.

Findings from outreach

22. All respondents said fact patterns such as those described in the submissions are not common.

23. However, some respondents noted that the matter is emerging as a result of the application of IFRS 16. Some respondents also said they are aware of entities in the airline industry considering the designation of hedge accounting relationships, such as the relationship described in one of the submissions (paragraphs 9–11).

24. Some respondents provided information about how entities demonstrate that the hedge accounting requirements in IFRS 9 are met for particular fact patterns. Some respondents also provided their views on the matter. Most of the information provided is similar to that included in the submissions (see Appendix B to this paper).

Staff Analysis

Should the Committee address the matter?

25. Although the matter described in the submission is not yet common, the responses to our outreach indicate that it might become so. We also think addressing the matter would contribute to the objective of helping stakeholders obtain a common understanding of the hedge accounting requirements in IFRS 9.

26. Therefore, we recommend that the Committee address the matter identified in the submissions. Rather than considering specific fact patterns that are not yet common, we think the Committee could be more helpful by considering more generally whether and how the hedge accounting requirements in IFRS 9 apply to foreign currency risk on non-financial assets.

Analysis of the requirements in IFRS 9

27. In approaching the matter described in paragraph 26, we have considered the following aspects, in order:

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

    (b) *risk component*—if there is foreign currency risk exposure, is it a separately identifiable and reliably measurable risk component?

    (c) *risk management activities*—can the designation of foreign currency risk on a non-financial asset held for consumption be consistent with an entity's risk management activities?

Exposure to foreign currency risk

28. The submitters ask the question in the context of fair value hedge accounting. 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** (bold added).

29. Fair value is a market-based measurement, and therefore the functional currency of the entity holding the underlying item is irrelevant to its measurement. In contrast, foreign currency risk, by definition, arises only with respect to a particular entity and its functional currency.

30. Depending on the particular facts and circumstances, a non-financial asset may be priced—and its fair value determined—only in a currency other than the holding entity's functional currency. The currency in which a non-financial asset is priced may be different from the currency used for the settlement of market transactions, because the currency chosen for settlement purposes does not affect the determination of fair value of the non-financial item. In other words, 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.

31. In the context of a fair value hedge, exposure to foreign currency risk arises when changes in foreign exchange rates result in changes to the fair value of the underlying item that could affect profit or loss. Applying IAS 21, if the fair value of a non-financial asset is determined in a foreign currency (as described in paragraph 30), 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 foreign exchange rate in a given period, even if the fair value (determined in the foreign currency) were to remain constant. Therefore, in such circumstances, an entity is exposed to foreign currency risk.

32. The holding entity's intention to consume or to sell the asset in the future does not affect how market participants determine the fair value of that asset. Therefore, changes in the fair value of the non-financial asset can occur regardless of whether the entity holds the non-financial asset for consumption or for sale.

33. IFRS 9 does not require that changes in fair value are expected to affect P&L, only that they *could* affect P&L. This is evident from the example in paragraph B6.5.1 of IFRS 9. That paragraph describes, as an example of a fair value hedge, the hedge of exposure to changes in the fair value of a fixed-rate debt instrument arising from changes in interest rates. Entities that hold such instruments within a business model whose objective is to collect contractual cash flows can apply fair value hedge accounting even though those entities may not expect changes in fair value of the instruments to affect profit or loss. Similarly, 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.

34. Therefore, depending on the particular facts and circumstances, it is possible for exposure to changes in fair value attributable to foreign currency risk that *could* affect profit or loss

to exist on a non-financial asset held for consumption. This would be the case when the fair value of a non-financial asset is determined only in a foreign currency.

Risk component

35. Paragraph 6.3.7 of IFRS 9 permits an entity to designate a risk component 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.

36. Previously, paragraph 82 of IAS 39 *Financial Instruments: Recognition and Measurement* had allowed designation of non-financial items as hedged items only for foreign currency risks, or in their entirety for all risks. The same paragraph explained this is because of the difficulty of isolating and measuring the appropriate portion of cash flows or fair value changes attributable to specific risks other than foreign currency risks. Those requirements suggest that there are situations in which foreign currency risk can be separately identified and reliably measured for non-financial items.

