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Hedge Accounting: Hedges of foreign currency risk in owned aircraft

Background:

Transactions related to large passenger aircraft are routinely denominated in USD (for example, sale, purchase, lease and valuation).

At least one airline with a non-USD functional currency has published accounts reporting a fair value hedge with the following fact pattern:

- Hedging instrument is the USD debt on owned aircraft.
- Hedged item is the wide-body aircraft owned by the airline.
- Functional currency is not USD and not a currency fixed to USD.
- Hedged risk is the variability in fair value of the FX component of the hedged item.
- Type of hedge is a fair value hedge.

Issues:

1. Does a hedge of the foreign currency (FX) risk of an owned wide-bodied aircraft qualify for hedge accounting?
2. If so, would this hedge be effective for any aircraft?
3. Would this hedging relationship apply to leased aircraft?
4. Could you use financial liabilities not linked to the aircraft in the hedging relationship (for example a financial liability related to a leased aircraft)?

Analysis of Issues:

Are wide-bodied aircraft bought, sold and traded only in USD?

The basis for the hedge is that there is an FX component of the aircraft based on the asset being priced, sold and traded exclusively in USD, making settlement of the asset similar to that of a USD monetary item. This is deemed unique in relation to cost based fixed assets.

KPMG Insights book, section 7A.2.260.70, identifies oil, large passenger aircraft, certain precious metals and diamonds as being routinely denominated only in USD in commercial transactions around the world.

Would this apply to any owned aircraft?

It would appear that as long as the aircraft is of a type that is only sold, bought and traded in USD, then yes this would apply. It is believed that all commercial jet aircraft are bought, sold and traded exclusively in USD, but this has not been validated by the IAWG.

<u>Does IFRS allow you to establish a fair value hedge for an asset not currently externalized?</u>

IFRS 9, 6.3.5 indicates that for hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions with a party external to the reporting entity can be designated as hedged items. It is unclear assets would need to be with an external party and if so, would that need to be currently or at a point in time in the future.

IAS 39, F.3.6 addressed whether an entity can designate inventories, such as copper inventory, as the hedged item in a fair value hedge of the exposure to changes in the price of the inventories. It indicated that this was permitted due to changes in the copper price because the change in fair value of inventories will affect profit or loss when the inventories are sold or their carrying amount is written down. This would also be the case for owned aircraft as the amortization, impairment, reversal of impairment or disposal of the aircraft at a price other than carrying value would affect profit or loss.

<u>Is there FX risk in an owned aircraft transacted in USD held by an entity with another functional currency?</u>

IFRS 9 provides for the hedging of separate components of non-financial items. This requires that the component be separately measurable. When an asset is bought, sold and traded in a single currency, it would be reasonable to measure the movement in value on the asset in relation to FX risk as that of the change in value of the relevant currencies as settlement would need to be made in the foreign currency.

While it is generally observed that an item of property, plant and equipment contains no FX risk component, this may be because these assets are usually transacted in a number of different currencies. Unique among these assets is commercial jet aircraft. As a result, the resale value of the aircraft asset varies in part to the movements in the USD in relation to entity's functional currency.

Furthermore, while the airline would not be exposed to volatility on the FX component of an aircraft carried at cost that is not required under IFRS 9. For example, an entity may hold a fixed rate bond and enter into a pay fixed – receive floating interest rate swap to hedge the variability in fair value on the bond with regard to the interest rate component of the bond. The entity would not be exposed to variability in the fair value on the bond. This type of fair value hedge is extremely common and is illustrated in IFRS 9. Therefore, an airline would not need to be exposed to variability in the fair value of the aircraft in order to establish an effective fair value hedge.

<u>Would this be valid for aircraft that are ROU Assets?</u>

In the case of the ROU Asset in a lease, the airline would not have full exposure to resale or residual value on the leased aircraft (for example, lessor retains market risk and obsolescence risks) and that is where the foreign currency risk exists. Therefore, an airline would not be able to hedge a ROU Asset for FX risk.

Could an airline use the financial liability in a lease to hedge an owned aircraft?

It would appear that an airline could because the same fact pattern is present in relation to the financial liability established as part of the lease.

Would the fact pattern described in the background section qualify as a fair value hedge of FX risk under IFRS 9?

The objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities that to manage exposures arising from particular risks that could affect profit or loss. Therefore it would be critical that the risk management strategy of the airline articulate how the FX risk exposure in the owned aircraft is managed through the hedging instrument.

Based on the analysis above, if the hedging relationship was documented to evidence that there is a FX risk element in the owned aircraft and that it was reliably measurable, then IAWG is of the view that it may qualify as a fair value hedge under IFRS 9.

It is important to note that IFRS 9, section 6.2.4 requires that a qualifying hedging instrument (the financial liability in a foreign currency) must be designated in its entirety with certain exceptions. A proportion of the amount may be designated and IFRS 9, 6.2.2 allows the foreign currency risk component of a non-derivative financial liability to be separately designated as a hedging instrument.

It is also important to note that IFRS 9, section 6.4.1 requires an economic relationship be established for the risk hedged in relation to the hedged item and hedging instrument that would reflect that they significantly offset each other in relation to changes in fair value.

Attached in Appendix 1 is a simple decision tree to assist in assessing this hedge.

IAWG Views:

1. **IAWG is of the view that a hedge of the FX risk of an owned aircraft may qualify as a fair value hedge if the FX risk component in the owned aircraft is established as part of the airline's risk management strategy and the hedge complies in all other respects with IFRS 9.**

2. **IAWG is of the view that this treatment would apply to all commercial jet aircraft and not just wide-bodied aircraft, but it has not established that all commercial jet aircraft are only transacted in USD.**

3. **IAWG is of the view that this treatment would not apply to leased assets as the lessee does not fully bear the residual value or resale risk elements that would hold the FX risk element.**

4. **IAWG is of the view that you could use financial liabilities not linked to the aircraft in the hedging relationship (for example a financial liability related to a leased aircraft).**

Appendix 1, Hedge Accounting Decision Tree