IATA Industry Accounting Working Group Guidance IFRS 9, Financial Instruments

3rd Edition
Issued April 2021

NOTICE

DISCLAIMER. This document has 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.

It is distributed with the understanding that IATA, the IAWG and its members, observers and advisors are not rendering accounting, legal or other professional services in this publication. If accounting, legal advice or other expert assistance is required, the services of a competent professional should be sought.

The paper addresses a specific issue related to the adoption of IFRS 9, Financial Instruments. This paper is not intended to provide accounting advice or a definitive analysis of the underlying issue as fact patterns, regulatory environment, practices and interpretations may vary. The views taken should not be used as a substitute for referring to the standards and interpretations of IFRS or professional advice from your auditor or other professional accounting advisor.

The information contained in this publication is subject to constant review in the light of changing government requirements and regulations. No subscriber or other reader should act on the basis of any such information without referring to applicable laws and regulations and/or without taking appropriate professional advice. Although every effort has been made to ensure accuracy, the International Air Transport Association shall not be held responsible for any loss or damage caused by errors, omissions, misprints or misinterpretation of the contents hereof. Furthermore, the International Air Transport Association expressly disclaims any and all liability to any person or entity, whether a purchaser of this publication or not, in respect of anything done or omitted, by any such person or entity in reliance on the contents of this publication.

IFRS 9, Financial Instruments

Table of Contents

Assessing Highly Probable Cash Flows in a Cash Flow Hedge

Background:

IFRS 9, section 6.3.3 states that if a hedged item is a forecast transaction (or a component thereof), that transaction must be highly probable.

IFRS 9 allows hedge accounting to be applied to highly probable cash flows if certain conditions are met. A common cash flow hedge in the airline industry is one where operating cash inflows in a foreign currency hedged using the foreign currency risk associated with a financial liability including aircraft financing or lease liabilities.

This creates questions on how an airline goes about supporting their assertion that their future cash flows are highly probable for future periods beyond the near term.

Issues:

1. What does highly probable mean?
2. How does an airline assess whether cash flows are highly probable?

Analysis of Issues

What does highly probable mean?

IFRS 9 does not define the term highly probable. The term probable is defined as more likely than not, so it clearly is significantly more than 50%, but there is no bright-line for highly probable.

Question 142.1 of the Implementation Guidance accompanying IAS 39 stated that the term 'highly probable' indicates a much greater likelihood of happening than the term 'more likely than not'. An assessment of the likelihood that a forecast transaction will take place is not based solely on management's intentions because intentions are not verifiable. A transaction's probability should be supported by observable facts and the attendant circumstances.

Each airline will need to exercise judgment in determining how to apply this term to varying risks and circumstances related to specific hedges.

Assessing cash flows as highly probable

In assessing the likelihood that a transaction will occur, an entity should consider all relevant factors, including the following circumstances:

(a) the frequency of similar past transactions;
(b) the financial and operational ability of the entity to carry out the transaction;
(c) substantial commitments of resources to a particular activity (for example, obtaining slots and aircraft to service the routes generating the cash flows);
(d) the extent of loss or disruption of operations that could result if the transaction does not occur; and
(e) the entity's business plan.

The length of time until a forecast transaction is projected to occur is also a factor in determining probability. Other factors being equal, the more distant a forecast transaction is, the less likely it is that the transaction would be regarded as highly probable and the stronger the evidence that would

be needed to support an assertion that it is highly probable. For example, a transaction forecast to occur in five years may be less likely to occur than a transaction forecast to occur in one year.

It should be noted that a hedge using a financial liability related to a borrowing for an aircraft or a lease liability will decline over time and therefore require a declining amount of future cash flows to establish a qualifying hedging relationship.

Also, forecasted cash flows would typically be highly probable if supported by an existing contractual obligation. For example, cash flows from maintenance service contracts are easier to support than passenger ticket sales as highly probable.