37. Paragraph BC6.176 of IFRS 9 indicates that the Board did not change its view in this respect. It states that 'the IASB 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'. Therefore, the Board went a step further when developing IFRS 9 by allowing the designation of any risk component (including foreign currency) if it is separately identifiable and reliably measurable within the context of the particular market structure.

38. As explained in paragraph 31 of this paper, when the fair value of a non-financial asset can be determined *only* in a foreign currency, the translated fair value of the non-financial asset is subject to foreign currency risk. An entity can separately identify and reliably measure the effect of changes in foreign exchange rates on the translation of fair value determined in that foreign currency.

39. Depending on the particular facts and circumstances, the fair value of a non-financial asset may also change as a result of changes in foreign exchange rates other than as a

result of translation. We have not analysed such situations because they are outside the scope of the submissions.

40. In our view, foreign currency risk *can* be a separately identifiable and reliably measurable risk component of a non-financial asset. However, that depends on an assessment within the context of the particular market structure, based on the relevant facts and circumstances. Nonetheless, we think foreign currency risk is separately identifiable and reliably measurable when the risk being hedged relates to changes in fair value arising from the translation into an entity's functional currency of a fair value that can be determined only in a foreign currency.

Risk management activities

41. As explained in paragraph 5, the objective of the hedge accounting requirements in IFRS 9 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 other comprehensive income). In particular, paragraph 6.4.1(b) requires that, at the inception of the 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. This includes identification of the hedged item and hedging instrument, and the extent to which the relationship is expected to be effective.

42. 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. Therefore, an entity cannot apply hedge accounting solely on the basis that it identifies items in its balance sheet that are measured differently but are subject to the same type of risk.

43. To the extent that an entity intends to consume a non-financial asset, rather than to sell it, changes in the fair value of the non-financial asset may be of limited significance to the entity. In such cases, an entity may not manage or hedge such risk exposures and, in that case, it cannot apply hedge accounting applying IFRS 9.

44. It may be argued that, because an entity can apply fair value hedge accounting to a fixed-rate debt instrument not held for sale (see paragraph 33 above), a similar hedge designation can also be made for non-financial assets that are not held for sale.

45. As explained in paragraph B6.6.16 of IFRS 9, the objective of a hedge of a fixed-rate debt instrument is not primarily to offset the fair value change of the hedged item but, instead, to transform the cash flows of the hedged item. Such a hedge can therefore be consistent with an entity's risk management strategy. However, a similar hedging strategy is not applicable to non-financial assets because they do not produce cash flows directly.

46. We expect that an entity would manage and hedge exposures to changes in fair value of non-financial assets held for consumption only in very limited circumstances. This may be the case, for example, if (a) the non-financial asset is priced, and its fair value determined, only in a foreign currency; (b) the entity has an established practice of selling the non-financial asset (eg a PPE asset) part-way through its economic life; (c) the expected residual value of the asset at the date of sale is significant; and (d) the entity manages the foreign currency exposure only on the residual value of the item.

47. Finally, we note that changing the accounting for lease contracts does not change an entity's exposure to the risks arising from such contracts. Therefore, we would not expect an entity's risk management activities to change simply because of a change in accounting requirements.

Other considerations

48. In this paper, we analysed only the applicable requirements in IFRS 9 related to 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.

49. However, an entity also 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 hedging instruments

and hedge effectiveness. For example, an entity would consider how its hedge accounting designation addresses differences in the size, depreciation/amortisation pattern and expected sale/maturity of the hedged item and the hedging instrument.

50. For any risk exposure for which an entity elects to apply hedge accounting, an entity also applies the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* related to hedge accounting. In particular, we highlight those that require the disclosure of information about the entity's risk management strategy and how it is applied to manage risk (paragraphs 22A–22C of IFRS 7).

Question 1 for the Committee
Does the Committee agree with our analysis of the hedge accounting requirements in IFRS 9, outlined in paragraphs 27–50 of this paper?

Should the Committee add this matter to its standard setting agenda?

Is it necessary to add to or change IFRS Standards to improve financial reporting?[1]

51. Based on our analysis in paragraphs 27–50 of this paper, we think that IFRS 9 provides an adequate basis for an entity to conclude on 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.

[1] Paragraph 5.16(b) of the *Due Process Handbook*.

