



## NOTICE

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## 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 overhedged.

#### 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 or 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.**