



On the runway

Global Aviation Group

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Contents

KPMG's market presence	2
Introduction	4
Asian airline: Restructuring	5
European airline: Restructuring services	7
Adria airways: Sell-side advisory	9
Global corporate: Corporate jet acquisition	11
European airline: Design of captive aircraft leasing business	13
African airline: Leadership development program	15
European airline: Business process outsourcing	17
Hawaiian airlines: SOX program implementation	19
Virgin America: SOX program implementation	20
Asian airline: Cyber security review	21
Asia Pacific airline: Cyber maturity assessment	24
IATA: Industry costs assessment	25
Latin American airline: Early adoption of IFRS 9	27
KPMG contacts	
— Global leadership	29
— Contact us	30

Market presence

KPMG member firms have invested extensively in developing an experienced Global Aviation practise, with a deep understanding of the Aviation industry which we believe is both current and forward looking, thanks to KPMG's knowledge, knowledge-sharing, industry training and use of professionals with direct experience in the industry. KPMG member firms' presence in many international markets, combined with industry knowledge, positions us well to assist you in recognizing and making the most of opportunities, as well as implementing changes necessitated by industry developments. KPMG member firms work extensively with:

- Passenger airlines;
- Freight airlines;
- Tour and charter operators;
- Regional and start-up airlines;
- Airports;
- Aviation services providers;
- Aviation authorities; and
- Air navigation civil aviation authorities.

KPMG's network spans the globe, with centers of excellence in Australia, Hong Kong, the UK and the USA.

We are passionate about the industry. KPMG aviation specialists meet regularly to share best practice and industry developments for the benefit of clients. For more information on KPMG's Global Aviation practice, please contact:

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Introduction

The aviation industry continues to experience enormously testing times and is continually having to adapt to a variety of demographic, political and regulatory changes. These range from the digitalization of business processes and consumer demands, to new taxes, surcharges, and environmental and security requirements set by Governments.

For all airlines and airport operators, adapting is part of survival.

- The digitalization of business models, processes and customer interaction is changing the aviation industry. Firms in the aviation and travel industry face a stark choice, get to the future first or get left behind in an outdated view of serving the passenger, as customer experience is the new operational excellence.
- As the industry digitalizes, cyber security is critical for airlines. This is particularly the case for more established airlines and airports with aging IT infrastructure. Protecting customer data is essential. If managed appropriately, it can enhance the customer experience. If managed inappropriately, it presents a major reputational and legal risk.
- Many airlines have developed innovative alliance and joint-venture structures to work within route right rules and foreign ownership restrictions. Given the cost structure of the airline industry, the trend to consolidation is likely to continue.
- As oil prices remain highly volatile, airlines must rethink hedging strategies. At the same time, cost efficiency remains indispensable. To be competitive, airlines must keep their supply chains and operations lean. They must ensure cash is managed effectively. As aviation taxes increase in many countries, it is important to keep operations tax efficient where possible.
- Many airlines around the world are restructuring to match changing circumstances. This is being achieved through a variety of options or combination of options. These include operational restructuring, a restructuring of the funding structure or undergoing a Chapter 11 procedure.
- Airlines continue to develop new ways to make their aircraft leases cost and tax-effective. The impact of IASB proposals to move operating leases onto the balance sheet will have a major impact on airlines' accounts.
- Many Governments worldwide continue to tentatively liberalize aviation markets to lower fares and/or increase quality of the services provided. Airlines should be poised to seize opportunities to enter new markets. They must also make sure they are fully aware of local regulatory and tax arrangements.
- Airports are being privatized or changing ownership more regularly. This presents an opportunity for international airport owners to expand. For example, airport regulators in Asia are looking for foreign or domestic partners. These partners are needed to provide the funding and expertise to meet the unprecedented regional demand for new and larger airports.

These are challenging times for the industry. This document presents a selection of KPMG member firms' work in helping clients navigate their way through this complexity.

Asian airline: Restructuring

Appointment of a KPMG member firm as Provisional Liquidators

Context

The client was an Asian long-haul budget airline.

The company made applications to the local court to be wound up on the grounds of insolvency, and for the appointment of partners of a KPMG member firm as Provisional Liquidators (PLs).

KPMG's role

Following a rapid business assessment by the PLs, during which the airline briefly continued to operate, and considering the position adopted by the aircraft financiers, the business ceased to trade ten days after the PLs' appointment. Approximately 25,000 customers had purchased tickets for flights cancelled following the PLs appointment, and a significant exercise was undertaken to assist displaced passengers in returning to their home countries.