Staff recommendation

52. Based on our assessment of the Committee's agenda criteria in paragraphs 5.16-5.17 of the Due Process Handbook (discussed in paragraph 51 above), we recommend that the Committee does not add this matter to its standard-setting agenda. Instead, we recommend publishing a tentative agenda decision that outlines how an entity applies the applicable hedge accounting requirements in IFRS 9.

53. Appendix A to this paper outlines the proposed wording of the tentative agenda decision.

Questions 2 and 3 for the Committee
2. Does the Committee agree with our recommendation not to add this matter to its standard-setting agenda? 3. Does the Committee have any comments on the proposed wording of the tentative agenda decision outlined in Appendix A to this paper?

Appendix A—proposed wording of the tentative agenda decision

Fair value hedge of foreign currency risk on non-financial assets (IFRS 9 *Financial Instruments*)

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 other comprehensive income).

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) 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 may be priced—and its fair value determined—only in a currency other than an 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 the fair value of a non-financial asset is determined only in a foreign 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 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, that 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 foreign currency risks, or in their entirety for all risks, because of the difficulty of isolating and measuring the appropriate

portion of 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 IASB 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 can be determined only in a foreign 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) 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 basis 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 may not be managing or hedging risk exposures on the non-financial asset and, in that case, it cannot apply hedge accounting.

The Committee also observed that a change in accounting requirements, such as that which arises from IFRS 16 *Leases*, does not change an entity's exposure to risks. Therefore, an entity's risk management activities would not be expected to change simply because of a change in accounting requirements.

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 hedging instruments 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, an entity also applies the disclosures requirements in IFRS 7 *Financial Instruments: Disclosures* related to hedge accounting. The Committee noted, in particular, those in paragraphs 22A–22C of IFRS 7 that require the disclosure of information about the entity's risk management strategy and how it is applied to manage risk.

The Committee concluded that the requirements in IFRS 9 provide an adequate basis for an entity to conclude on 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.

Appendix B—submissions

B1. We have reproduced the submissions below, and in doing so deleted details that would identify the submitters of the request. We have only reproduced information relevant to the matter discussed in this paper.

Submission A

In the context of a fair value hedge, how should an entity determine whether foreign currency is a separately identifiable and reliably measurable risk component of non-monetary assets such as property, plant and equipment ('PP&E')? In particular, is it sufficient that sales and purchases of similar assets are currently routinely denominated in USD and the entity's functional currency is non-USD?

Background

The application of IFRS 16 will result in the recognition of additional lease liabilities. Where these are denominated in a foreign currency (i.e. a currency other than the entity's functional currency), the application of IAS 21 will require these lease liabilities to be translated into the entity's functional currency at the spot rate at the reporting date, resulting in additional foreign currency gains and losses being recognised in profit or loss.

As a result, some entities are reconsidering their hedging strategy and whether hedge accounting might be applied. One particular hedge being considered is to designate the lease liability as a hedging instrument in a fair value hedge of the foreign currency risk in owned PP&E, in particular where the lease liability is denominated in USD and sales and purchases of similar assets are routinely denominated in USD. Examples could include some kinds of aircraft, ships and heavy machinery.

We are seeking clarification of how to identify whether foreign currency risk is a separately identifiable and reliably measureable component that could be designated as the hedged risk in a fair value hedge of a non-financial item such as PP&E.

Please note:

(a) for the purposes of this submission it is assumed the proposed hedged item is PP&E that is owned by the entity, rather than a right of use asset that arises from a lease;

(b) a core principle of hedge accounting under IFRS 9 is that the hedge is in line with the entity's risk management strategy. For the purposes of this submission it is assumed that this is the case, though we note this will need to be demonstrated in the particular facts and circumstances;

(c) this submission assumes the entity has adopted IFRS 9. The same question could arise for entities that choose to continue to apply IAS 39's hedge accounting requirements, but we think the analysis would be substantially the same;

(d) this submission considers fair value hedge accounting. It might be possible to designate a cash flow hedge of the future sale of the PP&E where the necessary criteria are met (including that the forecast sale is highly probable). This is not considered in this submission as in practice we understand the necessary criteria are often not met.

