



# Airline Disclosure Guide

## Hedge accounting under IFRS 9



In association with



# Purpose of Airline Disclosure Guides

These Airline Disclosure Guides (ADGs) have been compiled by the IATA Industry Accounting Working Group (IAWG), which consists of senior finance representatives from IATA member airlines. This working group's mandate is to promote consistency in the application of International Financial Reporting Standards (IFRS) and to lobby accounting standard setters to take into consideration the interests of airlines globally.

The ADGs cover the latest accounting practices, principally from airlines reporting under IFRS related frameworks, to highlight key issues, judgements and disclosures made by airlines. They are designed to help in the development and analysis of airlines annual reports. The sample for the disclosures used in the ADGs comes mainly from annual reports of members of the IAWG and of IATA's Financial Committee.

The ADGs are not intended as critical assessments of specific disclosures or accounting policies nor as a guide of best practice. Furthermore, they do not provide accounting advice or detailed analysis of the underlying standards, including relevant disclosure requirements, and they should not be used as a substitute for referring to the standards and interpretations of IFRS.

KPMG is a global network of member firms, providing audit, tax and advisory services and has provided the IATA IAWG with assistance in compiling the ADGs. The views expressed in the ADGs are not necessarily the views of KPMG.

## Foreword

At the time of issue of this ADG IFRS 9 is a recently issued standard. The disclosures included in this ADG represent a limited range of current presentation and disclosure practices that you may find useful, considering that few entities have adopted IFRS 9. Care must be taken when applying the observations outlined in this ADG in a rapidly changing environment.





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# Hedge accounting under IFRS 9

## Introduction

Hedge accounting impacts a vast cross section of industries including the airline industry. In addition to foreign currency, interest rate and credit risks, the airline industry has to manage significant fuel price exposures. Many airlines have risk management policies that include the use of derivative financial instruments to hedge these risks.

The International Accounting Standards Board (IASB) issued IFRS 9 *Financial Instruments* in July 2014 as a replacement to IAS 39 *Financial Instruments: Recognition and Measurement*. Adoption is mandatory for accounting periods beginning on or after 1 January 2018 in countries applying International Financial Reporting Standards (IFRS).

The rules-based approach required by IAS 39 has led to significant divergence between how airlines economically manage their fuel and foreign currency risk exposures and how they are reflected in their financial statements. When IFRS 9 was being drafted, the IATA Accounting Working Group in conjunction with KPMG met the IASB staff and the Board's representatives to share the airline industry's perspective on various accounting issues and to influence the change towards better accounting standards that could enable the financial statements to reflect the operations and economic outcomes of an entity's risk management strategies.

The IFRS 9 hedge accounting model has been welcomed and supported by the airline industry in general and IATA, mainly because it provides a more principles-based approach, which aligns hedge accounting more closely with risk management activities of an entity. The new hedge accounting model was well received, three airlines elected to early-adopt IFRS 9 following endorsement of the international standard by the local accounting standards boards.

## Scope

This ADG publishes the results of the review of the financial reports of the three airlines that have early-adopted IFRS 9. This ADG provides accounting guidance and summarises observed practice in relation to:



**Time value of options**



**Forward points and cross-currency basis**



**Risk components of non-financial items**



**Aggregated exposures**



**Prospective effectiveness testing**

# 1. Time value of options



Airlines may purchase option contracts to hedge changes in the value of fuel, foreign currency, and other exposures.

Under IAS 39, changes in the time value of a purchased option were usually excluded from the hedge relationship and recorded in the income statement – this created earnings volatility.

Under IFRS 9, an entity may separate the intrinsic value and the time value of a purchased option contract and designate only the change in intrinsic value as the hedging instrument. The excluded portion of the option is then accounted for as a 'cost of hedging' which may be deferred or amortised.



## What does the time value of a purchased option represent?

The time value of a purchased option represents the premium that the purchaser pays over the value of exercising the option immediately – i.e. the option's intrinsic value – based on the probability that the option will increase in value before expiry.

