



Consolidated Financial Statements

Azul S.A.

December 31, 2018 and 2017
with Registered Public Accounting Firm




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Management Comments

2018 was another milestone year for Azul as we celebrated the tenth anniversary of our first flight. Visiting the many destinations in Azul's network, I could not be more excited to see our outstanding crewmembers delivering the Azul experience every day, with the same passion and energy as they did ten years ago. Together we have built a great airline with a differentiated business model, focused on delivering superior customer service and investor returns.

In 2018, we continued to successfully execute on our margin expansion plan consisting of three strategic pillars: transforming our fleet by replacing smaller aircraft with larger, more fuel-efficient next generation aircraft; growing our loyalty program TudoAzul; and expanding cargo and ancillary revenues. As a result, even with the year-over-year increase in jet fuel of 30% and the strengthening of the U.S. dollar of 15%, we delivered a record adjusted net income of R$ 703.6 million in 2018. In addition, we ended the year with a strong liquidity position of approximately R$4.0 billion, representing 44% of last twelve month's revenue, and generated R$266.2 million in free cash flow, reflecting our commitment to sustainable growth and building long-term value.

Our capacity grew 16% in 2018, mostly through our upgauging strategy, and we were also able to increase RASK year over year by 7.6% adjusted for stage length. As a result, our top line grew 18.4% compared to 2017. In the fourth quarter, RASK adjusted for stage length increased 2.7% and revenue grew 13.5% year over year. Our average fare rose 12.2% to R$ 377.2, the highest in the country.

The main driver of our margin expansion plan is the unit cost reduction derived from the renewal of our fleet with next-generation aircraft, which have more seats and higher fuel efficiency. The Airbus A320neos and the Embraer E2s have a CASK that is approximately 29% and 26% lower than the current generation aircraft that we operate. In 2018, 30% of our capacity was generated by next-generation aircraft, leading to a 2.4% decrease in CASK ex-fuel even with the 15% depreciation of the real. In 4Q18, our CASK ex-fuel decreased an impressive 8.1% as we ended the year with 20 A320neos. I could not be happier with its performance. This is the main reason why we have decided to accelerate our fleet renewal plan in 2019. During the year, we expect to add 21 next-generation aircraft, an increase of eight units from our previous plan, and replace 15 older jets. As a result, we expect that by the end of 2019, an industry leading 50% of our capacity will be coming from next-generation aircraft.

With revenue growth of 56.5% in 2018, Azul Cargo Express was the strongest performer among our business units, benefiting from the expansion of our network and fleet. We have a diversified customer base including the main retailers, manufacturers, and online companies in Brazil, who value our reliable and far-reaching logistic solution.

Our wholly-owned loyalty program TudoAzul maintained its strong growth pace, reaching 10.8 million members by December, an increase of almost two million members from December 2017. Gross billings ex-Azul grew 29.3% in 2018 compared to 2017, with the majority of this increase coming from sales to banking partners and direct sales to members, further increasing our share of the Brazilian loyalty market.

Once again, in 2018, our on-time performance was the highest in Brazil and in South America. For the eighth year in a row, we won the Skytrax award of Best Regional Airline in South America, and also Best Airline Staff. In addition, for the second year in a row we were elected among the world's top 10 airlines and best carrier in Latin America by TripAdvisor Travelers' Choice. Winning these awards is a true testament to the dedication and commitment of all our crewmembers.

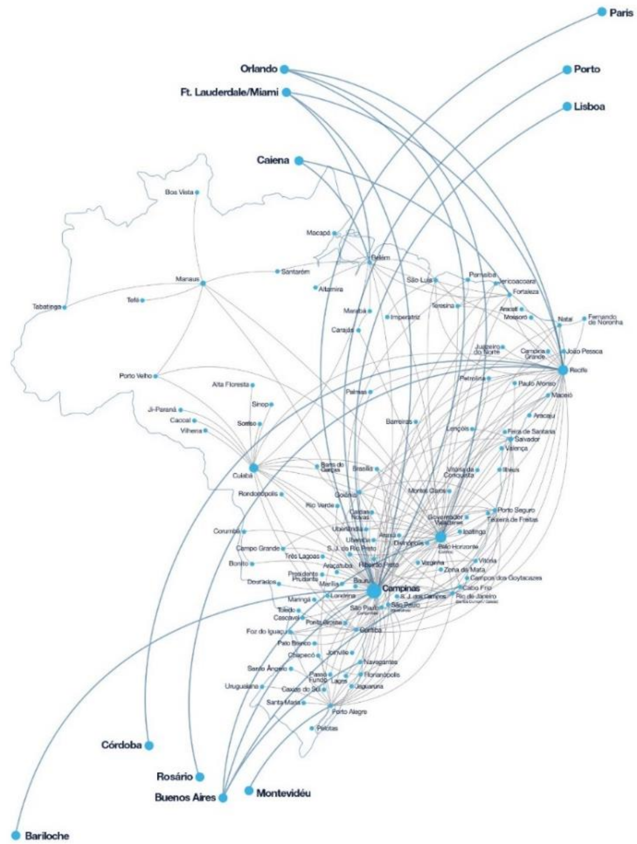
We ended our first decade confident that we will continue generating positive returns for our shareholders, be the preferred airline for our customers, and offer a great place to work for our crewmembers. We have a proven and resilient business model and we are just getting started. While we have achieved significant milestones in our first ten years, I am confident as ever that our best years are still ahead of us.

Thank you for your continued support.

John Rodgerson, CEO of Azul S.A.

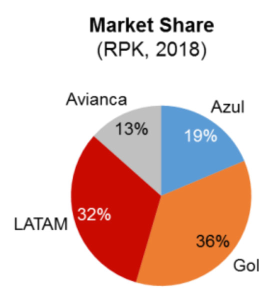
Azul in 2018

- ✓ 821 daily flights to 110 destinations
- ✓ 30% of domestic departures and 19% market share (RPK)
- ✓ Operating fleet of 125 aircraft with an average age of 5.9 years consisting of 63 E-Jets, 33 ATRs, 20 A320neos, 7 A330s, and 2 B737 freighter aircraft



Aviation market

In 2018, the Brazilian aviation market grew 4.4% in terms of RPKs on a capacity growth of 4.6% year over year. As a result, the industry's average load factor totaled 81.3%, down 0.2 percentage points compared to 2017.



In comparison, Azul recorded an RPK growth of 16.4% on an ASK growth of 16.0%, resulting in a load factor of 82.3%, 0.2 percentage points higher than in 2017. In 2018 Azul's RPK share reached 19%.

Environmental, Social and Governance ("ESG") Responsibility

Aviation is a key driver of sustainable development, bringing together people, businesses and communities. Safe, reliable, efficient and cost-effective air transport are important components of a broader mobility strategy to foster development. Since the beginning, Azul has engaged in activities that promote social awareness aiming to be a reference in the transformation of the individual, company and society in the Brazilian market.

Azul is the sole airline in 156 routes of the 220 routes it serves and there are still several communities that are underserved or not served at all in Brazil. Each time Azul connects a new, previously isolated destination with other regions of the country, it contributes to the local development of the region providing employment, trade links and tourism. In 2018 Azul announced five new destinations, including Mossoró, São José dos Campos, and Aracati, while identifying a list of another 30 potential new destinations.

Azul's corporate social responsibility work also includes social projects, corporate volunteer programs and social campaigns. Pink October is one of the main causes defended by the Company. In October of 2018 Azul conducted the largest breast cancer awareness campaign in its history, reaching more than two million customers and 12,000 crewmembers. We also support Operation Smile, an international nonprofit medical service organization providing cleft lip and palate repair surgeries to children worldwide, and Vaga Lume, an entity that supports 121 communities along the Amazon River by collecting food, preparing meals, reading to children and teenagers in the community, and offering library maintenance training to regional volunteers. Other organizations supported by Azul in 2018 includes Litro de Luz, which provides illumination to underpriviledged communities by installing light poles and lamps powered by solar panels, and Teto Brasil, which connects volunteers and local communities to work together to improve housing conditions of families living in slums. Approximately 16% of our crewmembers are part of our volunteer program, and with their help, during 2018, we continued to support nonprofit organizations focused on the development of the country, specially in the areas of health, education and infrastructure.

Respect for people is fundamental to building strong and lasting relationships. We take good care of our crewmembers by providing them with training opportunities and promoting equality, non-discrimination and diversity. For our customers, we offer a great customer experience including friendly, reliable and punctual service. We are continuously working to increase accessibility to our services. More recently, in 2018, our website adopted Hugo, a sign language assistant, becoming the first Brazilian carrier with a website designed to be disability-friendly.

We have the youngest fleet in the country and continue to make progress towards the long-term sustainability of our business by replacing older aircraft with next-generation planes that are more fuel efficient. By 2023, all of our domestic capacity will be produced by fuel-efficient aircraft, namely the A320neos, Embraer E2s and ATR turboprops. Azul complies with all environmental legislation relating to the protection of the environment, including the disposal of waste, the use of chemical substances and aircraft noise, and also requires its suppliers to comply with several environmental management system procedures and to use technical audits to enforce compliance. In addition, Azul is the only airline in Brazil with an onboard recycling program, and in almost 4.5 years of the program, a total of 74,400 kg of waste has been recycled.

Dialog and transparency are the foundation of Azul's corporate governance structure. The Company adopts management procedures that comply with SEC and CVM requirements and seek to guarantee international standards of transparency. In addition, Azul was the first Brazilian company to become signatory to the Brazilian Takeover Panel (CAF), a private self-regulated organization for the Brazilian securities market ruled by the highest levels of corporate governance standards.

ESG KEY INDICATORS	2018	2017	% Δ
Environmental			
Fuel			
GHG (Kg of CO2, million)	2,610.1	2,372.0	10.0%
Total fuel consumed per ASK (kg / ASK, million)	28.2	29.8	-5.2%
Fleet			
Average age of operating fleet	5.9	5.6	4.6%
Social			
Labor Relations			
Employee gender: (%) male	58.0	57.0	1.8%
(%) female	42.0	43.0	-2.3%
Employee turnover (%)	0.95	1.03	-7.8%
Employees unionized (%)	18.0	17.0	5.9%
Governance			
Management			
Independent directors (%)	82.0	85.0	-3.5%
Percent of board members that are women	9.0	7.7	17.0%
Director average age	56.1	53.7	4.5%
Director meeting attendance (%)	99.0	94.9	4.3%
Board size	11.0	13.0	-15.4%
Participation of woman in leadership positions (%)	28.3	28.7	-1.3%

Consolidated Results

The following revised income statement and operating data should be read in conjunction with the quarterly results comments presented below. Prior periods presented have been adjusted to reflect adoption of new IFRS accounting standards effective from January 2018.

Income statement (R$ million)	2018[1]	2017	% ∆
OPERATING REVENUES			
Passenger	8,721.3	7,399.7	17.9%
Other	483.2	373.7	29.3%
Total operating revenues	**9,204.6**	**7,773.5**	**18.4%**
OPERATING EXPENSES			
Aircraft fuel	2,644.3	1,848.2	43.1%
Salaries, wages and benefits	1,413.0	1,296.2	9.0%
Aircraft and other rent	1,509.9	1,181.7	27.8%
Landing fees	592.1	490.6	20.7%
Traffic and customer servicing	395.4	357.8	10.5%
Sales and marketing	368.7	309.5	19.1%
Maintenance materials and repairs	504.5	568.1	-11.2%
Depreciation and amortization	324.9	299.8	8.4%
Other operating expenses	643.1	573.1	12.2%
Total operating expenses	**8,395.8**	**6,925.1**	**21.2%**
Operating income	**808.7**	**848.4**	**-4.7%**
Operating Margin	*8.8%*	*10.9%*	*-2.1 p.p.*
FINANCIAL RESULT			
Financial income	41.4	94.8	-56.3%
Financial expenses	(410.2)	(524.0)	-21.7%
Derivative financial instruments	298.1	(90.2)	n.a.
Foreign currency exchange, net	(194.7)	57.9	n.a.
Result from related party transactions, net	342.1	194.4	76.0%
Income before income taxes	**885.4**	**581.2**	**52.3%**
Income tax and social contribution	(11.2)	2.9	n.a.
Deferred income tax	(170.6)	(67.7)	151.9%
Net income	**703.6**	**516.3**	**36.3%**
Net margin	*7.6%*	*6.6%*	*+1.0 p.p.*
Weighted avg. of PN equivalent shares (million)	337.7	315.6	7.0%
Fully diluted shares	342.8	321.8	6.5%
Basic net income per PN[2] share (R$)	**2.08**	**1.64**	**27.3%**
Diluted net income per PN[2] share (R$)	**2.05**	**1.60**	**27.9%**
Basic net income per ADS (R$)	**1.61**	**1.49**	**8.3%**
Diluted net income per ADS (R$)	**1.59**	**1.45**	**9.4%**

[1] 2018 adjusted for non-recurring items in 2Q18.
[2] One ADS equals three preferred shares (PN).