At appointment, the airline's five aircraft were located in the UK, Canada, Namibia and Asia. More than 120 employees were also located in these overseas locations, and both aircraft and crews required repatriation to their home bases.


Given the highly regulated nature of the airline industry, the PLs had significant dealings with regulators and aviation authorities, including the local Transport and Housing Bureau, Civil Aviation Department ("CAD"), Air Transport Licensing Authority ("ATLA") and Airport Authority. The issues dealt with included the maintenance of Certificates of Air Worthiness to enable the aircraft to be operated and the maintenance of Route Licenses while potential rescue plans and sale alternatives for the business were being explored.

As the focus turned to liquidation rather than rescue, KPMG's role included:

Negotiating the safe return of all Aircraft and employees to Asia;

Successfully negotiating with the CAD to ensure that the Aircraft Certificates of Air Worthiness were only suspended and not revoked in order to maximise the realizable value of the aircraft;

Reaching agreement with ATLA to help ensure that Route Licenses were not revoked prior to abandoning efforts to sell the business and/or find an investor;



"a significant exercise was undertaken to assist displaced passengers in returning to their home countries"

- Facilitating the sale of all aircraft resulting in a significant surplus for unsecured creditors; and
- Supervising the sale of rotables and consumables, and derived significant value from wind down of international deposits – recovery of VAT/GST and various deposits paid to suppliers.

Outcome

KPMG's close liaison with the CAA during the contingency planning was a critical factor in the group retaining the confidence of the regulator to provide time to explore the restructuring options.

Although ultimately a restructuring was not possible in this particular case, the rapid and cohesive deployment of KPMG's global network of restructuring professionals was instrumental in successfully recovering and realizing the aircraft, as well as ensuring that both passengers and air-crews were repatriated without undue delay.

European airline: Restructuring services

Review of strategic options and preparation of contingency plans

Context

The client was an airline and travel group operating domestic, European and trans-continental routes in both the schedule and charter carrier space.

Faced with market overcapacity, price competition from low cost carriers and increased operating and regulatory costs, the airline had incurred a sustained period of losses and faced a substantial seasonal working capital shortfall at the same time as it approached the renewal of its operating licences. The shareholders, which had injected substantial funding over a number of years, announced they wished to exit the business and would not provide additional liquidity to the group. The board were forced to urgently look for a new owner and finance provider.


In support of the board a KPMG member firm was asked to review the airline's strategic options and prepare contingency plans should a sale/refinancing not be achieved before the operating licences expired.

KPMG's role

Working closely with management and their legal advisers KPMG professionals were able to quickly narrow down the most pragmatic and achievable options for the group. The options analysis highlighted that a share sale was not going to be feasible without the group undertaking a wholesale restructuring of its operations, as the investment case without it was weak — failing which the group faced bankruptcy, the termination of its operating licences and huge disruption to travellers.

Substantial value in the business was attributed to customer and other stakeholder goodwill; to retain confidence and preserve this value required the restructuring was undertaken outside of a formal insolvency. A critical tool in this, driving counter-party contract negotiations, was KPMG's assessment of the estimated outcome for each stakeholder group should the group fail and go into bankruptcy. Using industry knowledge and insolvency experience KPMG's aviation specialists were able to assess the financial impact on each class of creditor, customer and financing party of the liquidation of the group, which management were able to use as leverage in renegotiating terms.

We were also able to advise on and support management in negotiating a critical debt-for-equity swap with the group's pension scheme, which represented a £660 million contingent liability.



“the board was able to secure sufficient cost savings, fleet re-configuration and operational changes to offer an attractive business case to a new investor”

As a fall-back transaction structure the member firm also carried out a detailed feasibility assessment of a business transfer to a NewCo via a pre-pack to ensure a seamless transition of ownership and operations of the airline.

In parallel with this activity, to protect the group and board's interests in the event that a sale/ refinancing could not be achieved, KPMG professionals worked closely with the management, Civil Aviation Authority ("CAA") (as regulator) and government to help ensure the most efficient and effective contingency plans were in place should the group be forced to file for bankruptcy. This included detailed implementation plans covering communications, repatriation of flown passengers, protection and recovery of assets, and operations in the event we were required to step in as administrators.