Sales and purchases of certain assets, such as some kinds of aircraft, ships and heavy machinery, are routinely denominated in a particular currency e.g. USD. Where an entity owns such an asset for use in its business operations, it will typically meet the definition of property, plant and equipment ('PP&E') in IAS 16 and, unless the revaluation model in IAS 16 para 31 is applied, be measured at depreciated cost less impairment. Nevertheless, changes in the fair value of the PP&E could affect profit or loss. Examples include: where the PP&E is expected to be sold part way through its useful economic life (via gains and losses on sale); and where the asset becomes impaired and the resulting impairment loss reflects the asset's fair value (i.e. fair value is higher than value in use). Where sales and purchases of similar assets are routinely denominated in a particular currency e.g. USD, some entities with a non-USD functional currency are considering designating a hedge for a USD risk component of the fair value.

The hedging instrument could be any of USD lease liabilities, USD loans or USD derivatives. However, given IFRS 16 will result in the recognition of additional lease liabilities, we are aware of a number of entities looking to designate foreign currency lease liabilities as the hedging instrument. If fair value hedge accounting is achieved, the carrying value of the hedged PP&E would be adjusted for the hedged USD risk to the extent the PP&E has been hedged and the hedge is effective. The resulting hedging gain or loss is recognised in profit or loss where it will offset the gains and losses from retranslating the USD lease liabilities. Any remaining exposure to changes in the fair value of the PP&E would remain unrecognised unless and until the PP&E is sold or impaired to its fair value.

IFRS 9 para 6.3.7(a) requires that for a risk component[2] to be designated as the hedged item, that risk component must be "separately identifiable and reliably measurable". Further guidance is given in IFRS 9 paras B6.3.8-B6.3.15. Questions have arisen as to how to apply that requirement in the case above. In particular, for there to be a separately identifiable and reliably measurable risk component in a fair value hedge, is it sufficient that sales and purchases of similar assets are currently routinely denominated in USD and the entity's functional currency is non-USD?

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[2] This paragraph describes a risk component as "changes in the cash flows or fair value of an item attributable to a specific risk or risks"

It has come to our attention that this hedging strategy is being actively pursued by certain industries (see IATA paper in the Appendix).

Question:

In the context of a fair value hedge, how should an entity identify whether foreign currency is a separately identifiable and reliably measurable risk of non-monetary assets such as property, plant and equipment ('PP&E')? In particular, is it sufficient that sales and purchases of similar assets are currently routinely denominated in USD and the entity's functional currency is non-USD?

View 1: Where sales and purchases of similar assets are routinely denominated in USD and this is different to an entity's functional currency, this is sufficient to support there being a separately identifiable and reliably measurable risk component.

Arguments for this view include:

1. When both new and used items of the PP&E are routinely bought and sold in USD, regardless of where they are manufactured or sold, there is an inherent foreign currency component/risk in the PP&E for entities who have a non-USD functional currency. This is because when measuring the fair value in functional currency terms, the entity will take a USD price and translate it into its functional currency. Hence the USD:functional currency exchange rate is a component or 'building block' in establishing the fair value in the entity's functional currency.
2. Foreign currency was a permitted hedgeable risk under IAS 39 para 82 which states "if the hedged item is a non-financial asset or non-financial liability, it shall be designated as a hedged item (a) for FX risk or (b) in its entirety for all risks". IFRS 9 has now introduced the concept of hedging other components of non-financial items based on "an assessment within the particular market structure" (IFRS 9 6.3.7(a)), but there is nothing specific in the standard to suggest that foreign currency is no longer a hedgeable component.
3. Consistent with IAS 39 IG F.3.6, a non-monetary item - specifically a commodity held as inventory - can be the hedged item in a fair value hedge because the fair value will have an impact on profit or loss when the hedged item is sold or impaired. Gains and losses reported through profit or loss as a result of such sales or impairments will include the effect of changes in foreign currency rates applied to the USD market value. Although most of the IGs (including IG F.3.6) have been removed in IFRS 9, the IASB has stated that this does not mean the guidance is no longer relevant.
4. IFRS 9 para 6.5.2(a) requires only that the exposure in a fair value hedge must be attributable to a particular risk that '*could* affect profit or loss'. Sales or impairments of the PPE 'could' result in foreign currency impacts on profit or loss even if they are unlikely (for example if the PP&E is not

expected to be sold for several years by which time its fair value will likely have declined due to use).