In 2018 we reported an operating income of R$525.4 million, a R$322.9 million decrease compared to 2017. Excluding non-recurring items totaling R$283.3 million, operating income would have been R$808.7 million, representing a margin of 8.8% in 2018 down from an operating margin of 10.9% in the previous year. This result was mostly driven by a 18.4% increase in revenue resulting from the 16.0% increase in capacity in terms of ASKs, mostly due to the introduction of next-generation A320neo aircraft, which are more fuel efficient and have a lower CASK, partially offset by (i) the 14.8% average depreciation of the Brazilian real against the U.S. dollar in 2018 compared to 2017, which increased expenses denominated in U.S. dollars, (ii) a 30% increase in fuel prices, and (iii) non-recurring events totaling R$283.3 million consisting of an expense of R$226.3 million related to the sale of six E-Jets and the loss of revenue and expenses totaling R$57.0 million related to the truckers' strike held in May, which disrupted economic activity throughout the country and affected our flights for a period of 10 days.

In addition to reporting positive operating results we also reported a net income of R$420.3 million in 2018, R$96.1 million lower than in 2017. Excluding the impact of non-recurring events, net income would have totaled R$703.6 million, a record amount.

The table below sets forth the breakdown of our operating revenues and expenses on per ASK basis for the periods indicated:

R$ cents	**2018[1]**	**2017**	**% ∆**
Operating revenue per ASK			
Passenger revenue	29.71	29.25	1.6%
Other revenue	1.65	1.48	11.4%
Operating revenue (RASK)	**31.36**	**30.73**	**2.1%**
Operating expenses per ASK			
Aircraft fuel	9.01	7.31	23.3%
Salaries, wages and benefits	4.81	5.12	-6.0%
Aircraft and other rent	5.14	4.67	10.1%
Landing fees	2.02	1.94	4.0%
Traffic and customer servicing	1.35	1.41	-4.8%
Sales and marketing	1.26	1.22	2.7%
Maintenance materials and repairs	1.72	2.25	-23.5%
Depreciation and amortization	1.11	1.18	-6.6%
Other operating expenses	2.19	2.27	-3.3%
Total operating expenses (CASK)	**28.60**	**27.37**	**4.5%**
Operating income per ASK (RASK - CASK)	**2.76**	**3.35**	**-17.8%**

[1] 2018 adjusted for non-recurring items in 2Q18.

Operating Data	2018	2017	% Δ
ASKs (million)	29,353	25,300	16.0%
RPKs (million)	24,156	20,760	16.4%
Load factor (%)	82.3%	82.1%	*+0.2 p.p.*
Average fare (R$)	377	336	12.2%
Revenue passengers (thousands)	23,122	22,014	5.0%
Departures	262,312	259,966	0.9%
Average stage length (km)	1,006	905	11.2%
Yield per passenger kilometer (cents)	36.10	35.64	1.3%
RASK (cents)	31.36	30.73	2.1%
PRASK (cents)	29.71	29.25	1.6%
CASK (cents)	28.60	27.37	4.5%
CASK ex-fuel (cents)	19.59	20.07	-2.4%

[1] 2018 adjusted for non-recurring items in 2Q18.

Operating Revenue:

Operating revenue increased 18.4%, or R$1.4 billion, from R$7.8 billion in 2017 to R$9.2 billion in 2018, primarily due to (i) an increase of 17.9% of passenger revenue and (ii) a 29.3% increase in other revenue discussed herein.

The R$1.3 billion, or 17.9% increase in passenger revenues in 2018 compared to 2017 was mainly attributable to (i) an increase of 16.4% of RPKs reflecting a 16.0% increase in ASK's and (ii) a 1.6% increase in PRASK due to higher load factors, yields and non-ticket revenue.
The R$109.5 million or 29.3% increase in other revenue was mainly due to a 56.5% increase in cargo revenue.

Operating Expenses

Operating expenses increased 21.2%, or R$1.5 billion, from R$6.9 billion in 2017 to R$8.4 billion in 2018 mainly due to:

- An increase in fuel expenses of 43.1% or R$796.1 million in 2018 compared to 2017, mainly as a result of (i) a 30.0% increase in jet fuel prices from an average of R$1.97 per liter in 2017 to R$2.56 per liter in 2018, and (ii) a 6.5% increase in block hours. In comparison, on a per-ASK basis, aircraft fuel increased by 23.3%.

- An increase in salaries, wages, and benefits of 9.0% or R$116.9 million in 2018 compared to 2017, due to (i) a 2.5% increase in salaries as a result of collective bargaining agreements with labor unions applicable to all airline employees in Brazil in 2018, and (ii) an increase in the number of crewmembers from 10,878 in 2017 to 11,807 in 2018, mostly related to the 16% increase in capacity.On a per ASK basis, salaries, wages and benefits decreased 6.0%.

- An increase in aircraft and other rent of 27.8% or R$328.2 million in 2018 compared to 2017, principally due to (i) an increase in the average number of aircraft under operating leases in 2018 to 120 compared to 111 in 2017 and (ii) the 14.8% average depreciation of the Brazilian real against the U.S. dollar in 2018 compared to 2017. On a per ASK basis, aircraft rent increased 10.1%.

- Landing fees increased 20.7% or R$101.5 million in 2018 compared to 2017 primarily due to (i) the 11.2% increase in average stage-length from 905 kilometers in 2017 to 1.006 kilometers in 2018, and (ii) an increase in international departures, which have higher landing fees. On a per ASK basis, landing fees increased 4.0%.

- Maintenance, materials and repairs decreased 11.2% or R$63.7 million in 2018 compared to 2017 primarily due to (i) a lower number of maintenance events in the year ended December 31, 2018 compared to 2017 and (ii) more favorable pricing conditions negotiated with suppliers. On a per ASK basis, maintenance decreased 23.5%.

- Other operating expenses increased 12.2% or R$69.9 million in the year ended December 31, 2018 compared to 2017 primarily due to (i) higher expenses related to A320neo training ramp up costs and (ii) an increase of 16% in IT expenses related to GDS expenses as a result of our international partnerships, which are US dollar denominated.

Liquidity and Financing

Azul closed the year with R$4.0 billion in cash, cash equivalents, short-term and long-term investments, and receivables, 13.7% above the R$3.6 billion recorded in 2017, representing 43.9% of its last twelve months' revenue.

Liquidity (R$ million)	**2018[1]**	**2017**	**% ∆**
Cash[1]	2,974.3	2,643.2	12.5%
Accounts receivable	1,069.1	913.8	17.0%
Total Liquidity	**4,043.4**	**3,557.0**	**13.7%**
Liquidity as % of LTM adjusted revenues	*43.9%*	*45.8%*	*-1.9 p.p.*

[1] Includes cash and cash equivalents and short-term and long-term investments.

Total debt considering currency hedges decreased R$50.9 million to R$3,449.0 million, mostly due to debt repayments partially offset by the issuance of new debentures replacing more expensive debt. As of December 31, 2018, Azul's average debt maturity was 3.9 years and the average interest for local and dollar-denominated obligations was 6.8% and 5.3%, respectively. In addition, considering currency swap agreements, approximately 69.3% of Azul's total debt and 100% of non-aircraft debt were denominated in Brazilian reais at the end of the year.

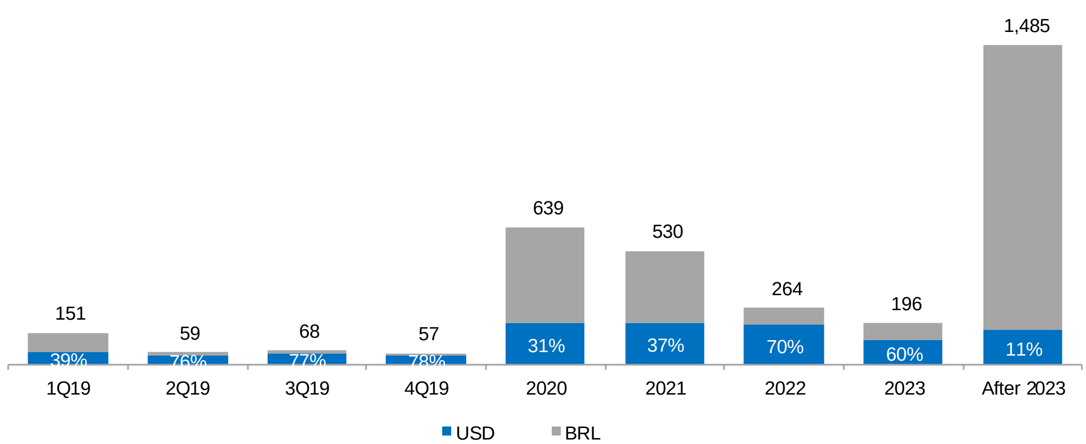
Loans and financing (R$ million)	2018[1]	2017	% Δ
Aircraft financing	1,252.2	1,505.8	-16.8%
Other loans, financing and debentures	2,196.8	1,994.1	10.2%
% of non-aircraft debt in local currency[1]	*100.0%*	*99.2%*	*+0.8 p.p.*
Gross debt	**3,449.0**	**3,499.9**	**-1.5%**
Short term	*335.1*	*563.5*	-40.5%
Long term	*3,114.0*	*2,936.4*	6.0%
% of total gross debt in local currency[1]	*69.3%*	*62.6%*	*+6.7 p.p.*
Operating leases (off-balance sheet)	**10,569.6**	**8,272.1**	**27.8%**
Loans and financing adjusted for operating leases	**14,018.7**	**11,772.0**	**19.1%**

[1] Considers the effect of currency hedges on debt.

Key financial ratios (R$ million)	2018[1]	2017	% Δ
Cash[1]	2,974.3	2,643.2	12.5%
Currency swaps on debt	3,449.0	3,499.9	-1.5%
Net debt	474.7	856.7	-44.6%
Capitalized aircraft rent	10,569.6	8,272.1	27.8%
Adjusted[2] net debt / EBITDAR (LTM)	4.2	3.9	6.6%

[1] Includes cash and cash equivalents and short-term and long-term investments.
[2] Net debt adjusted to reflect the capitalization of aircraft rent corresponding to 7x of LTM rent and EBITDAR adjusted to reflect non-recurring items.

Debt Maturity* 4Q18
(R$ million)



*Adjusted for currency swaps and hedge accounting

Fleet

As of December 31, 2018, Azul had a total operating fleet of 125 aircraft and a contractual fleet of 143 aircraft, with an average age of 5.9 years. The 18 aircraft not included in our operating fleet consisted of 15 aircraft subleased to TAP and three ATRs that were in the process of exiting the fleet.

Total Contractual Fleet

Aircraft	Number of seats	2018[1]	2017	% Δ
A330	242-271	7	7	0.0%
A320neo	174	20	12	66.7%
E-Jets	106-118	72	79	-8.9%
ATRs	70	42	49	-14.3%
B737 Freighter	-	2	-	n.a.
Total[1]		**143**	**147**	**-2.7%**
Aircraft under operating leases		*123*	*120*	*2.5%*

[1] Includes aircraft subleased to TAP

Total Operating Fleet

Aircraft	Number of seats	2018	2017	% Δ
A330	242-271	7	7	0.0%
A320neo	174	20	12	66.7%
E-Jets	106-118	63	70	-10.0%
ATRs	70	33	33	0.0%
B737 Freighter	-	2	-	n.a.
Total		**125**	**122**	**2.5%**

Declaration of the officers on the financial statements

In compliance with CVM Instruction No. 480/09, the Executive officers declare that they have discussed, reviewed and approved the financial statements for the year ended December 31, 2018.

São Paulo, March 12, 2019.

John Peter Rodgerson
President and Chief Executive Officer

Alexandre Wagner Malfitani
Executive Vice President and Chief Financial Officer

Declaration of the officers on the independent auditors report on the financial statements

In compliance with CVM Instruction No. 480/09, the Executive officers declare that they have discussed, reviewed and approved the conclusions expressed in the independent auditors report on the individual and consolidated financial statements for the year ended December 31, 2018.

São Paulo, March 12, 2019.

John Peter Rodgerson
President and Chief Executive Officer

Alexandre Wagner Malfitani
Executive Vice President and Chief Financial Officer

Summary report of the audit committee

The members of the Audit Committee, considering the documents presented and the information and clarifications provided by the Company's Board of Executive Officers and by Ernst & Young Auditores Independentes SS during the year, Management Report and the individual and consolidated Financial Statements (including explanatory notes) for the fiscal year ended December 31, 2018, together with an opinion to be issued by Ernst & Young Auditores Independentes SS, recommending to the Board of Directors its approval.

Gilberto de Almeida Peralta
Member of the Audit Committee

Sergio Eraldo de Salles Pinto
Member of the Audit Committee

Gelson Pizzirani
Member of the Audit Committee

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A free translation from Portuguese into English of Independent Auditor´s Report on financial statements prepared in accordance with the accounting practices adopted in Brazil and International Financial Reporting Standards (IFRS)

INDEPENDENT AUDITOR'S REPORT ON INDIVIDUAL AND CONSOLIDATED FINANCIAL STATEMENTS

The Management and Shareholders of Azul S.A.

Opinion

We have audited the individual and consolidated financial statements of Azul S.A. ("the Company"), identified as Parent Company and Consolidated, respectively, which comprise the balance sheet as of December 31, 2018 and the statements of income, of comprehensive income, of statement of changes in equity, and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements referred to above present fairly, in all material respects, the individual and consolidated financial position of Azul S.A. as at December 31, 2018, its individual and consolidated financial performance and its individual and consolidated cash flows for the year then ended, in accordance with accounting practices adopted in Brazil and International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB).