If an airline designates only the change in intrinsic value of a purchased option as the hedging instrument in a fair value or a cash flow hedge, then any change in the fair value of the time value of the option is recognised in Other Comprehensive Income (OCI) to the extent that it relates to the hedged item. For example, if an entity hedges the price risk on a forecasted purchase of jet fuel using option contracts, then the changes in fair value of the time value of a purchased option are recognised in OCI. On actual purchase of the jet fuel, any accumulated amount in OCI is removed and included in the initial cost of the jet fuel.

For continuing hedges existing on the date of initial application of IFRS 9, retrospective application of the accounting for the time value of purchased options as a cost of hedging is required where the hedging instrument is designated under IAS 39 as the intrinsic value of the option.

## Key accounting judgements and estimates

At the time of hedge designation an airline can choose whether to separate the intrinsic value and the time value of a purchased option. Airlines hedge fuel or foreign currency risks in forecast transactions. The cash flows of these forecast transactions do not include a time value component but options do. If the option is designated in its entirety, then the hedge ineffectiveness is measured by comparing the full fair value change of the option (including time value) and the present value of the change in cash flows of the forecast transaction (which does not include time value). This could result in hedge ineffectiveness. Therefore, when hedging with options, it is expected that airlines will designate only the change in intrinsic value as the hedging instrument.

## Observed practice

The three airlines that adopted IFRS 9 as at 1 July 2014 all chose to designate only the change in the intrinsic value of options as the hedging instrument and recognised changes in time value in OCI.

### Example disclosure: Air New Zealand 2015 Interim Financial Report

Some components of hedge accounted derivatives are excluded from the designated risk. Cash flow hedges in respect of fuel derivatives include only the intrinsic value of fuel options. Time value on fuel options is excluded from the hedge designation and is marked to market through Other Comprehensive Income, and accumulated within a separate component of equity (the 'Costs of Hedging Reserve' within Hedge Reserves), until such time as the related hedge accounted cash flows affect profit or loss. At this stage the cumulative amount is reclassified to profit or loss within 'Fuel'. Previously under NZ IAS 39 [IAS 39], the above excluded elements were marked to market through the Statement of Financial Performance. The impact of this change has been applied retrospectively with losses having been reclassified from earnings to Other Comprehensive Income.

## 2. Forward points and cross-currency basis



Airlines may use forward contracts to fix the price for a future transaction such as a foreign currency payment for aircraft or fuel, both of which are typically denominated in USD.



### What does the forward element of a forward contract represent?

The forward element of a forward contract represents the difference between the forward price and the current spot price of the underlying item. The characteristics of forward elements depend on the underlying item, for example for foreign exchange contracts the forward element represents the interest differential between the two currencies.

Airlines may use cross-currency swaps to convert foreign currency borrowings to their functional currency or other currencies that achieve a risk management outcome that matches the currency of principal and interest repayments with forecast income.



### What does the foreign currency basis spread of a financial instrument represent?

Foreign currency basis spreads are commonly found in cross-currency swaps and can be considered to be a charge to convert one currency into another.

Under IAS 39 the forward element of a forward contract and the foreign currency basis spread of a financial instrument could not be separated from the designated hedging instrument and may have caused ineffectiveness for airlines.

Under IFRS 9 the forward element of a forward contract or the foreign currency basis spread of a financial instrument (e.g. currency basis spread in a cross-currency swap) may be separated and excluded from the designated hedging relationship. The change in fair value of the excluded portion may be accounted for as a cost of hedging.

### Key accounting judgements and estimates

At the time of hedge designation an airline can choose whether to separate the forward element of a forward contract or the foreign currency basis spread of a financial instrument. Excluding these items from hedge relationships and accounting for them as a cost of hedging will reduce income statement volatility.

### Observed practice

The three airlines that adopted IFRS 9 as at 1 July 2014 chose to exclude forward points and foreign currency basis spread from hedging instruments and recognise the fair value changes of these elements in OCI as a cost of hedging.