View 2 – An assessment of the particular market structure for how the asset is priced must evidence that USD is a building block of the quoted (USD) price. It is not sufficient that sales and purchases of similar assets are routinely denominated in USD and the entity's functional currency is non-USD.

Arguments for this view include:

1. IFRS 9 para 6.3.7(a) requires for a risk component to qualify as a hedged item, that the risk component is separately identifiable and reliably measurable. The assessment of whether this is the case is "based on an assessment within the particular market structure" (IFRS 9 6.3.7(a)). The fact that an item is routinely bought and sold in USD, is not of itself sufficient. Rather, to demonstrate the necessary market structure (such that the USD would be a hedgeable component), IFRS 9 takes a "building block" approach – as illustrated by the examples in B6.3.10. This would require an entity to demonstrate that USD is one of the building blocks or components of the USD market price/fair value. (Whether this is the case will require a separate analysis that is not addressed in this submission, though for many assets would seem questionable.)
2. Fair value is a market-based measurement, not an entity-based measurement (IFRS 13.2). This means that fair value is measured using the assumptions that market participants would use when pricing the PP&E. A key consideration in this context is that for there to be a separately identifiable and measurable USD component in the fair value, it must exist independently from the functional currency of a particular market participant.
3. It follows that translation of the USD price of the PP&E to the functional currency of an entity should not change the existence of such a hedgeable component. Rather, translating the USD price into the entity's functional currency is merely a retranslation under IAS 21 - i.e. is expressing the value in functional currency terms for financial reporting purposes. This is different from there being a USD hedgeable component of the fair value. Under view 1, which (if any) FX risk is a hedgeable component depends on the entity's functional currency (e.g. for a euro functional currency entity under view 1 there would be hedgeable USD/euro risk; for a GBP functional currency entity there would be hedgeable USD/GPB risk; and for a USD functional currency there might be no hedgeable FX risk component). This is inconsistent with IFRS 9's view of what is a hedgeable *risk* component that requires an assessment of "the particular market structure", and with the examples in para B6.3.10 that all look to how the market price is determined.

4. IAS 39 IG F.6.5 makes it clear that an entity with a non-USD functional currency cannot apply fair value hedge accounting to a hedge of the foreign currency risk in a ship because "there is no separately measurable foreign currency risk", even though many types of ships are routinely bought and sold in USD. Whilst there is additional guidance in IFRS 9 on eligible risk components (including replacing the words "separately measurable [foreign currency] risk" with "separately identifiable and reliably measurable") there is no change in the underlying principle. And although most of the IGs (including IG F.6.5) have been removed in IFRS 9, the IASB has stated that this does not mean the guidance is no longer relevant.

Reasons for the Committee to address the issue

We believe that entities with significant foreign currency leases have become more aware of and concerned about their exposure to foreign currency volatility as a result of IFRS 16's requirement to record lease liabilities on balance sheet and are therefore seeking to mitigate that volatility in different ways.

We understand that fair value hedges of foreign currency risk in non-monetary assets is being widely considered in certain industries (see IATA paper in the Appendix). We are aware that both of the views set out above have been put forward and hence there is a risk of diversity in practice developing.

We believe that the issue is narrow enough that it could be addressed by confirming how to identify whether foreign currency risk is a separately identifiable and reliably measurable as described above. Furthermore, this issue will not be addressed by any of the IASB's current agenda projects and hence a solution would likely be effective for a reasonable period. We therefore believe that this meets the criteria for acceptance onto the Committee's agenda.

Given the effective date of IFRS 16 is accounting periods beginning on or after 1 January 2019, we would encourage the IFRS IC to address this issue as quickly as possible.

Appendix – IATA paper

See separate attachment or https://www.iata.org/whatwedo/workgroups/Documents/IAWG/IFRS-9-Hedges-of-foreign-currency-risk-in-owned-aircraft.pdf

Submission B

Suggested agenda item: Fair value hedge accounting a physical non-financial asset for foreign currency risk under IFRS 9 *Financial Instruments*

It has come to our attention that there are diverse views on whether it is acceptable to apply fair value hedge accounting to a physical non-financial asset for foreign currency risk under IFRS 9. We are seeking clarification by the Committee of the issue detailed below.

