

**IATA Industry Accounting
Working Group Guidance
IFRS 9, Financial
Instruments**

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IFRS 9, Financial Instruments

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NOTICE

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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.

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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.**

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 a number of 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

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.

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

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.

Would this be valid for aircraft that are ROU Assets?

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:

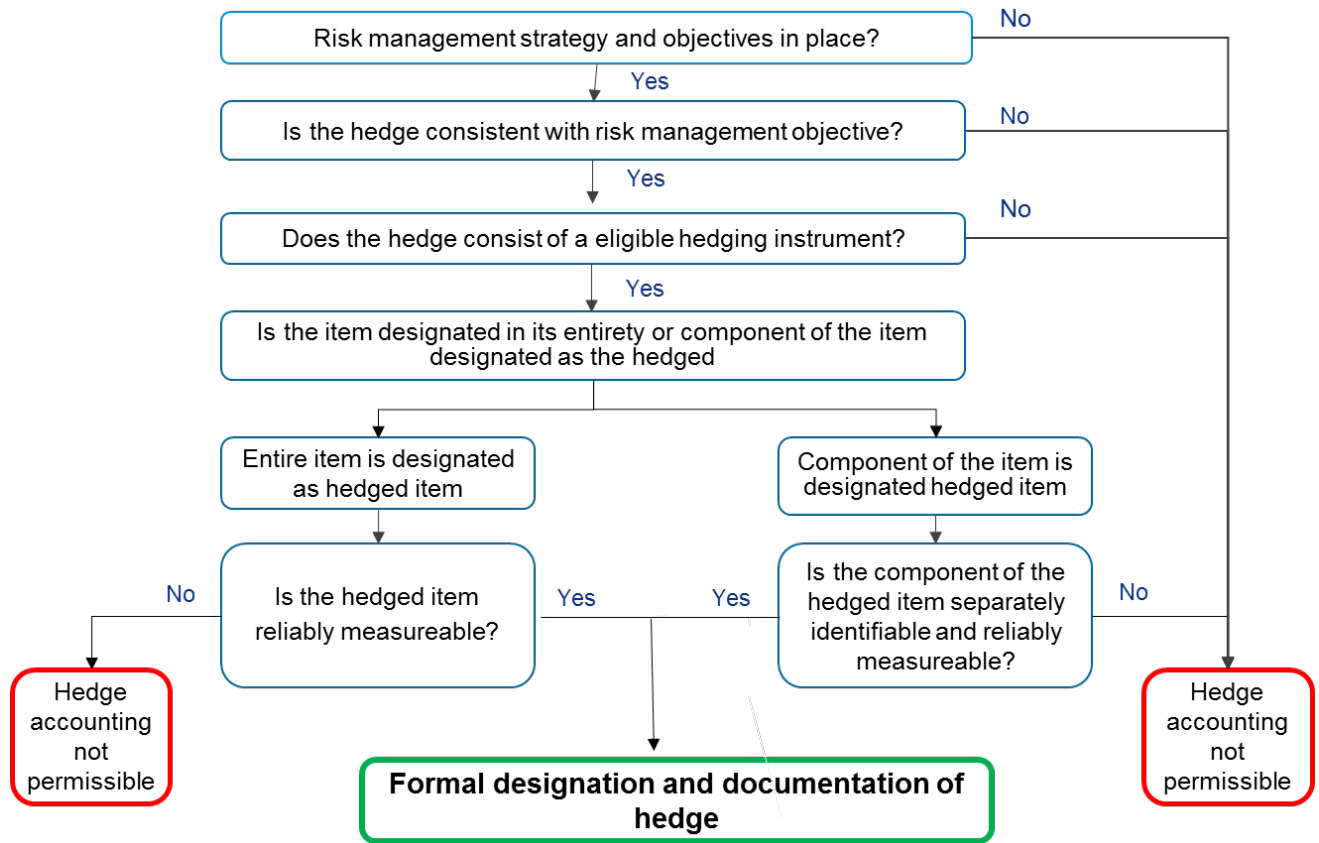
- 1. IAWG is of the view that a hedge of the FX risk of an owned aircraft may qualify as a fair value hedge if the FX risk component in the owned aircraft is established as part of the airline's risk management strategy and the hedge complies in all other respects with IFRS 9.**
- 2. IAWG is of the view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

Note that the IASB's International Financial Reporting Interpretation Committee (IFRIC) issued an agenda decision (AD) in relation to this issue in 2019. It is shown on Pages 12-14.