Example disclosure:  
Qantas Airways 2015 Interim Financial Report

Cost of hedging – AASB 9 [IFRS 9] allows the time value of an option, the forward element of a forward contract and any foreign currency basis spread to be excluded from the designation of a financial instrument and accounted for as a cost of hedging. The fair value changes of these elements are recognised in other comprehensive income and depending on the nature of the hedged item, will either be transferred to the Consolidated Income Statement in the same period that the underlying transaction affects the Consolidated Income Statement or be capitalised into the initial carrying value of a hedged item. Under AASB 139 [IFRS 9] the Group recognised the change in these elements in the Consolidated Income Statement. This change has reduced mark-to-market movements of these elements of derivative instruments being recognised in the Consolidated Income Statement as “ineffective and non-designated derivatives”.

# 3. Risk components of non-financial items



Due to what is considered by industry participants as a lack of liquidity in the market for jet fuel derivatives with a maturity of greater than six months, many airlines use crude oil derivatives with maturities of up to two or three years to meet their risk management objectives. The exposure to changes in jet fuel price is reduced because crude oil is a component of the price of jet fuel, however there is a basis difference between the hedging instrument: a crude oil derivative, and the hedged item: the highly probable purchase of jet fuel.

Under IAS 39 hedge accounting for a risk component of a non-financial item is not permitted.

Using IFRS 9 an airline can separate out the crude oil component of an exposure to a highly probable future purchase of jet fuel because:

- The crude oil component is a separately identifiable component of the jet fuel price; and
- The changes in the fair value of the jet fuel price attributable to changes in the crude oil price are reliably measurable.

IFRS 9 therefore allows airlines to eliminate accounting ineffectiveness that arises through the basis difference between their jet fuel exposures and hedging strategies that appropriately use crude oil derivatives.

## Key accounting judgements and estimates

At the time of hedge designation an airline can choose whether to separate and designate only a particular risk component of a non-financial item in a hedged item.

Jet fuel can be produced from different types of crude oil (Brent, West Texas Intermediate) and therefore the relevant crude oil risk component is generally based on the physical crude oil actually used in the hedged item to avoid ineffectiveness. However in certain circumstances, the contractual price of jet fuel is based on a specific crude oil benchmark regardless of the physical crude oil input.



### Which type of crude oil affects the price of jet fuel?

IFRS 9 application guidance indicates that different crude oil benchmarks (for example, Brent and West Texas Intermediate (WTI) crude oil) may be relevant for different geographical areas, and if an entity uses derivatives based on a benchmark that is not the relevant benchmark for hedging its risk then ineffectiveness may arise. The considerations for determining the appropriate crude oil benchmark in a geographical location are set out below. Typically steps 1 and 2 are not conclusive and therefore step 3 may be conclusive:

1. If available, use the crude oil benchmark explicit in the jet fuel purchase contract.
2. If the purchase contract is not explicit but the jet fuel in a given geography is produced exclusively from one crude oil product then use this as the crude oil benchmark.
3. If steps 1 and 2 are not conclusive, then perform an economic analysis to determine the crude oil benchmark that most directly affects the price of jet fuel products purchased in each representative geography.

### Observed practice

The three airlines that early-adopted IFRS 9 as at 1 July 2014 chose to separate risk components in the designation of jet fuel hedging relationships.

#### Example disclosure:

#### Air New Zealand 2015 Interim Financial Report

NZ IFRS 9 [IFRS 9] permits hedge accounting of risk components of both non-financial and financial items, provided they are separately identifiable and reliably measurable. Crude oil derivatives, which were previously designated as a proxy for jet fuel derivatives, are now designated in qualifying cash flow hedges of the crude oil component of highly probable future jet fuel purchases. This change has been applied prospectively with effect from 1 July 2014 and better aligns the accounting of such derivatives with the Group's risk management strategy, resulting in a more logical outcome. Accounting ineffectiveness may still arise where the price index of the designated hedging instrument is different to the crude oil benchmark in the geographical location of the hedged fuel uplift.

### 3. Risk components of non-financial items (cont.)



Example disclosure:  
Qantas Airways 2015 Interim Financial Report

AASB 9 [IFRS 9] allows derivatives that are hedging a non-financial component of an economic risk that is separately identifiable and measurable, to be designated in an accounting hedge for that non-financial component only. The Qantas Group uses options and swaps on jet kerosene, gasoil and crude oil to hedge exposure to movements in the price of aviation fuel. Previously, non-financial components were prohibited from being designated as hedged items under AASB 139 Financial Instruments: Recognition and Measurement [IAS 39], and as a result ineffectiveness occurred due to the differences in the mark-to-market movements of crude oil derivatives and the underlying aviation fuel exposure. This change has reduced the mark-to-market movements in changes in the fair value of derivative instruments being recognised immediately in the Consolidated Income Statement as “ineffective and non-designated derivatives”.