In addition, other factors being equal, the greater the physical quantity or future value of a forecast transaction in proportion to the entity's transactions of the same nature, the less likely it is that the transaction would be regarded as highly probable and stronger evidence that would be required to support an assertion that it is highly probable. Therefore, it is likely that the expected cash flows will need to be substantially more than the hedged exposure and that this variance will increase as the transactions are more distant.

A history of having designated hedges of forecast transactions and then determining that the forecast transactions are no longer expected to occur would call into question both an entity's ability to predict forecast transactions accurately and the propriety of using hedge accounting in the future for similar forecast transactions.

While it is more difficult to support an assertion that future transactions are highly probable for periods beyond the next business cycle, which does not mean that future transactions cannot be supported as highly probable for longer periods. For example, forecasted passenger ticket sales on long established routes, with significant capital investment made and a history of sustained activity could be supported for relatively long periods.

IAWG View

1. **Highly probable indicates a much greater likelihood of happening than probable (more likely than not), but is subject to judgment.**
2. **An airline assesses whether cash flows are highly probable by assessing the factors outlined in this paper and all other relevant factors.**

Assessing Recoverability of the Cash Flow Hedge Reserve

Background:

IFRS 9 requires a cash flow hedged transaction to remain highly probable for the specified transaction to have hedge accounting applied. If that test is failed, the airline must determine if the hedged transaction is expected to occur. If not, the cash flow hedge reserve (CFHR) is reclassified to income or loss. If it is probable, it is retained in the CFHR until the same period or periods during which the hedged item occurs

In addition, IFRS 9, paragraph 6.5.11(d) (iii) indicates that if the amount recorded as a CFHR 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 (see IAS 1). That is the focus of this paper.

The requirement in paragraph 6.5.11(d) (iii) has become an issue of concern to airlines due to the combined effect of Covid-19 and the sharp decline in fuel prices as it raises the question of whether the loss held in OCI will be recovered. When fuel prices sharply declined in the past activity did not decline (2015) or the activity and fuel price level was expected to rebound near term (2001 and 2009).

This paper addresses the applicability of this paragraph, the relevant IFRS guidance and how recoverability might be addressed by an airline.

Issues:

1. **Does IFRS 9, paragraph 6.5.11(d) (iii) apply to all cash flow hedges or only those that involve the recognition of non-financial assets?**
2. **What are the applicable IFRS standards in relation to determining the recoverability of the CFHR?**
3. **How might an airline determine the recoverability of the negative CFHR?**

Analysis of Issues

The assessment of recoverability applies to all cash flow hedges

IFRS 9, paragraph 6.5.11(d) (iii) is relevant to all cash flow hedges and not only those that involve the recognition of a non-financial asset, such as inventory. The guidance modifies both paragraphs 6.5.11 (d) (i) and 6.5.11 (d) (ii). This does not imply that an assessment is required in all instances when the CFHR is negative. It is only required when indicators of non-recoverability are present.

Which IFRS standards address this issue?

IFRS 9 does not address how an airline should go about assessing the recoverability of OCI. The concept of recoverability is addressed in IFRS under a number of standards:

- IAS 2, Inventory – with the carrying value limited to the net realizable value;
- IAS 36, Impairment – when the assets carrying value is not recoverable through sale or use;
- IAS 37 – in relation to creating a liability for onerous contracts when the cost is not recoverable.

Financial instruments are generally outside of the scope of these standards, either explicitly or implicitly, as the hedging instrument is within the scope of IFRS 9 and those financial instruments are out of the scope of the other standards.

There have been discussions around the applicability of two standards to the issue of recoverability:

1. A purchase of fuel is an inventory purchase in the scope of IAS 2. Therefore, the determination of the recoverability by comparing the expected net realisable value with the expected purchase cost of the fuel and other direct costs including considering an appropriate allocation of fixed costs.

2. A purchase of jet fuel is not within the scope of IAS 2. It is rather a cost of rendering a flight service and therefore the onerous contract guidance in IAS 37 may be analogised to as part of the recovery test.