Outcome

The close liaison with the CAA during the contingency planning was a critical factor in the group retaining the confidence of the regulator to give time for the restructuring.

Utilising the information KPMG professionals provided, the board was able to secure sufficient cost savings, fleet re-configuration and operational changes to offer an attractive business case to a new investor. A private equity fund acquired the shares and provided liquidity to complete the restructuring before the regulatory licences expired.

Adria Airways: Sell-side advisory

KPMG's role as financial advisor to on the disposal of a majority shareholding

Context

Adria Airways (AA) is the largest airline and the flagship carrier in Slovenia. The Consortium of sellers appointed an International Slovene-German KPMG Corporate Finance team as the exclusive financial advisor to advise on the sales procedure

The Consortium wanted to dispose 91.58% shareholding in AA. AA was also one of the companies on the privatization list of 15 companies confirmed by the Slovenian National Assembly.

KPMG's role

KPMG in Slovenia was appointed in March 2015 as the exclusive advisor to the Consortium and was actively involved for 10 months. The engagement comprised two phases, namely:

- **Phase 1:** Business preparation activities (in-depth analysis of the financial and operational situation in AA and challenging the business plan). KPMG prepared a report on its findings.
- **Phase 2:** Sell-side process in line with international M&A best practice including the following services:
 - Review of the strategic plan of AA;
 - Preparation of marketing documents (teaser and information memorandum);
 - Assistance to management of AA in preparation of management presentation;
 - Approach of an exhaustive long list of international strategic and financial prospective buyers;
 - Data-room management; and
 - Negotiation support.
- During the legal structuring (e.g. EU State aid rules) and SPA negotiations phase, KPMG closely with the legal advisor Karanović & Nikolić.

Outcome

- Special situation in AA (i.e. severe liquidity and profitability issues and in worst case threat of insolvency) called for possible alternative structures of the procedure.



"KPMG suggested an accelerated one stage process where interested parties that expressed interest based on the teaser, signed a NDA and receive all information needed to prepare a binding offer "

- Deviating from the two stage process originally envisaged, KPMG suggested an accelerated one stage process where interested parties that expressed interest based on the teaser, signed a NDA and receive all information needed to prepare a binding offer.
- KPMG co-ordinated all stakeholders, namely the Government, consortium members, buyer universe and general public.

Global corporate: Corporate jet acquisition

Advising a global corporate on the indirect tax implications of a US\$65 million business jet acquisition and performing EU importation

Context

A global corporation purchased a new \$65 million long-range business jet to be used for transporting senior employees on company business to destinations in the EU, USA and South East Asia. The client required a robust ownership and operational structure which was both compliant and efficient for EU VAT and Customs purposes, and requested KPMG's assistance with the structuring, importation and any tax implications that may arise.

KPMG's role

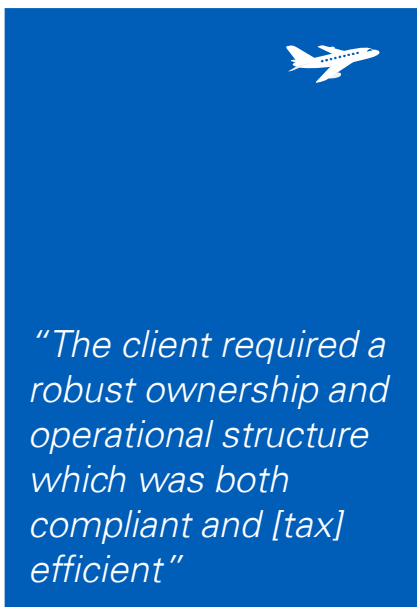
Prior to taking delivery of the aircraft, the client engaged KPMG in the Isle of Man, utilising their VAT and Customs experts who have deep business aviation sector knowledge to work with their appointed aviation lawyers, fiduciary service providers, aircraft operator and employee benefits team to determine the best structure for the client.

KPMG in the Isle of Man's key service delivery areas were:

- Advising the client on the most appropriate and tax efficient EU jurisdiction in which to incorporate the aircraft ownership entity and how best to maximise the recovery of VAT incurred on costs (including import VAT) and appropriate VAT treatment for leasing arrangements of the aircraft;
- Reviewing lease agreements and operational agreements with regard to their VAT treatment;
- Registering the aircraft ownership entity for VAT in the Isle of Man, securing recovery of the import VAT charged on importation and on future operational costs;
- Utilising the EU's End Use Relief in order to mitigate the 2.7% Customs import duty normally applied to aircraft;
- Importing the aircraft through the Isle of Man, securing its EU free-circulation status and serving it with its on-board Customs paperwork; and
- Advising the client on certain employee benefit in kind issues as a result of their usage of the aircraft.