Basis for opinion

We conducted our audit in accordance with Brazilian and International Standards on Auditing. Our responsibilities, under those standards, are further described in the "Auditor's responsibilities for the audit of the individual and consolidated financial statements" section of our report. We are independent of the Company and its subsidiaries and comply with the relevant ethical principles set forth in the Code of Professional Ethics for Accountants, the professional standards issued by the Brazil's National Association of State Boards of Accountancy (CFC) and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to support our opinion.

Key audit matters

Key audit matters are those matters that, in our professional judgment, were the most significant in our audit of the financial statements of the current year. Those matters were addressed in the context of our audit of the overall individual and consolidated financial statements, and to form our opinion on these individual and consolidated financial statements. Therefore, we do not express a separate opinion on those matters. The presentation of the matters below, including any description of our procedures to address the matter and any findings resulting from our procedures is presented in the context of the financial statements as a whole.

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We have fulfilled the responsibilities described in the “Auditor’s responsibilities for the audit of the individual and consolidated financial statements” section of our report, including our responsibilities with respect to these key audit matters. Accordingly, our audit included the performance of procedures designed to respond to our assessment of the risks of material misstatement of the financial statements. The results of our audit procedures, including the procedures performed to address the matters below, provide the basis for our audit opinion on the accompanying financial statements.

Passenger Revenue

Flight revenue is recognized upon effective rendering of the transportation service. Tickets sold and not used, corresponding to advanced ticket sales (air traffic liability), are recorded in current liabilities and are recognized when used, on an accrual basis. The recognition of certain revenues takes into account estimates with a high degree of professional judgment by management, such as the expectation of expiration of unused tickets, these assumptions are evaluated by management based on historical data. Additionally, the process of ticket sales and flight revenue recognition is highly dependent on information technology (IT) systems.

Considering the facts listed above and the magnitude of these balances on the financial statements as a whole, we consider this a key audit matter.

How our audit addressed this matter

The audit procedures included, among others (i) the analysis of the adequacy of manual journal entries included in the revenue accounts; (ii) comparison of a sample of flights with reports issued by the aviation regulatory agency (ANAC); (iii) observation of a sample of passenger boarding the airplanes in order to verify the respective revenue; (iv) analytical review of revenue balances considering our expectations and market indicators; and (v) analysis of revenue recognition over expired credits (breakage); and (vi) evaluation of financial statements disclosures, included in notes 3.17 and 22, were appropriate.

Based on the results of the audit procedures performed, which is consistent with management's assessment, we consider the Company's passenger revenue recognition policies are acceptable to support the judgments, estimates and information included in the financial statements taken as a whole.

TAP Convertible Bond

On March 14, 2016, the Company acquired series A convertible bonds issued by TAP (the “TAP Convertible Bonds”) for an amount of €90 million. The TAP Convertible Bonds are convertible, in whole or in part at, the option of Azul into new shares representing the share capital of TAP benefiting from enhanced preferential economic rights (the “TAP Shares”). Upon full conversion, the TAP Shares will represent 6.0% of the total and voting capital of TAP, with the right to receive dividends or other distributions corresponding to 41.25% of distributable profits of TAP, as disclosed in footnote 12(f)(ii)).

The fair value of the option was classified as a single financial asset recorded at changes in the fair value through profit or loss, under "Result from related parties transactions, net", classified in "Long term investments" as disclosed in footnote 12(f)(ii).

The above matter was considered a key audit matter, due to the relevance of the amounts and the required judgment, exercised by management in the calculation of the fair value.

How our audit addressed this matter

Our auditing procedures included, among others, (i) reviewing the assumptions for the fair value calculation prepared by management of the non-current financial asset(Bond TAP) including the involvement of our Valuation professionals to assist us in the execution of procedures; (ii) the evaluation of the adequacy of the accounting records related to the operation; and (iii) the evaluation whether the disclosures in the financial statements, included in the footnotes 12(f)(ii) and 21, were appropriate.

Based on the results of the audit procedures performed, which is consistent with management's assessment, we consider acceptable the fair value measurement policies of the non-current financial asset (Bond TAP) to support the judgments, estimates and information included in the context of the financial statements taken as a whole.

<u>Maintenance reserve</u>

The Company had 123 aircraft under operating leases as of December 31, 2018, according to note 25a. Under the terms of operating lease agreements with aircraft lessors, the Company is contractually committed to maintain or reimburse the lessor based on the actual condition of the airframe, engines and life limited parts.

The recoverability of these deposits is assessed by management from a comparison of the amounts that are expected to be reimbursed at the time of the next maintenance event. Amounts determined as non-recoverable are recognized as expenses in the income statement of income. As of December 31, 2018, the balance of maintenance reserves totaled R$1.3 billion.

Considering the magnitude of the amounts involved, in addition to the degree of judgment applied in determining the maintenance cost estimates to be incurred and the need for management to monitor the recoverability of these deposits, we consider this a key audit matter.

How our audit addressed this matter

The audit procedures included, among others, (i) sending confirmation letter to the lessors in order to confirm the balance of the maintenance reserve for each individual contract; (ii) comparison of the actual cost incurred in maintenance with the documentation of the expense incurred with the suppliers, comparing this information with the reimbursement paid to the Company by the lessor; (iii) analysis of the recoverability of the maintenance reserve, prepared by management, which considers the recoverability of each deposit for each aircraft item and lessor; (iv) evaluation of financial statements disclosures included in notes in Note 3.12b and 13, were appropriated.

Based on the results of our audit procedures, which is consistent with management's assessment, we consider acceptable the maintenance reserve measurement policies to support the judgments, estimates and information included in the financial statements.

Other matters

Statements of value added

The individual and consolidated statements of value added for the year ended December 31, 2018, prepared under the responsibility of the Company's Management and presented as supplementary information under IFRS, were submitted to the same audit procedures performed in accordance with the audit of the Company's financial statements. For the purposes of forming our opinion, we evaluated whether these statements are reconciled with the financial statements and accounting records, as applicable, and whether their form and content are in accordance with the criteria provided for in Accounting Pronouncement CPC 9 - Statement of Value Added. In our opinion, these statements of value added were prepared fairly, in all material respects, in accordance with the criteria defined in Accounting Pronouncement CPC 9 and are consistent with the overall individual and consolidated financial statements as a whole.

Other information accompanying the individual and consolidated financial statements and the auditor's report

The Company's Management is responsible for other information that includes the Management Report. Our opinion on the individual and consolidated financial statements does not cover the Management Report and we do not express any form of audit conclusion on the Management Report. In connection with the audit of the individual and consolidated financial statements, our responsibility is to read the Management Report and, in doing so, consider whether this report is materially inconsistent with the financial statements or based on our knowledge obtained in the audit, or otherwise, whether this report appears to be materially misstated. If based on our work performed, we conclude that there is material misstatement in the Management Report, we are required to report this fact. We have nothing to report on this matter.

Responsibilities of Management and those charged with governance for the individual and consolidated financial statements

Management is responsible for the preparation and fair presentation of the individual and consolidated financial statements in accordance with the accounting practices adopted in Brazil and International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB), and for such internal control as Management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. In preparing the individual and consolidated financial statements, Management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless Management either intends to liquidate the Company and its subsidiaries or to cease operations, or has no realistic alternative but to do so. Those charged with governance of the Company and its subsidiaries are responsible for overseeing the financial reporting process.

Auditor's responsibilities for the audit of the individual and consolidated financial statements

Our objectives are to obtain reasonable assurance about whether the individual and consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with the Brazilian and International Standards on Auditing will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with the Brazilian and International Standards on Auditing, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the individual and consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the internal control of the Company and its subsidiaries.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by Management.

- Conclude on the appropriateness of Management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the ability of the Company and its subsidiaries to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the individual and consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company and its subsidiaries to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the individual and consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

São Paulo, March 12, 2019

ERNST & YOUNG
Auditores Independentes S.S.
CRC-2SP034519/O-6

Anderson Pascoal Constantino
Accountant CRC-1SP190451/O-5

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Azul S.A.

Consolidated statements of financial position
As of December 31, 2018, 2017 and 2016
(In thousands of Brazilian reais)

	December 31,		
	2018	**2017**	**2016**
Assets			
Current assets			
Cash and cash equivalents (Note 6)	**1,169,136**	762,319	549,164
Short-term investments (Note 7)	**517,423**	1,036,148	331,210
Restricted investments (Note 8)	**-**	8,808	53,406
Trade and other receivables (Note 9)	**1,069,056**	914,428	673,275
Inventories (Note 10)	**200,145**	150,393	107,102
Taxes recoverable	**283,841**	112,891	44,488
Derivative financial instruments (Note 21)	**6,654**	10,345	17,638
Prepaid expenses (Note 11)	**163,829**	109,784	97,501
Other current assets	**111,714**	199,225	36,542
Total current assets	**3,521,798**	3,304,341	1,910,326
Non-current assets			
Long-term investments (Note 21)	**1,287,781**	835,957	753,200
Restricted investments (Note 8)	**-**	-	108,630
Security deposits and maintenance reserves (Note 13)	**1,546,720**	1,259,127	1,078,005
Derivative financial instruments (Note 21)	**588,726**	410,477	4,132
Prepaid expenses (Note 11)	**21,683**	4,472	6,907
Other non-current assets	**520,723**	215,707	156,613
Property and equipment (Note 14)	**3,289,219**	3,325,535	3,439,980
Intangible assets (Note 15)	**1,016,556**	961,000	942,616
Total non-current assets	**8,271,408**	7,012,275	6,490,083
Total assets	**11,793,206**	10,316,616	8,400,409

	December 31,		
	2018	**2017**	**2016**
Liabilities and equity			
Current liabilities			
Loans and financing (Note 17)	**335,051**	568,234	985,238
Accounts payable	**1.166.291**	953,534	1,034,317
Accounts payable – Forfaiting	**162.778**	-	-
Air traffic liability (Note 18)	**1,672,452**	1,287,434	949,360
Salaries, wages and benefits	**244,008**	246,336	186,474
Insurance premiums payable	**34,999**	24,411	24,264
Taxes payable	**56,999**	44,418	64,830
Federal tax installment payment program	**9,749**	9,772	6,468
Derivative financial instruments (Note 21)	**180,975**	48,522	211,128
Financial liabilities at fair value through profit and loss	**-**	-	44,655
Other current liabilities	**193,492**	151,696	110,909
Total current liabilities	**4,056,794**	3,334,357	3,617,643
Non-current liabilities			
Loans and financing (Note 17)	**3,370,971**	2,921,653	3,049,257
Derivative financial instruments (Note 21)	**260,019**	378,415	20,223
Deferred income taxes (Note 16)	**443,894**	326,911	181,462
Federal tax installment payment program	**95,705**	105,431	75,560
Provision for tax, civil and labor risk (Note 27)	**80,984**	73,198	76,353
Other non-current liabilities	**321,139**	343,041	377,924
Total non-current liabilities	**4,572,712**	4,148,649	3,780,779
Equity			
Issued capital (Note 19)	**2,209,415**	2,163,377	1,488,601
Capital reserve	**1,918,373**	1,898,926	1,290,966
Treasury shares (Note 19)	**(10,550)**	(2,745)	-
Other comprehensive loss (Note 19)	**(117,324)**	(11,192)	(33,785)
Accumulated losses	**(836,214)**	(1,214,756)	(1,743,795)
	3,163,700	2,833,610	1,001,987
Total liabilities and equity	**11,793,206**	10,316,616	8,400,409

The accompanying notes are an integral part of these financial statements.

Azul S.A.

Consolidated statements of operations
Year ended December 31, 2018, 2017 and 2016
(In thousands of Brazilian reais, except income (loss) per share)

	Year ended December 31,		
	2018	**2017**	**2016**
Operating revenue (Note 3.17 and 22)			
Passenger revenue	**8,670,132**	6,695,340	5,786,809
Cargo and other revenue	**483,225**	1,094,157	883,082
Total revenue	**9,153,357**	7,789,497	6,669,891
Operating expenses			
Aircraft fuel	**(2,644,261)**	(1,848,195)	(1,560,223)
Salaries, wages and benefits	**(1,413,017)**	(1,296,166)	(1,091,871)
Aircraft and other rent	**(1,509,947)**	(1,181,731)	(1,160,912)
Landing fees	**(592,100)**	(490,569)	(442,692)
Traffic and customer servicing	**(395,394)**	(357,841)	(327,289)
Sales and marketing	**(368,663)**	(309,540)	(276,203)
Maintenance materials and repairs	**(504,477)**	(568,144)	(708,739)
Depreciation and amortization	**(324,902)**	(299,793)	(301,201)
Other operating expenses, net (Note 24)	**(875,148)**	(572,497)	(456,475)
	(8,627,909)	(6,924,476)	(6,325,605)
Operating income	**525,448**	865,021	344,286
Financial result (Note 23)			
Financial income	**41,393**	94,805	51,067
Financial expense	**(410,207)**	(524,033)	(731,200)
Derivative financial instruments, net	**298,094**	(90,171)	10,800
Foreign currency exchange, net	**(194,706)**	57,871	179,668
	(265,426)	(461,528)	(489,665)
Result from related parties transactions, net	**342,083**	194,351	163,045
Net income before income tax and social contribution	**602,105**	597,844	17,666
Income tax and social contribution (Note 16)	**(11,224)**	2,875	8,731
Deferred income tax and social contribution (Note 16)	**(170,604)**	(71,680)	(152,711)
Net income (loss)	**420,277**	529,039	(126,314)
Basic net income per common share - R$ (Note 20)	**0.02**	0.02	(0.01)
Diluted net income per common share - R$ (Note 20)	**0.02**	0.02	(0.01)
Basic net income per preferred share - R$ (Note 20)	**1.24**	1.68	(0.55)
Diluted net income per preferred share - R$ (Note 20)	**1.23**	1.64	(0.55)

The accompanying notes are an integral part of these financial statements.