Background

Under IFRS 9 an entity may designate a foreign currency risk component of a recognised asset as the hedged item if that component is separately identifiable and reliably measurable. [IFRS 9:6.3.1 & 6.3.7] This submission considers whether it is possible to identify a foreign currency risk component in a physical non-financial asset. For illustrative purposes only we have used copper inventory as the hedged recognised asset, however, the principles in this paper equally apply to other physical non-financial assets where the market structure supports the identification of a foreign currency risk component.

Fact pattern for illustrative purposes only

Entity A holds copper inventory which it has purchased in an established market place in USD. The copper is consumed as part of the entity's production processes. The output from Entity A's production is sold in its functional currency, LCY (LCY is used to denote a currency other than USD). There are no established market places where copper is traded in LCY.

The quantity of copper inventory held at the beginning of the financial period is 200 tonnes valued at $5,000 per tonne, equating to a total value of $1 million. Entity A only has access to markets where copper is bought and sold in USD which is also the principal market for copper (per IFRS 13 definition). Consequently, Entity A considers itself exposed, from holding the copper inventory, to both (1) copper price risk in USD and (2) foreign currency risk from translating the USD copper price to LCY. It considers this a risk that would affect profit or loss if the copper inventory was sold. For example, assume on 1 January 20X1 the entity purchased 200 tonnes of copper at a spot price of $5,000 per tonne which it holds on balance sheet at cost. At the end of the month on 31 January 20X1 it sells that copper at the spot price of $5,000 per tonne. In this scenario Entity A is exposed to changes in the LCY:USD exchange rate from 1 January 20X1 to 31 January 20X1, on $1 million and recognises a gain or loss from any change in the exchange rate upon sale of the inventory. This is illustrated in the table below which shows that despite the copper price not changing over the month, the value of Entity A's copper inventory has changed from LC0.8 million to LC0.9 million resulting in a gain of LC0.1 million which would be recognised in profit or loss if Entity A sold that inventory on 31 January 20X1.

	1 January 20X1	31 January 20X1
Spot copper price in USD	5,000	5,000
Fair value of 200 tonnes of copper in USD	$1 million	$1 million
LCY:USD exchange rate	0.8	0.9
Fair value of 200 tonnes of copper in LCY	LC0.8 million	LC0.9 million

Entity A wishes to hedge the LCY:USD risk on a portion of its inventory held. All inventory held is expected to be consumed in the business and incorporated into products that are sold in LCY. No sales of the copper inventory are expected. Because of potential fluctuations in the USD value of its copper inventory and potential variations in the amount of copper consumed each month, the entity's hedging policy is to hedge less than the total USD value of copper inventory that it holds at any one time.

Assume that Entity A hedges $200k of the value of 50 tonnes of its copper inventory held at cost for the period from 1 January 20X1 to 30 June 20X1 using a forward contract that pays $200k and receives LC160k on 30 June 20X.[3] The designated copper inventory is held for the whole period of the hedge (i.e. it is not consumed during the 6 months of the hedge). It should be assumed that the value of copper inventory designated in the hedge is not expected to, and does not, fall below $200k.

Entity A wishes to designate this forward contract in a fair value hedge of $200k of the value of 50 tonnes of copper inventory held for changes in LCY:USD foreign currency risk for the period from 1 January 20X1 to 30 June 20X1. This hedge is in accordance with Entity A's risk management strategy which imposes limits on the fixing of foreign currency exposures arising from advance purchases of copper, i.e. purchasing copper in advance of it being consumed means the entity has locked in the LCY:USD exchange rate and cannot benefit from any future strengthening of LCY. Fair value hedging the LCY:USD risk on a portion of the inventory held reverses this fixing of the exchange rate.

Questions

This submission considers whether a fair value hedge of a physical non-financial asset is permitted under IFRS 9.

[3] This represents a hedge of $4,000 value of each of the 50 tonnes of copper (50*$4,000=$200k).

The relevant IFRS 9 hedge accounting requirements are consistent with IAS 39 *Financial Instruments: Recognition and Measurement*. Consequently, the implementation guidance of IAS 39 has been considered in the application of the relevant hedge accounting requirements under IFRS 9.

To answer this question the following two sub-questions are considered. If the answer to both questions is View A, then a fair value hedge of a physical non-financial asset is permitted under IFRS 9.

Question 1: Is a fair value hedge of a physical non-financial asset for an eligible risk (e.g. all price risk) permitted if the entity does not intend, or expect, to sell the asset but instead plans to consume it?