IAWG agrees that the purchase of jet fuel may be within the scope of IAS 2, but believe that IAS 2 does not address inventory purchases. It addresses inventory assets. Commodity derivatives are only one of many of a portfolio of derivatives an entity may hold, such as foreign currency forwards or futures, which would have no relationship to inventory. The physical asset when received may be inventory, but may also be a number of other physical assets (such as an aircraft in a capital expenditure hedge), therefore this issue is not within the scope of IAS 2

We believe that as indicated in the second view, guidance in IAS 2, IAS 36 and IAS 37 may be useful by analogy even though the issue is outside of the scope of each of those standards.

IAWG also believes that the issue of assessing the recoverability of a negative CFHR is not limited to non-financial liabilities and therefore the approach to be taken should be relevant not only to the price risk of a non-financial liabilities, but other risks, such as foreign currency exchange risk and other hedged items, such as financial assets.

How does an airline take into account the uncertainty around an event like Covid-19?

An airline would use an approach that consists of using a number of expectations about possible recoverability scenarios with a base, best and worst case being most common. Uncertainties are reflected through probability-weighted scenarios.

Management should consider probability-weighting different scenarios to estimate the expected recoverability. This should enable an understanding of the range of potential outcomes – for example, a normal, a short-/medium-term disruption scenario, and a longer period of disruption scenario. IAWG expects the application of consistent scenarios as those used to determine the level of de-designate where an entity is over-hedged.

How might an airline address the recoverability of a negative CFHR?

Generally, that assessment is intuitive as airlines hedge a portion of their jet fuel (and other) needs for the next 18-24 months and enter into hedges to stabilize their costs in relation to forecasted revenues. In extraordinary periods where both flight activity and jet fuel prices suffer dramatic declines with limited visibility over future activity, the assessment will need to be quantitative for many airlines.

IFRS 9 requires that a cash flow hedge be designated with sufficient specificity in terms of timing and magnitude so that when such transactions occur the entity can identify whether the transaction is the hedged transaction. As a result, these hedges will specify quantity and timing, and not percentages of jet fuel requirements over a period. An analysis of recoverability must follow the hedging documentation that will identify time buckets (usually months). The assessment of recoverability would need to be approached consistently with this principle of specificity.

In assessing recoverability an airline would need to establish the revenue and costs that are relevant to the activity related to the use of the jet fuel that is hedged for the period being assessed for recoverability.

Recoverability of the CFHR would need to be addressed consistently with how the jet fuel is used to generate revenue. As jet fuel is used to generate revenues from passenger/cargo operations it would require an analysis at the level above that of the jet fuel.

It would not be reasonable to look at the issue of recoverability by comparing overall revenue for activities where the relevant jet fuel is used, nor would it be reasonable to look at indirect costs or costs of idle assets or staff as they would not relate to the use of the fuel.

IAS 36 provides for a concept of a cash generating unit (CGU) and while this is outside the scope of that standard that guidance around that concept could be applied by analogy, but with modification so that only direct costs in relation to flight activity related to the hedged jet fuel are included.

The analysis that would be performed then must identify the relevant items on inflow and outflow. IAWG does not believe that cash flows are the appropriate items to measure.

Another approach would be to compare the contribution margin to the pre-fuel hedging costs to assess whether that margin would be enough to cover the expected fuel hedging loss on the relevant hedging contracts.

The contribution margin focuses on the variable and an allocation of fixed costs related to the provision of the flight service. This would be only on those aircraft/routes in operation (those which are grounded would already be reflected as part of the over-hedging assessment). It should exclude indirect costs such as administration and overhead costs, but include costs directly related to the provision of the relevant flight services (e.g. ground handling, staff costs, airport fees, etc.)

IAWG believes that many other approaches could also be used if they reflected a comparison of relevant revenue and variable direct costs related to the flight activity where the hedged jet fuel is to be utilized.

Is the assessment of recoverability limited to revenue that would be generated during the hedging period?

IFRS 9 does not link the period for recovery to the contract period of the hedging instrument or the designated hedge.

IAWG believes that as the hedged item is jet fuel, revenue in future periods (for example, expected forfeiture of mileage credits or expiration of tickets) generated from its use during the hedged period could be included in the determination of recoverability.