Azul S.A.

Consolidated statements of other comprehensive income
Year ended December 31, 2018, 2017 and 2016
(In thousands of Brazilian reais)

	December 31,		
	2018	**2017**	**2016**
Net income (loss)	**420,277**	529,039	(126,314)
Other comprehensive income to be reclassified to profit or loss in subsequent periods:			
Changes in fair value of cash flow hedges, net of tax	**(106,132)**	22,593	58,984
Total comprehensive income (loss)	**314,145**	551,632	(67,330)

The accompanying notes are an integral part of these financial statements.

Azul S.A.

Consolidated statements of changes in equity
Year ended December 31, 2018, 2017 and 2016
(In thousands of Brazilian reais)

	Issued capital	Capital reserve	Treasury shares	Cash flow hedge reserve	Accumulated losses	Total
December 31, 2015	479,423	838,658	-	(92,769)	(1,617,481)	(392,169)
Loss for the period	-	-	-	-	(126,314)	(126,314)
Other comprehensive loss	-	-	-	58,984	-	58,984
Total comprehensive loss	-	-	-	58,984	(126,314)	(67,330)
Issued capital (Note 19)	985,174	487,934	-	-	-	1,473,108
Share issuance costs	-	(21,501)	-	-	-	(21,501)
Capitalization of reserve (Note 19)	24,004	(24,004)	-	-	-	-
Share-based payment (Note 26)	-	9,879	-	-	-	9,879
December 31, 2016	1,488,601	1,290,966	-	(33,785)	(1,743,795)	1,001,987
Profit for the period	-	-	-	-	529,039	529,039
Other comprehensive income	-	-	-	22,593	-	22,593
Total comprehensive income	-	-	-	22,593	529,039	551,632
Issued capital (Note 19)	661,500	646,479	-	-	-	1,307,979
Issuance of shares due exercise of stock options (Note 19)	13,276	4,623	-	-	-	17,899
Share issuance costs (Note 19)	-	(71,283)	-	-	-	(71,283)
Treasury shares, net (Note 19)	-	-	(2,745)	-	-	(2,745)
Share-based payment expense (Note 26)	-	28,141	-	-	-	28,141
December 31, 2017	2,163,377	1,898,926	(2,745)	(11,192)	(1,214,756)	2,833,610
Impact of adoption of IFRS 9 (Note 3)	**-**	**-**	**-**	**-**	**(416)**	**(416)**
Impact of adoption of IFRS 15 (Note 3)	**-**	**-**	**-**	**-**	**(41,319)**	**(41,319)**
January 1, 2018	**2,163,377**	**1,898,926**	**(2,745)**	**(11,192)**	**(1,256,491)**	**2,791,875**
Profit for the period	**-**	**-**	**-**	**-**	**420,277**	**420,277**
Other comprehensive income	**-**	**-**	**-**	**(106,132)**	**-**	**(106,132)**
Total comprehensive income	**-**	**-**	**-**	**(106,132)**	**420,277**	**314,145**
Issued capital (Note 19)						
Issuance of shares due exercise of stock options (Note 19)	**46,038**	**1,596**	**-**	**-**	**-**	**47,634**
Treasury shares, net (Note 19)	**-**	**-**	**(7,805)**	**-**	**-**	**(7,805)**
Share-based payment expense (Note 26)	**-**	**17,851**	**-**	**-**	**-**	**17,851**
December 31, 2018	**2,209,415**	**1,918,373**	**(10,550)**	**(117,324)**	**(836,214)**	**3,163,700**

The accompanying notes are an integral part of these financial statements.

Azul S.A.

Consolidated statements of cash flows
Year ended December 31, 2018, 2017 and 2016
(In thousands of Brazilian reais)

	For the year ended December 31,		
	2018	**2017**	**2016**
Cash flows from operating activities			
Net income for the period	**420,277**	529,039	(126,314)
Adjustments to reconcile net income to cash flows provided by (used in) operating activities			
Depreciation and amortization (Note 14 and 15)	**324,901**	299,793	301,201
Write-off of fixed assets and intangibles (Note 14 and 15)	**101,818**	42,242	63,425
Results unrealized from derivative financial instruments	**(672.630)**	(166,640)	41,119
Share-based payment expenses	**22,225**	28,141	9,879
Exchange (gain) and losses on assets and liabilities denominated in foreign currency	**90,142**	(62,236)	(528,514)
Interest (income) and expenses on assets and liabilities	**182,274**	222,127	360,718
Deferred income tax and social contribution	**170.604**	71,680	135,265
Allowance for doubtful accounts (Note 9)	**5,168**	1,586	(2,729)
Provision for tax, civil and labor risks (Note 27)	**70,439**	78,469	53,688
Provision for inventory (Note 10)	**3,259**	(6,218)	2,894
Provision for return of aircrafts and engines	**-**	-	(53,270)
Loss (profit) on sale of property and equipment (Note 14 and 15)	**144,251**	(75,410)	(119,586)
Changes in operating assets and liabilities			
Trade and other receivables, net	**(160,427)**	(242,739)	(20,138)
Inventories	**(53,011)**	(37,073)	(17,550)
Security deposits and maintenance reserves	**(65,030)**	(168,940)	(68,927)
Prepaid expenses	**(71,723)**	(20,017)	34,958
Recoverable taxes	**(170,950)**	(68,403)	(1,897)
Other assets	**(288,409)**	(141,108)	183,212
Accounts payable	**142,631**	(93,524)	(17,804)
Accounts payable - Forfaiting	**162,778**	-	-
Salaries, wages and employee benefits	**(2,328)**	59,862	28,387
Insurance premiums payable	**10,588**	147	(7,769)
Taxes payable	**12,581**	(20,412)	(31,106)
Federal installment payment program	**(8.722)**	116,316	(6,505)
Air traffic liability	**322,410**	338,074	71,510
Provision taxes, civil and labor risks (Note 27)	**(62,653)**	(81,624)	(59,110)
Other liabilities	**27,265**	(5,689)	171,708
Interest paid	**(214,671)**	(301,943)	(342,773)
Net cash provided by operating activities	**443,057**	295,500	53,972
Cash flows from investing activities			
Short and long term investment			
Acquisition of short-term investments	**(2,843,002)**	(3,673,743)	(679,029)
Disposal of short-term investments	**3,387,015**	3,044,183	377,272
Long-term investment			
Acquisition of long-term investments from related party (Note 12)		-	(360,769)
Acquisition of long-term investments	**-**	1,122	(1,093)
Restricted investments, net	**5,635**	120,925	(70,583)
Proceeds from sale of property and equipment	**363,157**	177,316	531,963
Acquisition of intangibles (Note 15)	**(100,204)**	(56,148)	(56,308)
Acquisition of property and equipment (Note 14)	**(754,637)**	(589,497)	(385,802)
Net cash (used) provided in investing activities	**57,964**	(975,842)	(644,349)
Cash flows from financing activities			
Debentures			
Proceeds	**700,000**	200,000	146,633
Repayment	**(168,098)**	(1,153,230)	(150,001)
Loans and financing			
Proceeds	**98,940**	1,750,111	833,011
Repayment	**(530,472)**	(885,849)	(1,221,053)
Repayment of finance lease	**(385,906)**	(204,463)	(178,031)
Issued capital	**-**	-	1,451,607
Issuance of shares due exercise of stock options (Note 19)	**47,634**	1,231,275	-
Redemption of preferred shares	**-**	(44,655)	(346,330)
Treasury shares (Note 19)	**(12,179)**	(2,745)	-
Proceeds from sale and leaseback	**11,889**	39,461	-
Related parties (Note 12)	**76,949**	(73,241)	(9,180)
Net cash (used) provided by financing activities	**(161,243)**	856,664	526,656
Exchange gain and (losses) on cash and cash equivalents	**67,039**	36,833	(23,620)
Net increase (decrease) in cash and cash equivalents	**406,817**	213,155	(87,341)
Balance cash and cash equivalents at the beginning of the year	**762,319**	549,164	636,505
Balance cash and cash equivalents at the end of the year	**1,169,136**	762,319	549,164

The accompanying notes are an integral part of these financial statements.

(In thousands of Brazilian reais, except when otherwise indicated)

1. Operations

Azul S.A. ("Azul") is a corporation headquartered at Av. Marcos Penteado de Ulhôa Rodrigues, 939, in the city of Barueri, in the state of São Paulo, Brazil. Azul was incorporated on January 3, 2008 and is a holding company for providers of airline passenger and cargo services. Azul and its subsidiaries are collectively referred to as the "Company".

Azul Linhas Aéreas Brasileiras S.A. ("ALAB"), a 100% owned subsidiary incorporated on January 3, 2008, has operated passenger and cargo air transportation in Brazil since beginning operations on December 15, 2008. Canela Investments LLC ("Canela"), a 100% owned special purpose entity, headquartered in the state of Delaware, United States of America, was incorporated on February 28, 2008, to acquire aircraft outside of Brazil and lease them to ALAB.

The Company's shares are traded on the BM&FBOVESPA and American Depositary Share ("ADS") on the New York Stock Exchange ("NYSE").

The consolidated financial statements are comprised of the individual financial statements of the entities as presented below:

			% equity interest	
Entities	**Main activities**	**Country of incorporation**	**December 30, 2018**	**December 31, 2017**
Azul Linhas Aéreas Brasileiras S.A. (ALAB)	Airline operations	Brazil	100.0%	100.0%
Azul Finance LLC (a)	Aircraft financing	United States	100.0%	100.0%
Azul Finance 2 LLC (a)	Aircraft financing	United States	100.0%	100.0%
Blue Sabiá LLC (a)	Aircraft financing	United States	100.0%	100.0%
ATS Viagens e Turismo Ltda. (a)	Package holidays	Brazil	99.9%	99.9%
Azul SOL LLC (a)	Aircraft financing	United States	100.0%	100.0%
Azul Investment LLP (a)	Group financing	United States	100.0%	100.0%
Fundo Garoupa (b)	Exclusive investment fund	Brazil	100.0%	100.0%
Fundo Safira (a)	Exclusive investment fund	Brazil	100.0%	100.0%
Fundo Azzurra (a)	Exclusive investment fund	Brazil	100.0%	100.0%
Canela Investments LLC (Canela) (a) (c)	Aircraft financing	United States	100.0%	100.0%
Canela 336 LLC (d)	Aircraft financing	United States	100.0%	100.0%
Canela 407 LLC (d)	Aircraft financing	United States	100.0%	100.0%
Canela 429 LLC (d)	Aircraft financing	United States	100.0%	100.0%
Canela Turbo Three LLC (d)	Aircraft financing	United States	100.0%	100.0%
Daraland S.A. (a)	Holding	Uruguay	100.0%	100.0%
Encenta S.A. (Azul Uruguai) (e)	Airline operations	Uruguay	100.0%	100.0%
TudoAzul S.A.	Loyalty programs	Brazil	100.0%	100.0%
Cruzeiro Participações S.A	Participation in others societies	Brazil	99.9%	-

(a) Azul's investment is held indirectly through ALAB.
(b) Azul's investment is held 4% directly and 96% through ALAB.
(c) Transfer of ownership from Azul to ALAB on December 1, 2017.
(d) ALAB's investments are held indirectly through Canela.
(e) Investments are held indirectly through Daraland.
(f) Subsidiary incorporated on February 6, 2018.

Secondary International Offering by Hainan Airlines Holding Co., Ltd ("HNA")

On June 29, 2018, Azul completed a secondary offering in the United States and elsewhere outside of Brazil, pursuant to which one of its shareholders, HNA, sold 100% of its interest in the Company by selling 58,138,005 preferred shares in the form of American Depositary Shares (ADSs), each representing three preferred shares. The offering did not grant preferred rights to the other shareholder. The international offering price was US$16.15 per ADS.

The international offering represented the sale of all the shares issued by the Company and held by HNA. Consequently, the Company did not receive cash from the transaction.

Senior notes

On October 19, 2017, Azul Investments LLP priced an offering of US$400 million aggregate principal amount of 5.875% senior unsecured notes due in 2024. This transaction is part of Company's indebtedness management strategy and net proceeds were used to refinance debt and general corporate purposes.

On December 14, 2017, the total amount referring to the Senior Notes was exchanged from dollars to eais by means of swap derivative contracts and exchange options to protect interest expenses, and through exchange options to protect the principal amount against foreign currency fluctuations up to an exchange rate of R$4.75 for US$1.00.