Example disclosure:  
Virgin Australia Holdings 2015 Interim Financial Report

AASB 9 [IFRS 9] introduces more principle-based requirements allowing more risk management activities to qualify for hedge accounting and therefore match the timing of the profit or loss on the hedge instruments with the profit or loss on the underlying exposures. The Group has achieved this through component hedges (jet fuel component) and deferral of time value on option-based contracts to the reserve relating to time value of options until maturity of the contract. Component hedges and option-based contracts are both commonly used in managing fuel price risk across the aviation industry.





## 4. Aggregated exposures



An aggregated exposure consists of a non-derivative exposure that can qualify as a hedged item and a derivative. Such a combination may create a different exposure that is managed as a single exposure for a particular risk or risks. Under the new standard an entity may designate such an aggregated exposure as the hedged item. The components that make up the aggregated exposure do not need to be designated in a separate hedge relationship.

For example, an airline that does not have a US dollar functional currency may have entered into a US dollar denominated forward contract for crude oil (a risk component of jet fuel) in order to hedge the crude oil financial risk and provide reasonable certainty over US dollar cash flows. The airline may later choose to enter into a forward contract to hedge the foreign exchange risk arising from the aggregate exposure of the crude oil component of the future jet fuel purchase and the US dollar-denominated forward contract.

### Key accounting judgements and estimates

Under IFRS 9 an aggregated exposure consists of a non-derivative exposure and a derivative and may be managed as a single exposure. In the example above an airline may designate a hedge of an aggregated exposure as follows:

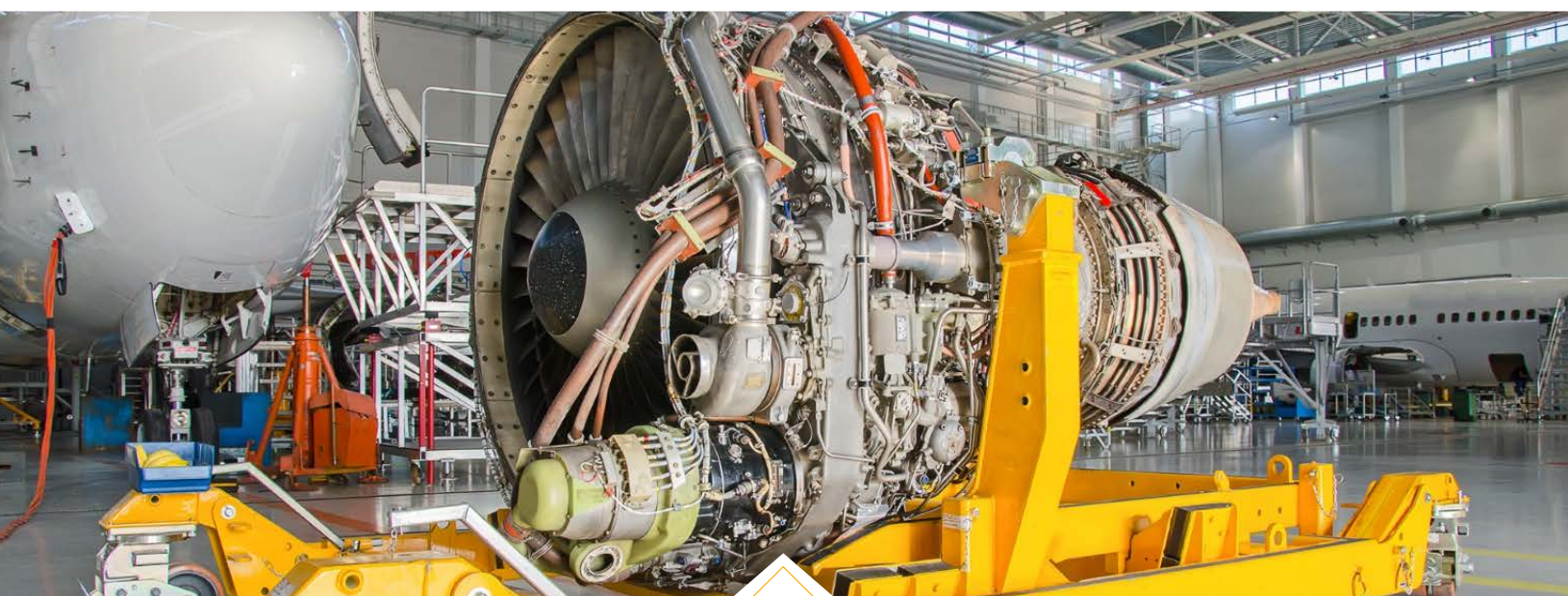
- Aggregate the first-level hedge and treat as a single exposure (the crude oil exposure and the US dollar denominated forward contract).
- Designate the new forward contract in a second-level hedge against the aggregated exposure from the first-level hedge.