Outcome

We played a key role in ensuring the client dealt with significant tax exposures efficiently and robustly which enabled them to operate the aircraft freely within the EU on a compliant basis. We also assisted the client in simplifying and reducing employee benefit in kind costs.





European airline: Design of captive aircraft leasing business

Design and stand-up of a captive aircraft leasing business

Context

The aviation industry has seen considerable change in recent years with record aircraft order books and continuing forecasts of strong growth for passengers and routes (notwithstanding an economic slowdown in certain markets).

This has led to significant growth plans for airlines and an increasing requirement for enhanced efficiency.

The client, a large European airline with a mix of short-haul and long-haul routes, was looking for opportunities to reduce balance sheet risk, drive efficiencies and create a framework to support ambitious growth plans.

Professionals from KPMG's Global Aviation practise led a multi-disciplinary engagement based on the client requirements. The team based in the Irish member firm's head offices in Dublin, has significant experience in aircraft leasing. KPMG member firms are leading advisors in the industry; we were included in the only Airfinance Power 30 list, a list of companies voted on by the industry that make an essential contribution to aviation finance.

KPMG's role

The client engaged KPMG in Ireland to design and advise on the set-up of a captive aircraft leasing company in Dublin. The team, which contained aviation finance and leasing specialists from across functions, created a three phase assignment and delivered the following aspects:

Plan

- Created and managed the detailed implementation plan to set-up the leasing business. This was a key aspect of the assignment and involved working with all major functions of the airline to ensure their commitment and buy-in to the plan.

Design

- Worked on the structure for the leasing business.
- Advised on the appropriate accounting for the business and in particular assisted the client work through particularly complex areas where the accounting policy of the airline and the captive leasing business conflicted.



"KPMG member firms are leading advisors in the industry; we were included in the only Airfinance Power 30 list"

- Proposed the most effective operating model for the business, based on the needs of the leasing business, while optimising the use of group resources to create an efficient and lean structure.

Implement

- Created a business as usual team, with a mix of audit and advisory specialists who initially advised on the set-up of the organisation and ensured that it was transacting correctly from the outset.
- Worked with the client to implement the strategic team and ensured that there was a robust handover plan with effective knowledge transfer.
- Supported the strategic team once in place to ensure the business continued to perform to expectation.

Outcome

The client created a fully operational aircraft leasing business which has the capability to manage its asset utilisation and orderbook and deliver synergies from maintenance and operations as the airline continues to open new routes and increase passenger numbers.

African airline: Leadership development program

Leadership development program for managerial roles

Context

The airline is a national carrier and the country in question had become a natural 'hotspot' for investors, resulting in the carrier facing new challenges and threats from potential competitors or market entrants. Hence, there was a need for the airline to change how business was done. The Board saw the solution as a thorough examination of the current leadership, the identification of areas for improvement in airline management and ensuring that as well as a "key man" retention strategy, a duly formalised succession plan was also approved. In this context, the Board, after the necessary tender process, engaged a KPMG member firm to change the way business was done at the airline and to implement airline management best practise. A key component of this engagement was that the Board wanted the future leaders of the business to come from within.

KPMG's role

Our role encompassed a thorough analysis of all managerial roles, related responsibilities and performance measurement. Thereafter, we assessed and detailed the level of skill required including the behavioural characteristics for each role. We performed a behavioural assessment of 140 managers, these managers included Business Line Managers, Department and Section Heads. The result of this process was to implement the guidelines for improved leadership and for leadership development.

KPMG assisted the Board in the formal communication to Staff to ensure that the correct message was given and that the project was afforded the appropriate awareness by all respective stakeholders. The alignment of expectations was crucial to the outcome of the project.

KPMG along with the client worked on the leadership competencies, derived from the strategic objectives required for each of the leadership clusters to be assessed. This enabled the identification of the transversal traits that a leader within the airline should possess and set a standardized baseline for staff assessment.

