



NOTICE

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Introduction

Airlines commonly apply hedge accounting in accordance with IFRS 9 to prevent an accounting mismatch between the movement in the value of the derivatives used to hedge the risk arising from changes in the fuel price and foreign exchange (FX) rates.

The COVID-19 crisis has disrupted global air travel resulting in a dramatic decrease in the consumption of jet fuel by airlines. Coupled with this decline was a deep and rapid decline in oil prices related to this decrease in demand and an increase in supply by some producers. As a result, airlines may have over-hedged their future jet fuel purchases with forward or futures contracts and find themselves with contracts that have significant negative values captured in equity (other comprehensive income or OCI) triggering a need to reassess the accounting for those hedges in accordance with IFRS 9.

This paper covers the accounting issues to consider in relation to over-hedges and then illustrates the practical aspects related to actions to consider in terms of maintaining or cancelling the hedging instruments.

Accounting for Hedges under IFRS 9

Is the hedge still highly probable or expected to occur?

Airlines need to consider whether their hedging relationships continue to be effective at the end of a reporting period. During this period of extreme price volatility and uncertainty around operational activity this exercise is challenging.

If an airline has designated the purchase of jet fuel as a hedged forecasted transaction in a cash flow hedge accounted for under IFRS, the entity will need to consider whether the transaction is still a "highly probable forecasted transaction".

If an airline determines that a forecasted cash flow is no longer highly probable, but still expected to occur, the entity must discontinue hedge accounting prospectively. In this case, the accumulated gain or loss on the hedging instrument that has been recognized in OCI will remain recognized separately in equity until the forecasted transaction occurs if the loss is recoverable.

Many airlines hedge a portion of their jet fuel requirements and only the portion hedged must remain highly probable. Each airline will need to consider their own specific situation and hedges in order to judge whether the forecasted cash flow that is hedged remains highly probable and whether it is still expected to occur.

If an airline determines that a forecasted cash flow is no longer expected to occur, in addition to discontinuing hedge accounting prospectively, it must immediately reclassify to profit or loss any accumulated gain or loss on the hedging instrument that has been recognized in OCI.

If an airline were to cancel a hedging contract it would account for the hedge in the same manner by determining if the hedged transaction is expected to occur. This is true even if it entered into another hedging contract that is similar.

Recoverability of effective hedge losses deferred in OCI

Even if a hedged future cash flow remains highly probable or is still expected, an airline must consider the implications of IFRS 9, 6.5.11 (d) iii that requires that if the amount held in OCI is a loss and an entity expects that all or a portion of that loss will not be recovered in one or more future periods, it shall immediately reclassify the amount that is not expected to be recovered into profit or loss as a reclassification adjustment.

IATA's Industry Accounting Working Group (IAWG) believes that the assessment is not limited to whether the fuel costs would be recovered through revenue generated by the relevant flights as this would not consider other costs related to that revenue. They also do not believe the assessment should include inefficiencies such as non-operating aircraft or idled staff. An airline would need to adopt a policy that compares the expected revenue generated from the relevant flights with the expected direct costs related to operating those flights. Expected revenues would not be limited to cash proceeds or ticket revenue (e.g., freight, loyalty redemption and ancillary revenues) nor would expected costs be limited to jet fuel or variable costs. It would be reasonable to assume that an airline would only operate those flights where they would recover their relevant direct costs. This should not be read to suggest that the assessment should be undertaken at a flight level, but rather that the assessment be limited to the activity hedged.

Nothing in IFRS provides guidance on how an airline is to assess recoverability of a hedged risk. The IAWG will issue a separate paper addressing the issue of how to determine whether a loss held in a hedging reserve is recoverable.