There is no need to de-designate and re-designate the first-level hedge when establishing the second-level hedge. This avoids complexity and the risk of ineffectiveness, because the derivative in the first-level hedge would probably have a fair value other than zero at that time.

### Observed practice

Example disclosure:  
Qantas Airways 2015 Interim Financial Report

Aggregated exposures – Under AASB 9 [IFRS 9] the Group has the ability to hedge an aggregated exposure, that is a combination of a derivative and a non-derivative exposure. This has allowed the Qantas Group to designate economic hedging relationships as accounting hedges, which would not have qualified under AASB 139 [IAS 39]. This change has reduced the mark-to-market movements of derivative instruments being recognised in the Consolidated Income Statement as “ineffective and non-designated derivatives”.



# 5. Effectiveness testing



For hedge relationships to qualify as accounting hedges under IFRS 9 there must be an economic relationship between the hedged item and the hedging instrument. This means that an airline is required to have the expectation that the hedging instrument and the hedged item have values that generally move in the opposite direction because of the same risk. For example it can be the same risk (e.g. a specific currency pair) or an economically related risk (e.g. crude oil and jet fuel). Because airlines typically have risk management policies that prohibit the use of financial instruments for speculative purposes, airline hedging instruments are generally expected to have an economic relationship to hedged items.

Under IAS 39, airlines were required to retrospectively test the economic relationship between a hedging instrument and a hedged item. If the relationship failed to be effective within the range between 80-125 percent, then hedge accounting was not allowed. This could cause income statement volatility for some economic hedges. For airlines, the basis difference between jet fuel price and crude oil price was a common reason for failure of the retrospective hedge effectiveness testing. Income statement volatility could also have resulted from continued hedging relationships that were valid economic hedges under an airline's risk management strategy, but were designated differently for accounting purposes under IAS 39.

IFRS 9 requires an entity's hedge accounting to be closely aligned with its risk management objectives. The entity's risk management objectives apply at the individual hedging relationships level and contribute to executing the overall risk management strategy of the entity.

Under IFRS 9, actual ineffectiveness is required to be calculated and in a cash flow hedge, if the change in fair value of the hedging instrument exceeds the change in fair value of the hedged item on a cumulative basis, then this excess is required to be recognised in the income statement.

## Key accounting judgements and estimates

Under the new standard an airline must assess hedge effectiveness at the inception of the hedging relationship and on an ongoing basis, at a minimum at each reporting period or on a significant change in circumstances affecting the hedge effectiveness requirements. This assessment relates to expectations about hedge effectiveness, therefore the test will only be forward-looking or prospective.

## Observed practice

Example disclosure:  
Qantas Airways 2015 Interim Financial Report



Hedge effectiveness – AASB 9 (2013) [IFRS 9] requires that the hedge effectiveness assessment be forward-looking and does not prescribe defined effectiveness parameters. Under AASB 139 [IAS 39] an entity had to test effectiveness both retrospectively and prospectively and hedge accounting could only be applied if the relationship was 80 to 125 per cent effective. Under AASB 9 (2013) [IFRS 9] ineffectiveness is the extent to which the changes in the fair value or the cash flows of the hedging instrument are greater or less than those on the hedged item.







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