Strategic Partnerships

Empresa Brasileira de Correios e Telégrafos (Brazil's Postal Service)

On December 20, 2017, ALAB and Correios (Brazil's Postal Service) signed a memorandum of understanding for the creation of a private integrated logistics solutions company, Azul will own a 50.01% stake of the new company and Correios the remaining 49.99%.

With the existing demand already served by ALAB and Correios, the new company anticipates handling approximately 100 thousand tons of cargo per year. Both companies expect the new company to generate cost savings, operating efficiency and revenue gains while improving the service offer to the consumer.

The memorandum of understanding was submitted to the Brazilian authorities and appropriate government bodies, including the Administrative Council for Economic Defense - "CADE" for approval. Only after the necessary approvals will the new company be established and its activities initiated. At the date of approval of these financial statements the approval has not yet occurred, consequently the operations have not yet begun.

2. Basis of preparation of financial statements

The consolidated financial statements of the Company for the years ended December 31, 2018 and 2017, were authorized for issuance by the executive board of directors on March 12, 2019.

The consolidated financial statements were prepared in accordance with the International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) and in Brazilian Reais, which is the functional currency of the Company.

The consolidated financial statements provide comparative information in respect of the previous period. In addition, the Company presents an additional statement of financial position at the beginning of the preceding period when there is a retrospective application of an accounting policy, a retrospective restatement, or a reclassification of items in financial statements.

The financial statements were prepared using the historical cost basis, except for certain financial instruments, which are measured at fair value.

The Company has adopted all standards and interpretations issued by the IASB and the IFRS Interpretations Committee that were in effect on December 31, 2018.

3. Significant accounting policies

3.1. Basis for consolidation

The consolidated financial statements comprise the financial statements of the Azul and its subsidiaries as at December 31, 2018. Control is achieved when the Company is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Specifically, the Company controls an investee if and only if the Company has:

- Power over the investee (i.e. existing rights that give it the current ability to direct the relevant activities of the investee)
- Exposure, or rights, to variable returns from its involvement with the investee, and
- The ability to use its power over the investee to affect its returns.

The Company re-assesses whether or not it controls an investee when facts and circumstances indicate that there are changes to one or more of the three elements of control. Consolidation of a subsidiary begins when assets, liabilities, income and expenses of a subsidiary acquired during the year are included in the statement of comprehensive loss from the date the Company gains control, and ceases on the date the Company loses control of the subsidiary.

When necessary, adjustments are made to the financial statements of subsidiaries to align their accounting policies with those of the Company. All intra-group assets and liabilities, equity, income, expenses and cash flows relating to transactions between members of the Company are eliminated in full on consolidation.

3.2. Cash and cash equivalents

Cash and cash equivalents are held in order to meet short-term cash commitments and not for investment or other purposes. The Company considers as cash equivalents deposits or instruments, which are readily convertible into a known cash amount and subject to an insignificant risk of change in value. The Company considers as cash equivalents, instruments with original maturities of less than three months.

3.3 Financial instruments

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

3.3.1. Non-derivative financial assets—initial recognition and subsequent measurement

<u>Initial recognition</u>

Non-derivative financial assets, other than trade receivables, are measured at initial recognition at their fair value plus (in the case of a financial asset not at fair value through profit or loss) transaction costs that are directly attributable to the acquisition of the financial asset.

Trade receivables that do not contain a significant financing component are measured at initial recognition at the transaction price.

<u>Classification of financial instruments</u>

Under IFRS 9 classification and measurement of financial instruments is based on the business model of the Company to manage financial assets and on the contractual cash flow characteristics of the financial assets.

Financial assets are classified in three categories:

(i) measured at amortized cost,
(ii) measured at fair value through other comprehensive income, and
(iii) measured at fair value through profit or loss

For a financial asset to be classified and measured at amortized cost or at fair value through other comprehensive income, it must generate cash flows that are "exclusively principal and interest payments" (also referred to as the "SPPI" test) on the principal amount outstanding. This evaluation is performed at instrument level.

The Company's business model for managing financial assets refers to how it manages its financial assets to generate cash flows. The business model determines whether cash flows will result from the collection of contractual cash flows, the sale of financial assets or both.

Purchases or sales of financial assets that require the delivery of assets within a period established by regulation or convention in the market (regular negotiations) are recognized on the trade date, that is, the date on which the Company undertakes to buy or sell the asset.

Business model assessment

The business model assessment requires classification of the asset in one of the business models defined by IFRS 9. The business models reflect how the Company manages the financial asset in order to generate cash flows on the basis of scenarios that the Company reasonably expects to occur. In order to perform the business model assessment the Company has grouped financial assets in portfolios of assets that are managed together.

Management Objective	**Measurement**
Collect contractual payments over the life of the instrument	Amortized cost
Collecting contractual cash flows and selling financial assets	Fair value through other comprehensive income
Held for trading or measured in a fair value basis	Fair value through profit or loss

Contractual cash flow characteristics assessment

The contractual cash flow characteristic assessment requires to determine whether the contractual cash flows of the assets consists solely of payment of principal or interest on the principal amount outstanding “SPPI”. When the asset cash flows is SPPI it will be subsequently measured following the result of the business model assessment. However when the asset cash flows is not SPPI it will be measured at fair value through profit or loss irrespective of the result of the business model assessment.

Subsequent measurement of the financial assets of the Company

The criteria for subsequent measurement of the financial assets of the Company is presented below:

- At amortized cost – Financial assets at amortised cost are subsequently measured using the effective interest rate method and are subject to impairment. Gains and losses are recognised in profit or loss when the asset is derecognised, modified or impaired.

  Financial assets at amortised cost includes: Restricted investments, Trade and other receivables other than credit card receivables, receivables from related parties, security deposits and maintenance reserves;

- At fair value through other comprehensive income – For debt instruments at fair value through OCI, interest income, foreign exchange revaluation and impairment losses or reversals are recognised in the statement of profit or loss and computed in the same manner as for financial assets measured at amortised cost. The remaining fair value changes are recognised in OCI. Upon derecognition, the cumulative fair value change recognised in OCI is recycled to profit or loss.

  Financial assets at fair value through other comprehensive income includes credit card receivables; and; and

- At fair value thorough profit of loss - Financial assets at fair value through profit or loss include financial assets held for trading, financial assets designated upon initial recognition at fair value through profit or loss, or financial assets mandatorily required to be measured at fair value. Financial assets are classified as held for trading if they are acquired for the purpose of selling or repurchasing in the near term. Derivatives, including separated embedded derivatives, are also classified as held for trading unless they are designated as effective hedging instruments. Financial assets with cash flows that are not solely payments of principal and interest are classified and measured at fair value through profit or loss, irrespective of the business model. Notwithstanding the criteria for debt instruments to be classified at amortised cost or at fair value through OCI, as described above, debt instruments may be designated at fair value through profit or loss on initial recognition if doing so eliminates, or significantly reduces, an accounting mismatch.

  Financial assets at fair value through profit or loss are carried in the statement of financial position at fair value with net changes in fair value recognised in the statement of profit or loss.

  Financial assets at fair value through profit or loss include:Financial instruments, short-term investments and the TAP Convertible Bonds presented under long-term investments

3.3.2.Non-derivative financial liabilities—initial recognition and subsequent measurement

<u>Initial recognition</u>

Financial liabilities are initially classified as financial liabilities at fair value through profit or loss, financial liabilities at amortized cost, or as derivatives designated as hedging instruments in an effective hedge, as appropriate.

Non-derivative financial liabilities are measured at initial recognition at its fair value less transaction costs that are directly attributable to the acquisition of the financial asset.

<u>Subsequent measurement</u>

The measurement of financial liabilities depends on their classification, as described below:

Financial liabilities at fair value through profit or loss

Financial liabilities at fair value through profit or loss include financial liabilities held for trading and financial liabilities designated upon initial recognition as at fair value through profit or loss.

Financial liabilities are classified as held for trading if they are incurred for the purpose of repurchasing in the near term. This category also includes derivative financial instruments entered into by the Company that are not designated as hedging instruments in hedge relationships as defined by IFRS 9. Separated embedded derivatives are also classified as held for trading unless they are designated as effective hedging instruments.

Gains or losses on liabilities held for trading are recognised in the statement of profit or loss. Financial liabilities designated upon initial recognition at fair value through profit or loss are designated at the initial date of recognition, and only if the criteria in IFRS 9 are satisfied. The Company has not designated any financial liability as at fair value through profit or loss.

Loans and borrowings

This is the category most relevant to the Company. After initial recognition, interest-bearing loans and borrowings are subsequently measured at amortised cost using the EIR method. Gains and losses are recognised in profit or loss when the liabilities are derecognised as well as through the EIR amortisation process.

Amortised cost is calculated by taking into account any discount or premium on acquisition and fees or costs that are an integral part of the EIR. The EIR amortisation is included as finance costs in the statement of profit or loss.

All non-derivative financial liabilities of the Company at the reporting date are measured at amortized cost and consists of loans and financings and accounts payable, except for those designated as hedge item in a fair value hedge (Note 21).

3.3.3. Financial instruments and hedge accounting– Initial recognition and subsequent measurement

<u>Initial recognition and subsequent measurement</u>

The Company uses financial instruments, such as currency forward contracts options and NDF to hedge itself against the currency risk, heating oil Swaps to hedge against the price risk and interest rate swaps to hedge against the interest risk. Financial instruments not designated as hedge instruments are recognized initially at fair value on the date when the derivative contract is entered into and are subsequently remeasured at fair value. The accounting for subsequent changes in fair value to derivatives that are hedge instruments in a hedge accounting depends of the nature of the item being hedged and the type of hedge relationship designated. Derivatives are presented as financial assets when the instrument's fair value is positive and as financial liabilities when fair value is negative.

Any gains or losses from changes in the fair value of derivatives not designated to hedge accounting during the year are recorded directly in profit or loss. The accounting treatments for derivatives designated as hedge instruments are presented in the next topic.

Hedge accounting

The following classifications are used for hedge accounting purposes:

- Fair value hedge when hedging against exposure to changes in fair value of recognized assets or liabilities, or an unrecognized firm commitment.

- Cash flow hedge when providing protection against changes in cash flows that is attributable to a particular risk associated with a recognized asset or liability or a highly probable forecast transaction which may affect the income or foreign currency risk in an unrecognized firm commitment.

On inception of a hedge relationship, the Company formally designates and documents the hedge relationship to which the Company wishes to apply hedge accounting, as well as the Company's objective and risk management strategy for undertaking the hedge. The documentation includes identification of the hedge instrument and item or transaction being hedged, the nature of the risk being hedged and risks excluded, and effectiveness assessment approach using prospect basis proving the existence of economic relationship between the hedged item and hedge instrument, that credit risk does not dominate the value changes that results from that economic relationship and how the hedge ratio is determined, including possible sources of ineffectiveness by performing a qualitative (when the critical terms of hedged item and hedge instrument match or are closely aligned - as nominal amount, maturity and underlying) or quantitative.

Hedges that meet the criteria for hedge accounting are accounted for as follows:

Fair value hedge

The gain or loss resulting from changes in fair value of a hedge instrument (for derivative hedge instrument) or the foreign exchange component of its carrying amount measured in accordance with IAS 21 (for non-derivative hedge instrument) is recognized in profit or loss or other comprehensive income, if the hedging instruments hedges an equity instrument for which the Company has elected to present changes in fair value in other comprehensive income. The gain or loss on the hedged item shall adjust the carrying amount of the hedged item (for on-balance item) and be recognized in profit of loss.

If the hedged item is derecognized, the unamortized fair value is recognized immediately in profit or loss.

When an unrecognized firm sales commitment is designated as a hedged item in a hedge relationship, the change in fair value of the firm sales commitment attributable to the hedge risk is recognized as a financial asset or as a financial liability, with the recognition of a corresponding gain or loss in the statements of operations. The accumulated balance in the statement of financial position resulting from successive changes in fair value of the firm sales commitment attributable to the hedged risk will be transferred to the balance of the hedged item upon its recognition (recognition of balance is either of accounts payable or accounts receivable).

The Company holds interest rate swaps to hedge against its exposure to changes in fair value of some of its aircraft financing (Note 21).

Cash flow hedge

The effective portion of a gain or loss from the hedge instrument is recognized directly in other comprehensive income. When the hedge ratio is not aligned, giving rise to ineffectiveness, but the risk management strategy is the same the Company shall rebalance the hedge ratio in order to meet the hedge effectiveness requirements.

Any gain or loss remaining from the hedge instrument (as result of the rebalancing) is a ineffectiveness and shall be recorded in profit or loss.

The amounts recorded in other comprehensive loss are transferred to the statement of operations in tandem with the hedged transaction impact on profit or loss. For example, when a forecasted sale occurs or when the income or expense being hedged is recognized. When the hedged item is the cost of a non-financial asset or non-financial liability, the amounts recorded as other comprehensive loss are transferred to initial carrying amount of the non-financial assets or liability.

The Company shall discontinue hedge accounting prospectively only when the hedging relationship ceases to meet the qualifying criteria (after taking into account any rebalancing of the hedging relationship).

If the occurrence of the forecast transaction or firm commitment is no longer likely, the amounts previously recognized in other comprehensive loss are transferred to the statement of operations. If the hedge instrument expires or is sold, terminated, exercised without replacement or rollover, or if its designation as a hedge is revoked, any cumulative gain or loss previously recognized in comprehensive loss remains deferred in other comprehensive loss until the forecast transaction or firm commitment affects profit or loss.