What flight activity should be included in the assessment of recoverability?

An assessment of recoverability would not be done at a flight level or fleet level, but rather at a level that reflected the flight activity where the hedged jet fuel would be used. As hedges are based on an amount of fuel to be used during a period with no mention of specific flight activity, this could be implemented differently by airlines. One approach could be to look at all flight activity during that time frame and using a weighted average of recoverability. IAWG believes that this would be acceptable. Another approach would be to attribute the jet fuel use to those flights that provide the best recovery of cost. IAWG believes that this method is also acceptable.

What price of jet fuel should be used in the analysis?

When an airline enters into a cash flow hedge of jet fuel it eliminates uncertainty around the price that it will pay for that jet fuel. Regardless of the price of jet fuel at a future date the airline will incur a current cost and a gain or loss on the hedging instrument that is largely constant. In analyzing the recoverability of the CFHR the airline would base their analysis on the forward or future curve as that is what is used to value the hedging instrument. While that forward of future value may not be consistent with the airline's forecasted price for jet fuel, the effective price of the relevant jet fuel is a product of the spot price of the jet fuel and the contract price of the hedging instrument.

IAWG View

1. **IAWG believes that IFRS 9, paragraph 6.5.11(d) (iii) apply to all cash flow hedges where the CFHR is negative.**

2. **IAWG believes that IFRS 9 is the applicable standard for the issue of recoverability of a negative CFHR and that IAS 2, IAS 36 and IAS 37 may provide useful guidance in developing an appropriate accounting policy.**

3. **IAWG believes that an airline should determine the recoverability of the negative CFHR in a manner that reflects economic reality and the information available at the time of the assessment using reasonable judgement.**

Benchmark Crude Oil Contracts Used in Jet Fuel Hedges

Background:

Airlines commonly use crude oil contracts to hedge their future jet fuel purchases as the market for these contracts is more cost effective than jet fuel contracts where supply is far more limited. Crude oil contracts are traded for several benchmarks, most notably Brent, West Texas Intermediate (WTI) and Dubai. The benchmarks trade at different prices with a premium paid for lighter crude oil as it is more easily refined into products including jet fuel.

Unlike IAS 39, IFRS 9 allows an airline at the time of hedge designation to choose whether to separate and designate only a particular risk component of a non-financial hedged item.

Jet fuel can be produced from different types of crude oil 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.

Issue:

This paper addresses whether a hedge using a single crude oil benchmark contract as the hedging instrument have no ineffectiveness if designated against the purchase of jet fuel when some of the jet fuel designated as the hedged item is not refined from that benchmark crude oil.

Analysis of Issues

IFRS 9 will allow for components of non-financial items to be hedged if the component is separately identifiable and reliably measurable. IAS 39 prohibited a components approach for non-financial items. As a result, if a crude oil contract was used to hedge jet fuel purchases, the hedge needed to be designated as a hedge of jet fuel and any ineffectiveness taken to income. Under IFRS 9, the hedge may be designated against the crude oil component resulting in the underlying hedged item and the hedging instrument both being crude oil.

The question then becomes whether this would result in no ineffectiveness in the hedge.

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 IASB addressed this issue in IFRS 9, BC6.188. The IASB noted that the hedge accounting requirements would apply to the risk component in the same way as they apply to other hedged items that are not risk components. Consequently, even when a risk component was designated as the hedged item, hedge ineffectiveness could still arise and would have to be measured and recognised.

A relevant example was provided in IFRS 9, BC6.188 (d).

> An entity is exposed to price risk from forecast purchases of jet fuel. The entity's jet fuel purchases are in North America and Europe. The entity determines that the relevant crude oil benchmark for jet fuel purchases at its North American locations is West Texas Intermediate (WTI) whereas it is Brent for jet fuel purchases at its European locations. Hence, the entity designates as the hedged item a WTI crude oil component for its jet fuel purchases in North America and a Brent crude oil component for its jet fuel purchases in Europe.