The engagement included individual interviews, behavioural tests and an 8 people group business case discussion. Each of the tools used by KPMG was linked to a specific set of competencies evaluated in each case enabling a fair, consistent and rigorous staff assessment. All work steps undertaken were designed with the engagement outcome in mind, that being, to implement the guidelines for improved airline management leadership including, leadership development.



"The country in question had become a natural 'hotspot' for investors resulting in the carrier facing new challenges and threats"

Outcome

KPMG developed a global assessment report per business area and functional cluster, individual reports for the Board, individual reports for participating staff including, a leadership development plan. Furthermore, KPMG professionals had individual feedback sessions with the participating staff in order to explain and assist on the interpretation of results including, in conjunction with the appropriate airline manager, detailing the respective individual's leadership development plan.

European airline: Business process outsourcing

Implementation of Business Process Outsourcing (“BPO”)

Context

The client, a leading global airline, had decided to implement BPO solutions for the procurement of indirect materials and for revenue accounting as part of a group-wide operational excellence and cost reduction program.

Given the criticality of the program, the client was asking KPMG to support the entire sourcing process up to contract signature and the following transformation and transition process.

KPMG’s role

The KPMG member firm deployed a senior advisory team with broad expertise in BPO, procurement and revenue accounting. In the first project phase, an intense review of the client’s readiness was conducted, focusing on key risk areas and utilizing the extensive sourcing expertise from across KPMG’s global network.

In the second phase, a focused data gathering and analysis exercise facilitated the preparation of a highly professional RFP for both BPO projects. This included detailed category reviews, procurement systems and processes analysis, initial solution workshops and business case reviews.

The following RFP process was leveraging the extensive market expertise and industry insights of KPMG professionals to help ensure the selection of capable providers, focused and clear communications, quality responses and maximum provider attention.

For the review of responses and initial selection of providers KPMG provided tested methodologies including assessment criteria matrices, solution workshops and decision-preparation support.

Based on best-and-final-offers from the selected providers, the Due Diligence process (inbound DD, outbound DD) was coordinated and results used to identify the provider of choice for the following, exclusive contracting phase. Here, KPMG professionals provided intensive negotiation support based on deep and pragmatic knowledge on industry best-practice terms and conditions for BPO agreements.

After contract signatures for both BPOs, KPMG transition managers supported the transformation and transition phase over a 4-month period.



“KPMG professionals provided intensive negotiation support based on deep and pragmatic knowledge on industry best-practice”

Outcome

A highly professional BPO sourcing process with service agreements achieved in time and on budget

Selection of the most capable provider a highly attractive terms combined with strong risk mitigation

Client quote: “We have been highly impressed by the outstanding engagement and expertise of KPMG’s consultants, while being down-to-earth and client-focused.”

Hawaiian airlines: SOX program implementation

Implementation of the company's Sarbanes-Oxley (SOX) program

Context

Hawaiian Airlines is a US-based airline operating flights to Australia, New Zealand, Asia, Hawaii, and the United States mainland. Upon emerging from Chapter 11 bankruptcy in 2005, the company hired another organization to implement the company's Sarbanes-Oxley (SOX) program. However, in 2006, the company decided to make a change, and KPMG in the US was selected to provide this service (which included internal controls rationalization, documentation, remediation and testing services over the financial, operational and technology areas).

KPMG's role

A multi-disciplinary team led by professionals from KPMG's Internal Audit, Risk and Compliance and IT Advisory Services practices assisted the company's corporate audit function in successfully implementing a SOX compliance program. In addition to the core team of Advisory professionals, KPMG in the US brought subject matter professionals from our Audit and Tax practices to provide airline industry experience for the more technical accounting areas of the project.

Outcome

Hawaiian Airlines has since remediated the significant control deficiencies, and has been working with KPMG in the US for internal audit co-sourcing services ever since. Over the last decade, KPMG's relationship with Hawaiian Airlines has evolved from that of a provider of SOX compliance services to one which offers a broader spectrum of subject matter professionals to support the corporate audit plan – specifically, in the areas of Enterprise Risk Assessment, Cyber Security, Disaster Recovery and Business Continuity, Data Centre Expansion, Major Project Risk Assessment, and COSO 2013 Adoption.