The Company uses swap contracts to hedge against its exposure to the risk of changes in floating rates related to its finance lease transactions and currency option to hedge the notional amount of debt denominated in foreign currency.

Current and non-current classification

Derivative instruments that are not classified as effective hedge instruments are classified as current, non-current or segregated into current or non-current portions based on the underlying contractual cash flows.

- When the Company expects to maintain a derivative as an economic hedge (and do not apply hedge accounting) for a period exceeding 12 months after the statement of financial position date, the derivative is classified as non-current (or segregated into current and non-current portions), consistent with the classification of the underlying item.
- Embedded derivatives that are not closely related to the host contract are classified in a manner consistent with the cash flows of the host contract.
- Derivative instruments that are designated as and are effective hedge instruments are classified consistently with the classification of the underlying hedged item. The derivative instrument is segregated into current and non-current portion only if a reliable allocation can be made.

3.3.4. Derecognition of financial assets and financial liabilities

Financial assets

Financial assets, or where appropriate, part of a financial asset or part of a group of similar financial assets, are derecognized when:

- The rights to receive cash flows from the assets have expired; or
- The Company has transferred their rights to receive cash flows of the assets and (a) the Company has substantially transferred all the risks and benefits of the assets, or (b) the Company has not transferred or retained substantially all the risks and benefits related to the assets, but has transferred control of the assets.

When the Company has transferred their rights to receive cash flows from assets and has not transferred all the risks and rewards relating to an asset, that asset is recognized to the extent of the continuing involvement of the Company. In this situation, the Company also recognizes an associated liability.

The transferred assets and associated liabilities are measured based on the rights and obligations that the Company has retained.

Continuing involvement that takes the form of a guarantee on the assets transferred is measured by the original book value of the assets or the maximum payment that may be required from the Company, whichever is lower.

Financial liabilities

A financial liability is derecognized when the obligation under the liability is discharged, cancelled or expires.

When an existing financial liability is replaced by another from the same lender with substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification is treated as the derecognition of the original liability and the recognition of a new liability, with the difference in the corresponding book values recognized in the statements of operations.

3.3.5. Offsetting of financial instruments

Financial assets and financial liabilities are offset and the net amount reported in the consolidated statement of financial position if there is a currently enforceable legal right to offset the recognized amounts and there is an intention to settle on a net basis, to realize the assets and settle the liability simultaneously.

3.3.6. Impairment of financial assets

The Company recognizes an allowance for losses on financial assets for expected credit losses in line of IFRS 9 requirements.

Trade receivables and contract assets

The Company uses the simplified approach allowed by IFRS 9 to estimate the allowance for losses on trade receivables.

Under the simplified approach the Company estimates expected credit losses over the life of the receivables at the reporting date (which in all cases have a contractual life shorter than 12 months) since they result from transactions with customers and do not have a significant financing component.

In estimating expected credit losses the Company considers credit card receivables as receivables with a low risk of default. Considering that it has a relevant history of no credit risk losses on such receivables and that it does not expect losses during the lifetime of those receivables no allowance has been recognized for those assets.

In order to estimate expected credit losses for other trade receivables and contract assets the Company aggregates such assets in portfolios of receivables which share credit risk characteristics. The Company currently use portfolios to estimate credit losses. For each portfolio the Company measures the historic rate of losses (net of recoveries) on defaulted receivables over a relevant historic period considering that, generally, a receivable has defaulted when is more than 90 days overdue. Such historical default rate for the portfolio is subsequently adjusted to incorporate an estimate of the impact of future economic conditions on past historic rates.

The estimate of the impact of future economic conditions is based on the observed correlation of defaults with macroeconomic indicators. The Company periodically reviews the historic period over which defaults are measured and, the relevant macroeconomic indicator to use and how the correlate with the experience of defaults.

Other financial assets

For other financial assets the Company assesses individually for each counterparty whether there has been a significant increase in the credit risk of the asset since initial recognition or not. Such determination is based on information already available to the Company. If and when credit risk ratings of the counterparty are publicly available such information is also taken into consideration.

For financial assets with no significant increase in credit risk an estimate is made of expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date while for those assets with a significant increase in credit risk the estimate is made of losses that result from default events that are possible over the lifetime of the asset.

An allowance for loss is recognized when the Company estimates that the risk of credit losses during the period. In measuring the allowance the Company considers at least three scenarios (standard, optimistic and pessimistic) and for each an estimate of cash inflows (including cash inflows from collateral) is made. The resulting estimated cash flows for each scenario is discounted to present value to the reporting date and are probability-weighted based on a judgmental determination of the probability of each scenario.

3.3.7. Fair value of financial instruments

The fair value of financial instruments actively traded in organized financial markets is determined based on prices quoted in the market at close of business at the statement of financial position date, not including the deduction of transaction costs.

The fair value of financial instruments for which there is no active market is determined using valuation techniques. These techniques can include use of recent market transactions, references to the current fair value of other similar instruments, analysis of discounted cash flows, or other valuation models.

An analysis of the fair value of derivative financial instruments and more details about how they are calculated is described in Note 21.

3.4. Inventories

Inventories consist of aircraft maintenance parts, snack supplies and uniforms. Inventories are valued at cost or net realizable value, whichever is lower, net of any provision for inventory.

3.5. Taxes

Income tax expense, deferred tax assets and liabilities reflect management's best assessment of estimated current and future taxes to be paid. Significant management judgment is required to determine the amount of deferred tax assets that can be recognized and the tax rates used, based upon the likely timing and the level of future taxable profits together with future tax planning strategies. In Brazil, income tax is determined on each legal entity, that is, not on a consolidated basis.

Provisions for income tax and social contribution are based on the taxable income of the year considering the offset of tax loss carryforwards, up to the limit of 30% of annual taxable income. Tax rates and tax laws used to calculate the amounts are those in force at the statement of financial position dates. The income from foreign subsidiaries is subject to taxation pursuant to local tax rates and legislation. In Brazil, these incomes are taxed according to Law 12.973/14.

Deferred income taxes and social contribution arise from temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements, which will result in taxable or deductible amounts in the future.

Deferred income tax assets and liabilities are measured at tax rates that are expected to be applicable in the year that the assets will be realized or the liability settled, based on tax rates (and tax law) enacted or substantially enacted on each statement of financial position date.

The book value of the deferred tax assets is presented net if there is a legal or contractual right to offset tax assets against tax liabilities and deferred taxes are related to the same taxable entity and is reviewed on each statement of financial position date and written off to the extent that it is no longer probable that taxable profits will be available to allow that all or part of the deferred taxes assets will be used.

Unrecognized deferred tax assets are reassessed on each statement of financial position date and are recognized to the extent that it becomes probable that future taxable profit will allow that the deferred tax assets be recovered.

Deferred income tax and social contribution relating to equity items are recognized directly in equity. The Company assesses on a regular basis the tax status of situations in which tax law requires interpretation and records provisions if appropriate.

3.6. Foreign currency transactions

The consolidated financial statements are presented in Brazilian reais (R$), which is the Company's functional currency.

Transactions in foreign currencies are initially translated into Brazilian reais using the exchange rates prevailing at the date of the transaction.

Monetary assets and liabilities denominated in foreign currencies are translated into the functional currency using the exchange rates prevailing at the statement of financial position date. Non-monetary items denominated in foreign currency at historical cost basis are translated into the functional currency using the exchange rates on the dates of original transactions. Non-monetary items denominated in foreign currency measured at fair value are translated using the exchange rates prevailing on the date of determination of fair value.

Differences arising on settlement or transaction of monetary items are recognized in the statement of operations. Changes in fair value of the hedging instruments are recorded using the accounting treatment described in note 3.3. “Derivative financial instruments and hedge accounting”.

3.7. Property and equipment

Assets included in property and equipment are stated at acquisition or construction cost including interest and other financial charges, net of accumulated depreciation and accumulated impairment losses, if any. Pre-payments for aircraft under construction, including interest and finance charges incurred during the manufacturing period of the aircraft and leasehold improvements, are also recorded in property and equipment.

The Company receives credits from manufacturers on acquisition of certain aircraft and engines that may be used for the payment of maintenance services. These credits are recorded as a reduction of the cost of acquisition of the related aircraft and engines and against other accounts receivable.

These amounts are then charged to expense or recorded as an asset, when the credits are used to purchase additional goods or services. In the case of operating leases, these credits are deferred and recorded as a reduction of operating lease expenses on a straight line basis during the term of the respective agreement.

Owned aircraft are recorded at cost of acquisition and are subject to impairment testing, if there are impairment indicators. Aircraft equipment, rotables and tools, including reparable spare parts with useful lives that exceed one year, are recorded as property, plant and equipment at cost of acquisition.

Aircraft lease agreements are accounted for as either operating or finance leases (note 3.11).

Depreciation is calculated using the straight-line method over the estimated useful lives of the assets as follows:

	Estimated useful lives
Aircraft	12 years
Furniture and fixtures	5 years
Aircraft equipment	12 years
Computer equipment and peripherals	5 years
Tools	5 years
Heavy maintenance – engines	5 to 6 years
Heavy maintenance – structural checks	2 to 10 years
Engines	12 years
Leasehold improvements	10 years
Simulators	20 years
Vehicles	5 years

The net book value and useful life of assets and the depreciation methods are reviewed at the end of each year and adjusted prospectively, if necessary.

The Company considers that its aircraft have four major components; airframe, engines, heavy maintenance and structural checks. The Company allocates a maintenance cost component to engines and structural checks as a portion of the total aircraft cost at the moment of acquisition. This component is depreciated over its useful life, which is the period extending up to the next heavy maintenance or structural check or the remaining useful life of the engines, whichever is shorter. The Company has maintenance contracts for its engines that cover all significant maintenance activities. The Company has "power-by-the-hour" type contracts, such agreements estipulate a rate for maintenance per hour flown, which are paid in accordance with the total hours flown when maintenance occurs.

Repairs and routine maintenance are expensed in the period in which they are incurred. Significant maintenance costs are capitalized when it is likely that they will result in future economic benefits that exceed the originally assessed performance target for existing assets of the Company. Capitalized maintenance cost is depreciated over the period of time from when they were capitalized through the next scheduled significant maintenance event. Heavy maintenance on aircraft held under operating lease is expensed at the time of the event, and it is recorded in the “maintenance material and repair” line items.

Depreciation expense of major capitalized maintenance expenses is recorded in “Depreciation and amortization” in the consolidated statement of operations.

An item of property, plant and equipment and any significant part initially recognized is derecognized upon disposal or when no future economic benefits are expected from its use or disposal. Any gain or loss arising on derecognition of the asset (calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is recognized in “Other operating expenses, net”.

3.8. Business Combinations

The Company accounts for business combinations using the acquisition method. The cost of an acquisition is measured as the sum of the consideration transferred, based on its fair value on the acquisition date. Costs directly attributable to the acquisition are expensed as incurred. The assets acquired and liabilities assumed are measured at fair value, classified and allocated according to the contractual terms, economic circumstances and relevant conditions on the acquisition date. Goodwill is measured as the excess of the consideration transferred over the fair value of net assets acquired. If the consideration transferred is smaller than the fair value of net assets acquired, the difference is recognized as a gain on bargain purchase in the statement of operations. After initial recognition, goodwill is measured at cost less any accumulated impairment losses. For the years ended December 31, 2018 and 2017, the Company has not completed any business combination transaction.

For combinations between entities under common control, the Company accounts under the Predecessor Accounting Method. Assets and liabilities of the acquired entity are stated at predecessor carrying values. These intra-group transactions have no impact in the consolidated financial statements.

3.9. Intangible assets

Separately acquired intangible assets are measured at cost on initial recognition. After initial recognition, intangible assets are stated at cost, less any accumulated amortization and accumulated impairment losses. Internally generated goodwill are not capitalized.

The useful life of intangible assets is assessed as definite or indefinite.

Intangible assets with definite useful lives are amortized over their estimated useful lives and tested for impairment, whenever there is an indication of any loss in the economic value of the assets. The period and method of amortization for intangible assets with definite lives are reviewed at least at the end of each fiscal year or when there are indicators of impairment. Changes in estimated useful lives or expected consumption of future economic benefits embodied in the assets are considered to modify the amortization period or method, as appropriate, and treated as changes in accounting estimates. The amortization of intangible assets with definite lives is recognized in the statements of operations in the expense category consistent with the use of intangible assets (Note 15).

Intangible assets with indefinite useful lives are not amortized, but are tested for impairment at each year-end or whenever there is an indicator that their carrying amount cannot be recovered. The assessment is reviewed annually to determine whether the indefinite useful life continues to be supportable. If not, the change in useful life from the indefinite to definite is made on a prospective basis.

Gains and losses resulting from the disposal of intangible assets are measured as the difference between the net disposal proceeds and the book value of assets, and are recognized in the statements of operations.

In connection with the acquisition of TudoAzul (former TRIP), the Company identified airport operating licenses as having indefinite useful lives. The fair value of Pampulha, Santos Dumont and Fernando de Noronha airports operating licenses were recognized at fair value at the acquisition date. Fair value of operating licenses was based on estimated discounted future cash flows. Operating licenses are considered to have indefinite useful lives due to several factors, including requirements for necessary permits to operate within Brazil and limited landing rights availability in Brazil's most important airports regarding traffic volume.