> Historically, WTI and Brent have been closely correlated and the entity's purchase volume in North America significantly exceeds its European purchase volume. Hence, the entity uses one type of hedge contract—indexed to WTI—for all its crude oil components. Changes in the price differential between WTI and Brent cause hedge ineffectiveness related to the forecast purchases of jet fuel in Europe. There is no market structure that would support identifying WTI as a component of Brent. In particular, the terms and conditions of the WTI futures cannot simply be imputed by projecting terms and conditions of those derivatives onto the forecast jet fuel purchases in Europe.

In IFRS 9, BC6.189, the IASB concluded that the designation of a risk component as a hedged item did not mean that no hedge ineffectiveness arises or that it would not be recognised.

The considerations for determining the appropriate crude oil benchmark in a geographical location as provided for in the IATA Airline Disclosure Guide - Hedge Accounting under IFRS 9, 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.

It has been observed that crude oil is exported around the world and even jet fuel itself is exported, making it sometimes difficult to establish the actual benchmark crude that was refined into the jet fuel purchased. Therefore, determining the relevant benchmark crude oil may be challenging.

It should also be noted that if an airline hedges a percentage of their jet fuel purchases equal to or less than the amount refined from a benchmark crude oil they would be able to designate those hedges against the relevant benchmark to avoid hedge ineffectiveness.

If an airline uses a single benchmark crude oil contract, but identifies multiple benchmark crude oils as relevant for the jet fuel they purchase, the hedge would be effective, but not perfect. An airline would then need to measure the hedge ineffectiveness. For example, if Brent contracts were used to cash flow hedge purchases of jet fuel refined in various locations from Brent, WTI and Dubai crude oil, the hypothetical perfect derivative used to measure hedge effectiveness would be the relevant benchmark contract against the Brent contract used with the variance taken to income as hedge ineffectiveness. As result, the Brent contract would be a perfect hedge, but the jet fuel purchases where WTI and Dubai are the relevant crude oil, there would be ineffectiveness.

IAWG View

A hedge using a single crude oil benchmark contract as the hedging instrument may have ineffectiveness in relation to the purchases of jet fuel designated as the hedged item in the hedge that is identified as not being priced based on the benchmark crude oil of the contract.

Hedges of Foreign Currency Risk in Owned Aircraft

IFRIC Agenda Decision - Fair Value Hedge of Foreign Currency Risk on Non-Financial Assets (IFRS 9) - *September 2019*

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

Hedge accounting requirements in IFRS 9

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

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

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

In considering the request, the Committee assessed the following:

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

Paragraph 6.5.2(a) of IFRS 9 describes a fair value hedge as 'a hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss'.

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

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

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

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

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

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

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

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

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

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

Paragraph 6.4.1(b) of IFRS 9 requires that, at the inception of a hedging relationship, 'there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge'. Accordingly, the Committee observed that, applying IFRS 9, an entity can apply hedge accounting only

if it is consistent with the entity's risk management objective and strategy for managing its exposure. An entity therefore cannot apply hedge accounting solely on the grounds that it identifies items in its statement of financial position that are measured differently but are subject to the same type of risk.

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

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

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

Other considerations

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

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

Provisioning for Impairment Losses on Amortized Cost and FVOCI Financial Assets

Background:

Under IAS 39, amortized cost assets were subject to impairment based on an incurred loss approach. This required the occurrence of an event that indicated that the recoverable value of a specific asset had declined below the carrying value and a provision for the estimate of losses that had occurred, but had not yet emerged. IFRS 9 requires an expected loss model be applied to amortized cost assets as well as debt instruments classified as fair value through other comprehensive income (FVOCI). IFRS 9 provisioning for expected losses has been generally seen as an issue that will result in significant changes for financial institutions, but not for airlines. This paper addresses the implications for airlines regarding impairment of debt instrument under IFRS 9.

Provisions for credit losses under IFRS 9 use probability-weighted outcomes. They take into account the probability that a credit loss occurs, even if that probability is low. This is not the same as the most likely outcome or a single best estimate method allowed under IAS 37 for other provisions.