“KPMG’s relationship with Hawaiian Airlines has evolved from that of a provider of SOX compliance services to one which offers a broader spectrum of subject matter professionals”

Virgin America: SOX program implementation

Sarbanes-Oxley implementation supporting Initial Public Offering

Context

Virgin America (the company) is an upscale, low-cost airline based in California that commenced operating flights in 2007, providing scheduled air travel in the United States and Mexico. Virgin America operates primarily from its focus cities of Los Angeles and San Francisco, with a smaller presence at Dallas Love Field, to other major business and leisure destinations in North America. In late 2014, the company listed on the NASDAQ, raising more than USD \$300 million in its initial public offering. In early 2015, the company turned to KPMG's US member firm for assistance with implementing its Sarbanes-Oxley (SOX) compliance program.

KPMG's role

Using a co-sourcing model to support the company's Internal Audit department, a core project team comprised of US firm professionals from KPMG's Internal Audit, Risk and Compliance Services and IT Advisory practices assisted the company with implementing and executing its SOX compliance program. KPMG's service delivery team had in-depth SOX and internal audit co-sourcing experience, as well as insight gained from providing similar services to other airline clients. Given the combination of KPMG professionals' technical and industry subject-matter expertise, the team was able to offer the client invaluable support with complex, industry-specific areas.

Outcome

Given the familiarity KPMG had with the company's external auditor, the overall project execution and communication between all parties (client, external auditor, and KPMG in the US) was organized, effective and collaborative. Together with KPMG, the company was able to implement a successful SOX compliance program, and is well positioned to build on a solid foundation in the second year of its compliance efforts.



"Together with KPMG, the [airline] was able to implement a successful SOX compliance program"

Asian airline: Cyber security review

An independent review of the airline's cyber security preparedness

Context

Organisations around the world are beginning to understand that the consequences of cyber risks can be significant, affecting both their bottom line and brand reputation. This is why cyber security concerns are no longer restricted to the IT department, and now appearing as a major issue on the agenda of Boards.

The client, one of Asia's largest carriers, wanted an independent perspective of the cyber security preparedness of the organisation.

KPMG's role

KPMG's member firm, the carrier's auditor, was engaged to perform an independent diagnostic review of the carrier's cyber security readiness. The review looked beyond pure technical preparedness, and took a rounded view of people, process and technology to help understand areas of vulnerability and to identify and prioritise areas for remediation.

The review focused on the following six critical areas:

- **Leadership and Governance:** Identify the board's understanding of cyber and its cyber risk appetite, and demonstrate due diligence, ownership and effective management of risk
- **Human Elements:** Assess the level and integration of a security culture that empowers and ensures the right people, skills, culture and knowledge
- **Information Risk Management:** Identify the approach to achieving comprehensive and effective risk management of information throughout the organisation, delivery partners and supply chain
- **Business Continuity:** Assess the preparedness for a security event and ability to prevent or minimise the impact through successful crisis and stakeholder management
- **Operations and Technology:** Assess the level of control measures implemented to address identified risks and minimise the impact of compromise
- **Legal and Compliance:** Assess the adherence to applicable regulatory and international certification standards



"Organisations around the world are beginning to understand that the consequences of cyber risks can be significant"

The KPMG audit team, together with cyber security specialists, leveraged deep industry knowledge and experience to perform the review through interviews with key stakeholders including the management team from finance, IT and business, internal audit, as well as the information security and operations team. By working closely with the audit team and client management team, key action plans were identified to mitigate the key risks.

Outcome

KPMG professionals' in-depth knowledge of the airline industry, coupled with the integration of cyber security specialists allowed us to provide meaningful insights and clarity of cyber risks to the client. The diagnostic report and recommendations allowed management to strengthen the overall cyber security posture, and focus on key areas that required greater priority, including areas such as strengthening the board and leadership role and oversight of cyber security in the organisation, strengthening capability and resources to respond to advance persistent threats and enhancing current security incident simulation exercises through cyber war-gaming and cyber security drills.



Asia Pacific airline: Cyber maturity assessment

An assessment of the cyber maturity of three core business segments

Context

The client has several core business segments operating semi-autonomous cyber environments. Each of these segments has a large amount of customer sensitive information and relies on IT heavily in their business model.

KPMG's role

The KPMG member firm performed an assessment of the cyber maturity of each of these segments against a KPMG developed framework that focuses on six areas. The results of each segment were benchmarked against each other, against other clients in the same industry, and against industry best practice.

Outcome

Following this assessment the client performed a gap analysis from the current state to the ideal state and commenced a project to update the cyber environment where necessary.