3.10. Impairment of non-financial assets

The Company performs an annual review for impairment indicators in order to assess events or changes in economic, technological, or operating conditions which may indicate that an asset is not recoverable. If any, those indicators are identified when performing the annual impairment testing and the Company estimates the asset's recoverable amount. An asset's recoverable amount is the higher of an asset's or cash generating unit's (CGU) fair value less cost to sell and its value in use. When the carrying amount of intangibles exceed its recoverable amount, an impairment charge is recorded and the asset is written down to its recoverable amount.

The Company operates as a single CGU.

In estimating the value in use of assets, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects the weighted average cost of capital for the industry in which the cash-generating unit operates. The fair value less cost to sell is determined, whenever possible, based on a firm sales agreement carried out on an arm's length basis between known and interested parties, adjusted for expenses attributable to asset sales, or when there is no firm sale commitment, based on the market price of an active market or most recent transaction price of similar assets.

For assets excluding goodwill, an assessment is made at each reporting date to determine whether there is an indication that previously recognized impairment losses no longer exist or have decreased. If such indication exists, the Company estimates the recoverable amount. A previously recognized impairment loss is reversed only if there has been a change in the assumptions used to determine the asset's recoverable amount since the last impairment loss was recognized. The reversal is limited so that the carrying amount of the asset does not exceed its recoverable amount, nor exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognized for the asset in prior years.

The following assets have specific characteristics for impairment testing:

<u>Goodwill</u>

Goodwill is tested for impairment annually or when circumstances indicate that the carrying value may not be recoverable.

Impairment is determined for goodwill by assessing the recoverable amount of the single CGU taking the Company as a whole. When the recoverable amount of the CGU is less than its carrying amount, an impairment loss is recognized. Impairment losses relating to goodwill cannot be reversed in future periods.

Intangible assets

Intangible assets with indefinite useful lives are tested for impairment annually at the CGU level, and when circumstances indicate that the carrying value may be impaired.

3.11. Leases

A lease is classified at the inception date as a finance lease or an operating lease. The leases of property and equipment in which the Company substantially hold the risks and rewards incidental to ownership are classified as finance leases. Finance leases are capitalized at the commencement of the lease at the inception date fair value of the leased property or, if lower, at the present value of the minimum lease payments. Lease payments are apportioned between finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability. Finance charges are recognized in finance expenses in the statement of operations.

The present value of the minimum lease payments, is calculated using the implicit interest rate when it is clearly identified in the lease agreement or the market interest rate.

The leased assets are depreciated over the remaining economic useful life of the leased assets or the contractual term, whenever there is no reasonable certainty that the Company will obtain ownership of the property at the end of the contractual term.

An operating lease is a lease other than a finance lease. Operating lease payments (including direct costs and incentives received from the lessor of each contract) are recognized as an operating expense on a straight-line basis over the lease term.

A sale and leaseback transaction involves the sale of an asset and leasing back the same asset.

Gains or losses related to sale-leaseback transactions classified as an operating leases upon the sale are immediately recognized as other (expense) income when it is clear that the transaction was at fair value. If the sale price is below fair value any gain or loss is recognized immediately, except if a loss is compensated by future lease payments at below market price, in which case, it is deferred and amortized in proportion to the lease payments over the contractual lease term.

Gains or losses related to sale-leaseback transactions classified as financial lease, upon the sale, are deferred and amortized over the lease term.

Sublease is an operation in which the Company has an original lease of a particular asset that is transferred to a third party generating a new lease under conditions that may be the same or different from the original lease. The original contract lease expense is recognized in the statement of operations under "Aircraft and other rent" and the income from the sublease under "Other revenues".

In certain circumstances, such as market conditions in which the contracts were negotiated, it may occur that the amount of rental expense paid is higher from the rental income received in the sublease agreement. For contracts in which this situation is identified, the Company records a provision for onerous contracts in accordance with IAS 37 - "Provisions, Contingent Liabilities and Contingent Assets".

3.12. Security deposits and maintenance reserves

a) Security deposits

Security deposits are guarantee deposits held as collateral related to aircraft lease contracts paid to lessors at the inception of the lease agreement that will be refunded to the Company when the aircraft is returned to the lessor at the end of the lease agreement. Security deposits are denominated in U.S. Dollars and do not bear interest.

b) Maintenance reserves

Certain master lease agreements provide that we pay maintenance reserves to aircraft lessors to be held as collateral in advance of the performance of major maintenance activities. Maintenance reserve deposits are reimbursable to us upon completion of the maintenance event in an amount equal to the lesser of (1) the amount of the maintenance reserve held by the lessor associated with the specific maintenance event or (2) the qualifying costs related to the specific maintenance event. Substantially all of these maintenance reserve payments are calculated based on a utilization measure, such as flight hours or cycles, and are used solely to collateralize the lessor for maintenance.

At the lease inception and at each statement of financial position date, we assess whether the maintenance reserve payments required by the master lease agreements are expected to be recovered through the performance of qualifying maintenance on the leased assets. Maintenance deposits expected to be recovered from lessors are reflected in security deposits and maintenance reserves in the accompanying statements of financial position. We assess recoverability of amounts currently on deposit with a lessor, by comparing them to the amounts that are expected to be reimbursed at the time of the next maintenance event, and amounts not recoverable are considered maintenance costs.

3.13. Provisions

Provisions are recognized when the Company has a present legal or constructive obligation, as a result of past events, it is probable that an outflow of resources will be required to settle the obligation and a reliable estimate of the amount can be made.

When the Company expects that the value of a provision will be reimbursed, in whole or in part, as for example under an insurance contract, the reimbursement is recognized as a separate asset but only when reimbursement is virtually certain. The expense relating to any provision is presented in the statements of operations, net of any reimbursement.
The Company is party in other judicial and administrative proceedings. Provisions are set up for all legal claims related to lawsuits for which it is probable that an outflow of funds will be required to settle the legal claims obligation and a reasonable estimate can be made. The assessment of probability of loss includes assessing the available evidence, the hierarchy of laws, the most recent court decision and their relevance in the legal system, as well as the assessment of legal counsel.

Lease contracts determine in what conditions the Company must return the leased aircraft to the lessor. The Company estimates a provision based on the projected future costs to be incurred to return the asset in an acceptable condition as contractually required, taking into consideration the current fleet and long term maintenance plans.

3.14. Treasury shares

Own equity instruments that are reacquired (treasury shares) are recognized at cost and deducted from equity. No gain or loss is recognized in profit or loss on the purchase, sale, issue or cancellation of the Company own equity instruments. Any difference between the carrying amount and the consideration, if reissued, is recognized in the share premium.

3.15. Employee benefits

i) Executive bonus

The Company records a provision for executive bonus, which payment is contingent to meeting predefined goals and it is recorded under Salaries, wages and benefits.

ii) Share-based payment

The Company offered its executives share-based payments, to be settled with the Company shares, where the Company receives services provided by these professionals in consideration for share options and restricted stock units.

The cost of equity settled awards with employees is measured based on the fair value as of the grant date. In order to determine the fair value of share options, the Company uses the Black-Scholes option pricing model (Note 26).

The cost of equity settled awards is recognized together with a corresponding increase in equity, over the period in which performance and/or service conditions are fulfilled, ending on the date the employee acquires the full right to the award (vesting date). The cumulative expense for equity settled transactions at each reporting date until the vesting date reflects the extent to which the vesting period has expired and management’s best estimate of the number of equity instruments that will be vested.

The expense or credit in the statement of the operations for the period is recorded in “Salaries, wage and benefits” and represents the change in the accumulated expense recognized in the period.

No expense is recognized for awards that do not vest, except for awards in which vesting is subject to a market or non-vesting condition. These are treated as vested, regardless of whether the market conditions are met or not, provided that all the other exercise conditions are met.

When the terms of an equity settled award are modified, the minimum expense is that, that would have been recognized had the terms not been modified. An additional expense is recognized for any modification that increases the total fair value of the share based payment transaction or those otherwise benefits the employee, as measured at the date of modification.

When an equity settled award is cancelled, it is treated as having vested on the cancellation date and any expense not recognized for the award is immediately recognized. This includes any award in which the non-vesting conditions within the control of the Company or the counterparty are not met. However, if a new plan replaces the plan canceled and designated as a replacement award on the date of grant, the canceled plan and the new plan are treated as if they were a modification to the original plan, as described in the previous paragraph.

The cost of cash-settled transactions is measured initially at fair value at the grant date. This fair value is expensed over the service period with the recognition of a corresponding liability. The liability is remeasured to fair value at each reporting date up to, and including the settlement date, with changes in fair value recognized in the statement of the operations for the period in ‘Salaries, wage and benefits’.

3.16. Accounts payable - Forfaiting

The Company negotiated with suppliers to extend payment terms. As a result, the Company signed an agreement with financial institutions to allow the anticipation of trade receivables from its suppliers. Taking into account that the early receipt with financial institutions is an option for suppliers, this does not generate financial expenses for the Company, it does not require the mandatory participation of suppliers, and the Company is neither refunded and/nor benefited with discounts from the financial institution due to prepayment before the maturity date agreed upon with the supplier. There is no change in the bill subordination level in the event of judicial execution. As of December 31, 2018, the balance of suppliers benefited from such agreement totaled R$162,778.

3.17. Revenue from contracts with customers

Passenger tickets revenue is recognized upon effective rendering of the transportation service. Travel related services revenue is recognized when the related transportation service is provided being classified as passenger revenue. Travel related services include baggage fees, administrative charges, upgrades and other travel related charges.

(In thousands of Brazilian reais, except when otherwise indicated)

The Company recognizes revenue for tickets and travel related services sold upon the departure of the related scheduled flight and for tickets and travel related services sold that are expected to expire unused (breakage). The Company estimates the value of future refunds and exchanges, net of forfeitures for all unused tickets, once the flight date has already passed. These estimates are based on historical data and experience from past events.

IFRS 15 requires disclosure of quantitative and qualitative information about transaction price allocation to unsatisfied or partially satisfied performance obligations. The Company decided to apply the practical expedient to not disclose such information as the performance obligations are part of contracts with expected duration of one year or less.

Revenue is segregated as follows:

	For the year ended December 31,	
	2018	**2017 (Pro forma)**
Operating revenue		
Tickets revenue	**7,744,031**	6,695,340
Travel related services	**926,101**	704,391
Total passenger revenue	**8,670,132**	7,399,731
Cargo and other revenue	**483,225**	373,742
Total revenue	**9,153,357**	7,773,473

3.18. “TudoAzul” Program

Under the “TudoAzul” program customers accrue points based on the amount spent on tickets flown. The amount of points earned depends on TudoAzul membership status, market, flight, day-of-week, advance purchase, booking class and other factors, including promotional campaigns. The Company recognizes revenue on points that are estimated to expire unused. Points in general expire two years after the date earned regardless of activity in the account.

Upon the sale of a ticket, the Company recognizes a portion of the ticket sales as revenue when the transportation service occurs and defers a portion corresponding to the points earned under the TudoAzul Program, in accordance with IFRS 15, Customer Loyalty Programs in the account “Air Traffic Liabilities”.

The Company determines the estimated selling price of the air transportation and points as if each element had been sold on a separate basis and was therefore based on the stand alone selling price.

The Company sell mileage credits to customers and also to business partners, including co-branded credit cards, financial institutions and other businesses. The related revenue is deferred and recognized as passenger revenue when points are redeemed and the related transportation service occurs, based on the weighted average price of the points sold.

Sales of mileage credits are comprised of two components, transportation and marketing. Accordingly, we recognize the marketing component in “other revenue” based on contractual terms.

Points awarded or sold and not used are recorded in “Air traffic liability”. The Company recognizes revenue for points sold and awarded that will never be redeemed by program members. The Company estimates such amounts annually based upon the latest available information regarding redemption and expiration patterns.

3.19. Segment information

IFRS 8 requires that operations are identified by segment based on internal reports that are regularly reviewed by the Company´s chief operating decision maker to allocate funds to segments and assess their performance.

The operations of the Company consist of air transportation services in Brazil. The Company's management allocates funds based on the consolidated results. The main assets generating revenue of the Company are its aircraft, from which revenue is generated in Brazil. Other revenues are basically derived from cargo operations and all items are directly attributed to air transport services that are recognized in income for the year when the services are rendered.

Based on how the Company manages its business and the way in which fund allocation decisions are taken, the Company has only one operating segment for financial reporting purposes.

3.20. New and amended standards and interpretations

The Company applied IFRS 15 and IFRS 9 for the first time. The nature and effect of the changes as a result of adoption of these new accounting standards are described below.

Several other amendments and interpretations hed been applied for the first time in 2018, but did not have impact in the consolidated financial statements of the Company. The Company has not early adopted any standard, interpretation or amendment that have been issued, but are not yet effective.

IFRS 9 – Financial instruments

In July 2014, the IASB issued the final version of IFRS 9 – Financial Instruments, which superseded IAS 39 – Financial Instruments: Recognition and Measurement. IFRS 9 is applicable for annual periods beginning on or after January 1, 2018.