Issues:

1. Are airlines required to provide for the impairment of financial assets recorded at amortized cost or FVOCI debt?
2. Would any instruments be exempt?
3. Would any instruments qualify for zero expected losses?

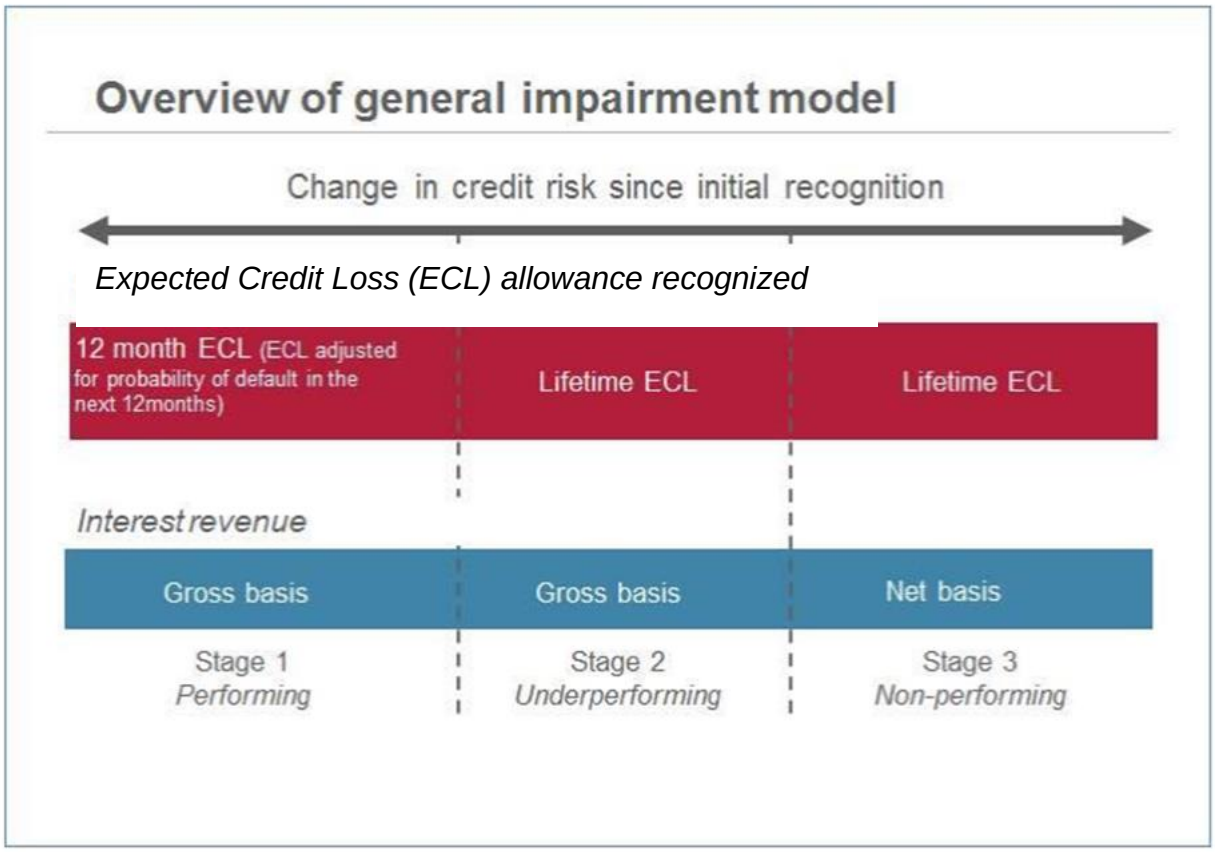
Analysis of Issues

IFRS 9 does not provide any exemptions from the impairment provisions for financial assets carried at amortized cost or FVOCI debt based on the reporting entity not being a financial institution. Therefore, this part of the standard fully applies to airlines and all other corporate entities.