"Each of these segments has a large amount of customer sensitive information and relies on IT heavily in their business model"

IATA: Industry costs assessment

Quantifying costs to the airline industry of operations involving capacity constrained airports

Context

At a growing number of airports worldwide, the increase in demand for air travel has placed pressure on airport capacity. Currently there are 167 airports around the world which require airlines to possess slots so as to operate air services. These slots can restrict the ability of an airline to provide services to customers, and can result in costs to airlines.

The KPMG member firm was engaged by International Air Transport Association ("IATA") to assess the costs incurred by airlines globally associated with the slot arrangement at capacity-constrained airports.

KPMG's role

KPMG spoke with senior management of around 35 global leading airlines including major Asia Pacific carriers – to understand the direct, indirect and revenue foregone associated with slot capacity constraints at capacity constrained airports.

Based on consultations with airlines, KPMG identified the major factors and costs of capacity constraint.

KPMG professionals utilized an econometric modelling tool to quantify the direct, indirect and revenue foregone identified, where possible.

Outcome

IATA was presented with the costs to airlines associated with operations in capacity constrained airports in terms of direct, indirect and revenue foregone. The results would be used by the aviation industry to advocate to governments, regulators and airport operators the need for timely investment to address demand needs.



"the growth in demand for air travel has placed pressure on airport capacity"



Latin American airline: Early adoption of IFRS 9

Context

During 2015, the world saw international oil prices moving from a relatively prolonged period of high prices to its lowest levels for at least a decade. The airline sector also experienced a boom, due to the increasing number of travellers worldwide, and the decline in fuel prices.

When fuel prices crossed the airline's self-defined threshold of US\$70 per barrel, a decision was made to buy option-based derivative contracts (and strategies with combinations of options) to hedge a portion of its fuel costs for the next twelve months, at what were then 'attractive' prices.

The client had complained previously about the negative effects on their income statement experienced under the application of IAS39, attributable to the use of option-based strategies. In summary these were as follows:

- The time value of the options were generally not treated as part of the effective portion of the hedging instrument, when hedging a portion of the forecasted jet fuel consumption under the Cash Flow Hedge (CFH) accounting model, hence giving rise to volatility throughout the hedge relationship's term.
- The need, under IAS39, to include those transportation costs incorporated as part of the final jet fuel price at the terminals where jet fuel was loaded, hence introducing variability within the hedging relationship and its corresponding effectiveness testing.

Based on this and KPMG professionals' advice, the airline decided to early adopt IFRS 9 (2013), which allowed them to do the following:

- Recognize the time value of options within OCI as part of the cost of hedging" and then recycling the cost to Cost of Service Sold (COSS) when the transaction (the burning of Jet Fuel) does take place on a monthly basis. These strategies are based on serial Asian-type options targeted at hedging a portion of the highly expected jet fuel consumption as far out as 10 months.
- Identify and exclude those jet-fuel transportation costs (identifiable and measureable) from the hedging relationship, thus allowing a jet fuel reference price (market-based) hedging relationship to be entered into



"the Company was able to successfully structure and formally designate several option-based jet fuel price hedging relationships."

KPMG's role

KPMG's member firm was engaged as advisor, to provide both an IFRS 9 Hedge Accounting sector awareness session, thus allowing the client to identify the new permissible hedge accounting treatment for options. Financial Risk Management (FRM)- Financial Instruments Valuation and Accounting (FIAV) advisory scope included the structuring of the options-based hedge strategy, the hedge relationship formal designation, the accounting entries, and IFRS 7 disclosures.

KPMG professionals' key activities included:

- A comparison to determine which permissible method of adoption offered the best path to achieve the Company's goals around mitigating profit and loss volatility;
- Identify those activities that are affected by the transition from IAS39 to IFRS 9;
- Identify the relevant risks and the reference price that best enabled achievement of the Company's goals;
- Design of the hedge documentation and a template for effectiveness testing;
- Drafting of accounting entries and disclosure requirements under IFRS 9,

Outcome

Observing a very tight deadline, in order to avoid an early application of a later version of IFRS 9, the Company was able to successfully structure and formally designate several option-based jet fuel price hedging relationships.

The accounting and disclosures were reviewed by this Client's external auditor with no further observations, and no comments were issued by the SEC.

KPMG professionals assisted the Company not only with the hedge accounting sections under IFRS 9 (2013), but also with the Classification and Measurement of Financial Assets/Liabilities and -no less important - with those related risks disclosures.

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