View A – Yes

In order for a fair value hedge of a physical non-financial asset to be eligible, the hedged risk must be a risk that *could* affect profit or loss. [IFRS 9:6.5.2(a)] The change in fair value of a physical non-financial asset for a particular risk would affect profit or loss if that asset was sold (i.e. the difference between the cost and the sale price would affect profit or loss).

Additionally, if the carrying amount of the physical non-financial asset is written down due to a reduction in its price, this would also affect profit or loss. This demonstrates that an entity holding a physical non-financial asset that it does not intend to sell is nonetheless exposed to changes in value of that asset, i.e. the entity is economically better off if the value increases or is worse off if the value decreases regardless of whether that asset is held at fair value or cost.

Therefore the change in fair value of a physical non-financial asset, due to changes in an eligible risk, is something that *could* affect profit or loss and therefore would, subject to the other hedge accounting requirements, be eligible to be designated in a fair value hedge. This view is consistent with IAS 39:IG.F.3.6 where the hedged physical non-financial asset is inventory.

Proponents of View A acknowledge that for a physical non-financial asset held at cost that is expected to be consumed rather than sold, it is the purchase price paid that is expected to ultimately affect profit or loss rather than the sale price (because it is not expected to be sold). However, hedging the change in value of that asset remains a valid risk management objective because the purchase price of that asset will affect profit or loss and an entity that has purchased the asset has fixed its cost which could put it at an economic disadvantage if the price of that asset subsequently fell before it was consumed. To ‘unfix’ the price of the asset, a net cash settled forward to sell that asset at a fixed price would allow the entity to benefit from any subsequent price decrease (or suffer from any subsequent price increase) and put it on an equal footing to a competitor that does not purchase non-financial assets to be consumed (e.g. copper inventory as per example above) in advance but purchases it shortly before it is required to be consumed.

Proponents of View A also note the common risk management strategy of fair value hedging fixed rate financial assets for changes in interest rates in cases where those assets are expected to be held for their

full term to collect their cash flows and not held for sale. IFRS 9 does not prohibit assets held at amortised cost being fair value hedged for the whole of their remaining time to maturity. Again, the hedge avoids the entity being put at an economic disadvantage if interest rates subsequently increase.

View B - No

An entity that holds a physical non-financial asset at cost which is expected to be consumed and not sold is not exposed to subsequent increases in value of that asset because the subsequent increase in value will not affect profit or loss. If the asset is consumed it will be the original cost that will affect profit or loss.

A valid hedge could only arise if there is an expectation of the hedged risk affecting profit or loss. This would be the case if there is an expected sale of the asset or if the selling price of the goods or services produced using the physical non-financial asset is affected by the change in value of that asset. Therefore proponents of View B believe it is not only necessary that the hedged risk *could* affect profit or loss but it is required that there is *an expectation* of it affecting profit or loss, otherwise it is a hedge of a risk that is not expected to affect profit or loss.

The example in IAS 39:IG.F.3.6 is where "the change in fair value of inventories *will* affect profit or loss *when* the inventories are sold or their carrying amount is written down" [emphasis added]. This indicates that the expectation is the inventory will be sold and will affect profit or loss when it is sold or will affect profit or loss earlier if it is written down prior to sale. Therefore this is different from a scenario where the hedged item is expected to be consumed and not affect profit or loss when it is consumed.

Question 2: Can foreign currency be a separately identifiable and reliably measurable risk component of a non-financial item designated in a fair value hedge?

View A - Yes

In accordance with IFRS 9:6.3.7, to designate a foreign currency risk component of a non-financial item in a hedge it is necessary for that risk component to be a 'separately identifiable and reliably measurable' component of the asset.