IFRS 9 provides two approaches for measuring expected credit losses for amortized cost and FVOCI debt. These are the General and Simplified approaches.

General Approach

IFRS 9, section 5.5.1 An entity shall recognize a loss allowance for expected credit losses on a financial asset that is measured in accordance with paragraphs 4.1.2 or 4.1.2A, a lease receivable, a contract asset or a loan commitment and a financial guarantee contract to which the impairment requirements apply in accordance with paragraphs 2.1(g), 4.2.1(c) or 4.2.1(d).



This approach requires the airline to establish a provision either at inception or at the end of the first reporting period and adopt a consistent policy for doing this. The provision should be one year of expected losses. This is frequently estimated by dividing one year by the expected life of the financial asset and then multiplying that times the lifetime expected losses.

After the financial asset is recorded, a significant increase in the probability of default requires that the provision be adjusted to the full lifetime expected loss. If this reverses so that the change is no longer significant, the provision is reversed to the one-year measurement.

When applying the general approach, a number of operational simplifications and presumptions are available to help entities assess significant increases in credit risk since initial recognition. These include financial instrument that have a low credit risk (equivalent to investment grade quality). An entity may assume no significant increases in credit risk have occurred.

The description of low credit risk is broadly equivalent to what rating agencies define an investment grade' quality assets. This is equivalent to or better than a rating of BBB- by Standard & Poor's and Fitch or Baa3 for Moody's.

The time value of money: For financial assets, the ECL is discounted to the reporting date using an approximation of the EIR that is determined at initial recognition. For loan commitments and financial guarantee contracts, the EIR of the resulting asset will be applied and if this is not determinable, then the current rate representing the risk of the cash flows is used.

Simplified Approach

IFRS 9, section 5.5.15 allows an entity to measure the loss allowance at an amount equal to lifetime expected credit losses for trade receivables or contract assets that result from transactions that are within the scope of IFRS 15 that are not accounted for as having a significant financing component, and lease receivables that result from transactions that are within the scope of IFRS 16. This accounting policy choice may be made by type of asset shown above, and separately for finance and operating lease receivables.

This provides relief from applying the General Approach for the vast majority of trade and lease receivables. It provides no relief for any other receivables.

IFRS 9 allows an entity to use a simplified "provision matrix" for calculating expected losses as a practical expedient (e.g., for trade receivables).

To determine the expected credit losses for the portfolio, the airline uses historical observed default rates over the expected life of the receivables and adjusts for forward-looking estimates. It is important to segregate losses relating to customer disputes or price adjustments provided from credit losses, as only credit risk is being accounted for under this impairment provision. Periodically, the historical observed default rates are updated and changes in the forward-looking estimates are analyzed. Forward looking variables are macro-economic factors that impact default rates in the future.

Illustrative Example 12 in IFRS 9 illustrates the use of a provision matrix as one possible way to implement the simplified approach. A provision matrix essentially applies an expected credit loss rate to every aging category of receivables, including the "current" category.

Zero Risk Assets

While in theory all debt contains a measure of credit risk, sovereign debt that is highly rated is considered credit risk free as the issuer is able to "print money" to avoid default and the market has accepted the absence of credit risk through the pricing of the debt. Likewise, if a financial asset is very highly collateralized it could be evidenced over its life to have no credit risk, especially if it was collateralized by cash or cash equivalents.

Some airlines have been allowed to treat short term financial assets with high quality counterparties (e.g. banks) as having substantially zero credit risk and others have treated these as having an immaterial effect on the accounts. These practices should be discussed with your auditor.

IAWG View:

1. **Airlines are required to provide for the impairment of financial assets recorded at amortized cost or FVOCI debt. There is no exemption for non-financial institutions.**

2. **No financial assets that are measured at amortized cost or FVOCI are exempt, but trade receivables, lease receivables and contract assets under IFRS 15 are eligible for the simplified approach.**

3. **Generally, financial instruments issued by highly rated sovereigns have been deemed to have zero credit risk. Financial assets that have similar risk patterns as evidenced by pricing may also qualify.**