While that AD agrees that for an asset denominated in a single currency, such as large commercial aircraft, a foreign currency risk element is both identifiable and reliably measurable. The AD requires that the foreign currency risk be part of the entity's risk management strategy and suggests that this will be rare for assets that are intended to be consumed. This view is inconsistent with the language in the standard that only require the potential for the hedged risk to impact fair value and not that it must or even be intended to impact fair value. IAWG is further engaging the IASB on this issue. We expect that there will be diversity in practice regarding this issue and that airlines will find difficulty obtaining agreement from their auditor.

Appendix 1, Hedge Accounting Decision Tree



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 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 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.

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 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.

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) 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/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, 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.

The Committee concluded that the principles and requirements in IFRS 9 provide an adequate basis for an entity to determine 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.

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 methods 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?

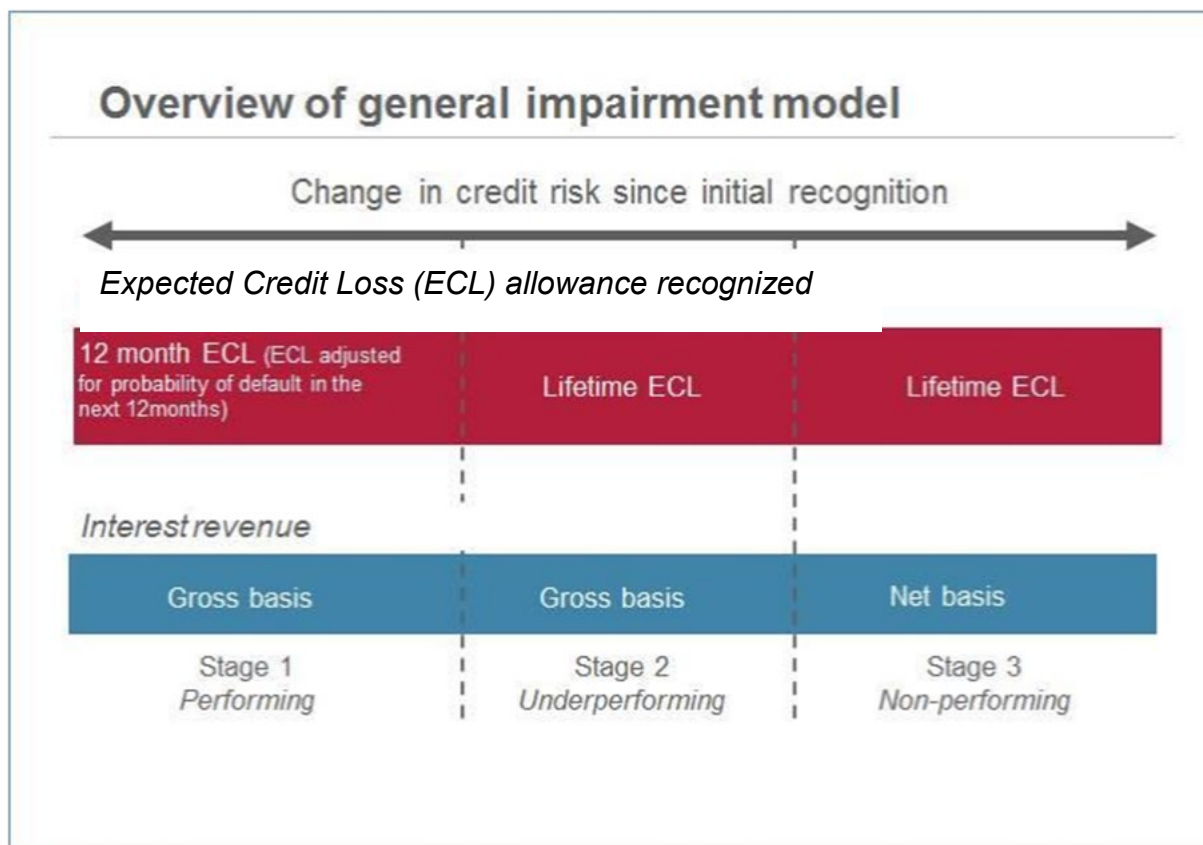
Analysis of Issues

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.**