When identifying what risk components qualify for designation as a hedged item, an entity assesses such risk components within the context of the particular market structure to which the risk or risks relate and in which the hedging activity takes place. Such a determination requires an evaluation of the relevant facts and circumstances, which differ by risk and market. [IFRS 9:B6.3.9]

Because a physical non-financial asset (e.g. copper inventory) is not a contract, it is not 'denominated' in any currency (e.g. copper inventory does not represent a contractual right to receive USD). Proponents of View A do not believe that fair value hedging of foreign currency risk components is restricted only to contracts denominated in a particular currency and consider IFRS 9:B6.3.10 supportive of this assertion which states:

"When designating risk components as hedged items, an entity considers whether the risk components are explicitly specified in a contract (contractually specified risk components) or whether they are *implicit in the fair value* or the cash flows of *an item* of which they are a part (non-contractually specified risk components). *Non-contractually specified risk components can relate to items that are not a contract* (for example, forecast transactions) or contracts that do not explicitly specify the component (for example, a firm commitment that includes only one single price instead of a pricing formula that references different underlyings)." [Emphasis added]

A physical asset does not represent a contract and therefore any identified risk component would be a 'non-contractually specified risk component' that is 'implicit in the fair value' of the item.

Fair value of an asset is defined in IFRS 13 as the price that would be received to sell the asset in an orderly transaction between market participants at the measurement date. Depending on the specific facts and circumstances, the fair value of a physical non-financial asset may be first determined in a particular foreign currency due to market transactions (i.e. purchases and sales of the physical non-financial asset) being denominated in that currency which is then translated into an entity's functional currency for reporting purposes. In this case, the market structure would support the identification of the foreign currency as a risk component of the non-financial item.

Proponents of View A consider that IAS 39:IG.F.2.19 further supports this view because that guidance states that a foreign currency risk component of an equity instrument is separately identifiable and reliably measurable if:

"(a) the equity instrument is not traded on an exchange (or in another established marketplace) where *trades* are denominated in the same currency as the functional currency of Entity A; and

(b) dividends to Entity A are not denominated in that currency." [Emphasis added]

Condition (b) is not relevant for a physical non-financial asset. However, condition (a) specifically considers the currency in which *trades* are denominated and not the currency in which the contract (i.e. the equity instrument) is denominated and supports the assertion that a physical non-financial asset may be hedged for foreign currency risk if trades are not denominated in the entity's functional currency in any established markets.

Application of View A to the illustrative fact pattern above:

In the fact pattern presented, the copper inventory is a physical asset and does not represent a contract and therefore the identified risk component is a 'non-contractually specified risk component' that is 'implicit in the fair value' of the item.

The fair value of the copper is be based on its USD quoted price because quoted prices in an active market that is the principal market provide the best evidence of fair value and if Entity A were to sell the copper purchased it would sell it in the principal market in USD (i.e. in the same currency in which it bought the copper).

Because the fair value of the copper is determined by market participants in USD, which is then translated to the entity's functional currency, the market structure for copper supports that USD is an identifiable risk component of the fair value of the copper inventory held by Entity A and the LCY:USD foreign currency risk is an eligible risk component (i.e. it is separately identifiable and reliably measurable given the market structure).

View B - No

Proponents of View B note that IAS 39:IG.F.2.19 relates only to equity instruments that, unlike physical assets, are contracts. For this reason, IAS 39:IG.F.2.19 considers not only the denomination of trades but also the currency of dividends received which is a key characteristic of the equity instrument, i.e. an equity instrument is a contract that conveys a right to receive cash when dividends are declared. A physical non-financial asset is different from an equity instrument because it is not a contract and does not convey any right to receive a particular currency and is therefore not itself denominated in a particular currency.

Given that a physical non-financial asset is not denominated in a particular currency, it is not possible to identify a 'separately identifiable and reliably measurable' currency component from a physical non-financial asset (unlike for the identifiable currency component from a financial asset as per IAS 39:IG.F.2.19).

Proponents of View B consider that IAS 39:IG.F.6.5 further supports this view because that guidance states, "a foreign currency borrowing cannot be classified as a fair value hedge of a ship since a ship does not contain any separately measurable foreign currency risk". That guidance does not consider the currency in which trades in ships are denominated because that assessment is not relevant for a physical non-financial asset that has no contractual cash flows and is not denominated in any currency.

Application of View B to the illustrative fact pattern above:

Entity A cannot identify USD as a separately identifiable and reliably measurable risk component of the copper inventory held because it is not denominated in USD (i.e. USD cannot be a characteristic of a physical non-financial asset).

Reasons for the Committee to address the issue

Currently, we are aware of divergent views on this matter in a number of different jurisdictions. The issue is not related to a Board project that is expected to be completed in the near future. For these reasons, we believe that this issue meets the criteria for acceptance onto the Committee's agenda.