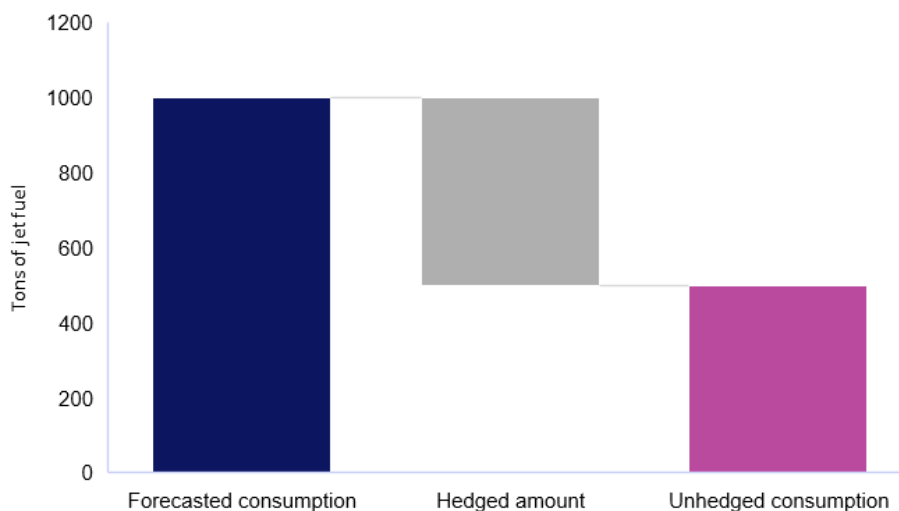
Disclosure considerations

It is not clear in IAS 1, *Presentation of Financial Statements*, how the reclassification adjustment would be presented in the income statement in terms of operating or non-operating. This would be based on the individual airline's accounting policies.

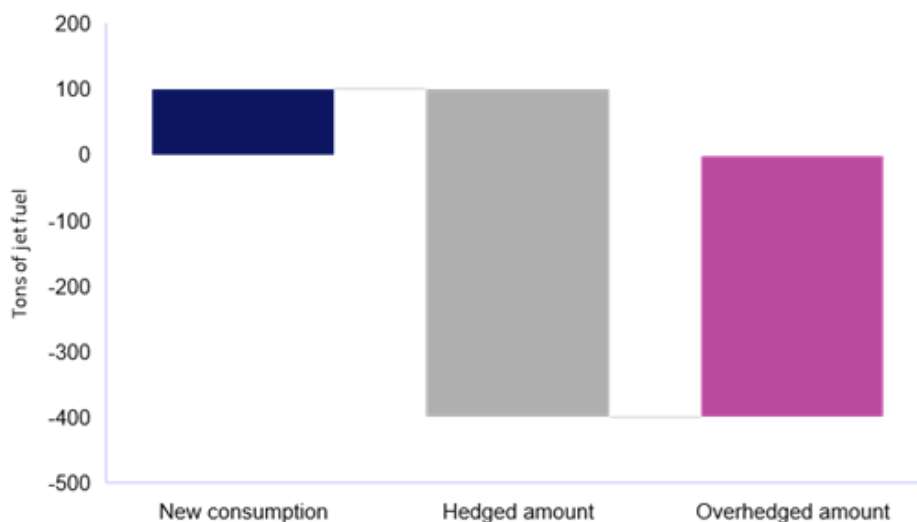
Hedging Scenarios

Due to the COVID-19, the underlying risk (primarily the jet fuel price and partly FX for those carriers not reporting in USD) disappeared as consumption dropped, resulting in airlines may have become over-hedged due to a steep decline in forecasted fuel consumption.

Base case scenario: 50% of the forecasted fuel consumption is hedged



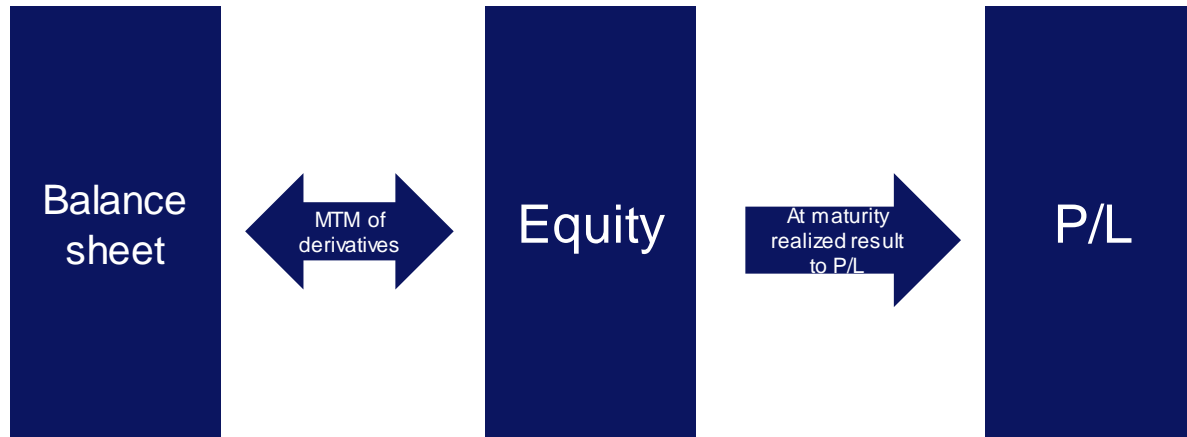
COVID-19 case scenario: the forecasted fuel consumption declines to 10% of the base case



In accordance with IFRS 9, as explained above, as soon as the airline recognizes that the underlying risk has disappeared from the FX and jet fuel positions (transactions are no longer expected or losses are not recoverable), the market value of the derivatives hedging the transaction that is no longer expected to occur has to be reclassified from OCI to profit and loss. For example, if an airline forecasted jet fuel consumption of 1,000 tons for the quarter and has hedged 50% of the forecast consumption with derivatives, but now estimates that its consumption will be 100 tons, its position is over-hedged by 400 tons.

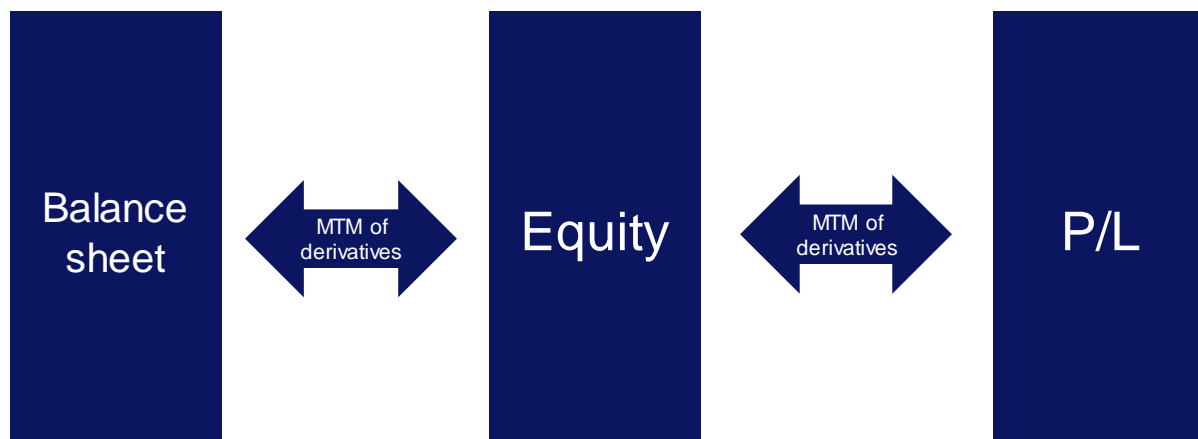
The airline must recognize immediately in profit and loss the market value of the derivatives hedging the 400 tons of consumption that is not expected to occur.

This differs from the base case where the mark-to-market of derivatives are recorded in equity until the fuel is consumed.



Assumes that hedge accounting is applied according to IFRS 9. MTM is impacting equity until the fuel is consumed (impacts profit and loss) and then it is reclassified to profit and loss to offset the hedged risk price movement resulting in a fixed price for the fuel based on the contract price.

In the over-hedging case, the portion of the value of the derivative contract(s) related to the over-hedging held in OCI is reclassified immediately to profit or loss, with any further change in value on the hedging instruments taken immediately to profit or loss.



Assumes that hedge accounting is applied according to IFRS 9. After the company recognizes that the underlying risk has disappeared, the MTM of derivatives needs to be reclassified from equity to P/L. This treatment is the same for the original derivative, as well as for the deal used to unwind the hedge

Actions in addressing an over-hedge

An airline has two basic two options in the scenario described above:

1. leave the hedging positions open (i.e. do nothing), or
2. close the positions (i.e. unwinding the hedging positions).

If an airline leaves the derivatives positions open, it will have 400 tons of speculative derivatives in its books, and the market value of those derivatives is still subject to changes in value. That means that the airline is exposed to substantial losses/gains from the derivatives positions and possible margin calls, even though the underlying risk has disappeared. Airline treasury policies and corporate governance policies generally prohibit speculative derivative positions.

Therefore, the option to unwind the hedging positions is usually the only practical choice. The simplest way to close the over-hedged position of 400 tons is by doing reversals. In this case, the airline sells forward 400 tons of jet fuel for the over-hedged period thereby offsetting the buy forward contract. This is because as the market prices move, the market value of the new sell contract moves in the opposite direction (in the exact same amount) compared to the original buy contract. As a result, there will no longer be a speculative derivative as the changes in value will offset. Cash settlement will offset. This is most useful when the original buy forward contract cannot be cancelled in its entirety as a portion of it remains in an effective hedge with that part of the hedge reserve remaining in equity not profit and loss.

In addition, it is possible to settle the current market value of the derivatives position with the counterparty, i.e. paying/receiving the current market value of the derivatives position. In this case, the original derivative no longer exists, and cash settlement happens immediately, and any hedge reserve is automatically taken to profit and loss. Note that while the impact to profit and loss is generally the same, settlement is undertaken by negotiation with a single counterparty, while an offsetting position would be undertaken competitively. Likewise, an offsetting position may result in a credit risk premium if the counterparties are not the same.