Except for hedge accounting, retrospective application is required, but comparative information is not required. The Company adopted the new standard on January 1, 2018.

The Company has opted not to present comparative information showing retroactively the results from the adoption of IFRS 9.

The effect of adopting IFRS 9 as at 1 January 2018 was, as follows:

	Increase / (decrease)
Balance Sheet:	
Air traffic liability	**(631)**
Deferred income taxes	**215**
Accumulated losses	**(416)**

Classification and measurement

The new standard establishes new requirements for the classification and measurement of financial assets and liabilities as detailed in note 3.3.

The Company classified its financial assets and liabilities in accordance with the business models established in IFRS 9 and evaluated the contractual terms of those instruments not measured at fair value through profit or loss. As result of the new classification and measurement requirements credit card receivables previously measured at amortized cost are measured at fair value through comprehensive income.

The following table presents for financial assets and liabilities at January 1, 2018 the original measurement category under IAS 39 and the current measurement category under IFRS 9.

	Original under IAS 39	Current under IFRS 9
	Measurement category	
Assets		
Short-term investments	Held for trading	Fair value through profit of loss
Restricted investments	Fair value through profit of loss	Amortized cost
Trade and other receivables	Loans and receivables	Amortized cost except for credit card receivables which are measured at fair value through other comprehensive income
Financial instruments	Held for trading except those under cash flow hedge accounting	Fair value through profit of loss except those under cash flow hedge accounting
Non-current related parties	Loans and receivables	Amortized cost
Long-term investments (TAP Convertible Bond)	Hybrid instrument recorded on its entity at fair value through profit or loss	Fair value through profit of loss
Non-current restricted investments	Fair value through profit of loss	Amortized cost
Security deposits and maintenance reserves	Loans and receivables	Amortized cost
Non-current Financial instruments	Held for trading except those under cash flow hedge accounting	Fair value through profit of loss except those under cash flow hedge accounting
Liabilities		
Loans and financings	Amortized cost	Amortized cost
Accounts payable	Amortized cost	Amortized cost

(In thousands of Brazilian reais, except when otherwise indicated)

	Original under IAS 39	Current under IFRS 9
Financial instruments	Held for trading except those under cash flow hedge accounting	Fair value through profit of loss except those under cash flow hedge accounting
Non-current loans and financings	Amortized cost	Amortized cost
Non-current accounts payable	Amortized cost	Amortized cost
Non-current financial instruments	Held for trading except those under cash flow hedge accounting	Fair value through profit of loss except those under cash flow hedge accounting

All changes result exclusively from the change in measurement criteria on transition to IFRS 9. No financial asset or liability was designated as measured at fair value through profit or loss under IAS 39 and the Company did not make any such designation upon adoption of IFRS 9.

Impairment

As further detailed in Note 3.3 the new impairment model requires the recognition of allowance for credit losses on assets not measured at fair value through profit or loss based on expected credit losses (ECL) rather than only incurred credit losses as was the case under IAS 39.

The estimate of the expected loss is based on the Company’s historical credit losses, adjusted for management’s expectations about future economic conditions for the relevant period.

The application of the requirements of impairment under IFRS 9 resulted in an increase in the allowance for doubtful accounts of R$631 at January 1, 2018 and a decrease of R$209 during the year ended December 31, 2018 which corresponds on its entirety to trade receivables (other than credit card receivables) measured at amortized cost.

Hedge accounting

On April 1, 2018, the Company opted to apply the new requirements of IFRS 9 related to hedge accounting. These requirements require that hedge accounting relationships reflects the Company's risk management objectives and strategies, the effectiveness assessment has a qualitative and forward-looking approach and prohibit voluntary discontinuation of hedge accounting as well.

The new standard allows the designation of net exposure related to group of similar instruments (not permitted on the previous standard IAS 39), separate the forward element of forward contracts as well as the foreign currency basis spread and temporal element of options to be recorded in other comprehensive income (when they are part of a hedge accounting relationship).

(In thousands of Brazilian reais, except when otherwise indicated)

IFRS 15 – Revenue from Contracts with Customers

IFRS 15 supersedes IAS 11 *Construction Contracts*, IAS 18 *Revenue* and related Interpretations and it applies, with limited exceptions, to all revenue arising from contracts with customers. IFRS 15 establishes a five-step model to account for revenue arising from contracts with customers and requires that revenue be recognized at an amount that reflects the consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer.

IFRS 15 requires entities to exercise judgement, taking into consideration all of the relevant facts and circumstances when applying each step of the model to contracts with their customers. The standard also specifies the accounting for the incremental costs of obtaining a contract and the costs directly related to fulfilling a contract. In addition, the standard requires extensive disclosures.

The Company adopted IFRS 15 using the modified retrospective method of adoption with the date of initial application of January 01, 2018. Under this method, the standard can be applied either to all contracts at the date of initial application or only to contracts that are not completed at this date. The Company elected to apply the standard to all contracts as at January 01, 2018.

The new standard requires reclassification of ancillary revenues, such as baggage fees, administrative charges, upgrades and other travel related charges that were previously classified in other revenue, to passenger revenue in the amount of R$926,101 for the year ended December 31, 2018. These ancillary fees are directly related to passenger travel and will no longer be considered distinct performance obligations separate from the passenger travel component. In this context, such ancillary revenues, which were previously recognized when sold, are now recognized when transportation is provided.

In addition, the adoption of IFRS 15 slightly increases the rate used to account TudoAzul Program credits in the amount of R$6.994 for the year ended December 31. 2018. We previously analyzed the market prices of airfares offered to travel agencies with high volumes of transactions to establish the selling price of our mileage credits. Considering the application of the new standard, the Company adopted the stand alone selling price method.

The effect of adopting IFRS 15 as at January 01, 2018 was, as follows:

	Increase / (decrease)
Balance Sheet:	
Air traffic liability	**62,603**
Deferred income taxes	**(21,284)**
Accumulated losses	**(41,319)**

Set out below, are the amounts by which each financial statement line item is affected as at and for the year ended December 31, 2018 as a result of the adoption of IFRS 15.

The first column shows amounts prepared under IFRS 15 and the second column shows what the amounts would have been had IFRS 15 not been adopted:

(In thousands of Brazilian reais, except when otherwise indicated)

Consolidated statement of operations and balance sheet for the year ended December 31, 2018 as below:

	Amounts prepared under		
Consolidated statement of operations	**IFRS 15**	**Previous IFRS**	**Increase/ (decrease)**
Passenger revenue	**8,670,132**	**7,839,086**	**831,046**
Cargo and other revenue	**483,225**	**1,409,326**	**(926,101)**
Deferred income tax and social contribution	**(170,604)**	**(202,923)**	**32,319**
Net income	**420,277**	**357,540**	**62,737**

	Amounts prepared under		
	IFRS 15	**Previous IFRS**	**Increase/ (decrease)**
Balance Sheet:			
Air traffic liability	**1,672,452**	**1,577,397**	**95,055**
Deferred income taxes	**443,894**	**476,213**	**(32,319)**
Accumulated losses	**(836,214)**	**(773,477)**	**(62,737)**

IFRIC Interpretation 22 *Foreign Currency Transactions and Advance Considerations*

The Interpretation clarifies that, in determining the spot exchange rate to use on initial recognition of the related asset, expense or income (or part of it) on the derecognition of a non-monetary asset or non-monetary liability relating to advance consideration, the date of the transaction is the date on which an entity initially recognises the non-monetary asset or non-monetary liability arising from the advance consideration. If there are multiple payments or receipts in advance, then the entity must determine the date of the transactions for each payment or receipt of advance consideration. This Interpretation does not have material impact on the Company's consolidated financial statements.

Amendments to IFRS 2 *Classification and Measurement of Share-based Payment Transactions*

The IASB issued amendments to IFRS 2 *Share-based Payment* that address three main areas: the effects of vesting conditions on the measurement of a cash-settled share-based payment transaction; the classification of a share-based payment transaction with net settlement features for withholding tax obligations; and accounting where a modification to the terms and conditions of a share-based payment transaction changes its classification from cash settled to equity settled. On adoption, entities are required to apply the amendments without restating prior periods, but retrospective application is permitted if elected for all three amendments and other criteria are met. The Company's accounting policy for cash-settled share based payments is consistent with the approach clarified in the amendments. In addition, the Company has no share-based payment transaction with net settlement features for withholding tax obligations and had not made any modifications to the terms and conditions of its share-based payment transaction. Therefore, these amendments do not have any impact on the Company's consolidated financial statements.

3.4. Standards issued but not yet effective

IFRS 16 was issued in January 2016 and it replaces IAS 17, *Leases*, IFRIC 4*, Determining whether an Agreement Contains a Lease*, SIC-15, *Operating leases-Incentives* and SIC-27 – *Evaluating the Substance of Transactions in the Legal Form of a Lease*.

IFRS 16 establishes the principles for the recognition, measurement, presentation and disclosure of leases and requires lessees to account for all leases under a single model in the balance sheet, similar to accounting for finance leases under IAS 17. The standard includes two elective exemptions of recognition for lessees - Leases of 'low-value' assets (e.g. personal computers) and short-term leases (i.e. one that does not include a purchase option and has a lease term at commencement date of 12 months or less), the lessee should recognize the lease payments associated with those leases as an expense on either a straight-line basis over the lease term or another systematic basis if that basis is representative of the pattern of the lessee's benefits, similar to the current accounting for operating leases.

Lessees will be also required to remeasure the lease liability upon the occurrence of certain events (e.g., a change in the lease term, a change in future lease payments resulting from a change in an index or rate used to determine those payments). The lessee will generally recognize the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset

Under IFRS 16, Azul will capitalize the right of use of all aircraft and other assets such as properties, vehicles and equipment currently held under operating leases. Azul will recognize a right-of-use asset representing its right to use the underlying asset and a corresponding lease liability that is initially measured at the present value of the future lease payments representing its obligation to make lease payments. Operating lease expenses will be replaced by a depreciation expense on right-of-use assets recognized and an interest expense as the interest rate implicit in Azul's lease liabilities. When the interest rate implicit in the lease cannot be readily determined, Azul's incremental borrowing rate will be used as an alternative.

IFRS 16 is effective for annual periods beginning on or after January 1, 2019.

Transition to IFRS 16

A lessee can apply IFRS 16 either by a full retrospective approach or a modified retrospective approach. Azul will apply the full retrospective transition approach to each prior reporting period presented. Under the full retrospective method the comparative information will be restated.

Azul will elect to use the exemptions proposed by the standard on lease contracts for which the lease terms ends within 12 months as of the date of initial application, and lease contracts for which the underlying asset is of low value. Azul has leases of certain equipment (i.e., personal computers, printing and photocopying machines as well as communicating equipment) that are considered of low value.

(In thousands of Brazilian reais, except when otherwise indicated)

During 2018, Azul has performed a detailed impact assessment of IFRS 16 in its consolidated financial statements. We note that the actual impacts from the adoption of the standard in January 1, 2019 may change if there is a change in certain estimates as a result of ongoing discussions. Given the complexity of the matter, until the initial adoption in 2019 there might be a variation from the amounts presented below and the Company estimates that such variation may be up to 20% from the disclosed amounts.

In summary the impact of IFRS 16 adoption is expected to be, as follows:

Matter	**Estimated impact**
Recognition of a right of use asset and a lease liability for aircraft related operating leases on the Consolidated Balance Sheet	As of December 31, 2018, the Company has 123 aircraft, 13 engines and 3 flight simulators classified as operating leases that will be recognized. The estimated impact on the opening balance sheet as of January 1, 2019 would lead to the recognition of R$3.8 billion of right of use assets and R$7.7 billion of lease liability, recognizing the difference in accumulated profit or losses.
Other lease contracts within the meaning of the standard	Based on its analysis, outside of aircraft leases, Azul has identified around 72 other lease contracts within the scope of the standard that will also be capitalized. The main lease contracts other than aircrafts relate to surface areas rented in hubs and other airports, rented building dedicated to the maintenance business, customized lounges in airports, rented office buildings and company cars. As of December 31, 2018 the Company estimates that will recognize R$70 million of right of use assets and R$83 million of lease liability as a result from such contracts, recognizing the difference in accumulated profit or losses.
Recognition of depreciation and interest expense instead of operating lease rental expense in the Consolidated Financial Statements	In 2018, lease rental expenses related to aircraft under operating leases amounted to R$1.5 billion.
Capitalization of heavy maintenance and structural checks performed on aircraft under operating lease and depreciation of such assets in line with accounting policies applicable to owned aircraft and aircraft under finance lease	In 2018, expenses related to heavy maintenance and structural checks performed on aircraft under operating lease amounted to R$239 million and were recognized under Maintenance materials and repairs within the Consolidated Statement of Operations.

The Company's aircraft lease rental payments are predominantly denominated in USD. While the Company's foreign currency cash flow risk for lease rental payments are unchanged, the adoption of IFRS 16 will result in foreign currency denominated lease liabilities recognized on the balance sheet revaluing in response to exchange rate fluctuations in the USD/BRL exchange rate.

IFRIC 23 – Uncertainty over income tax treatments

The Interpretation IFRIC 23 addresses the he application of requirements in IAS 12 "Income Taxes" when there is uncertainty over the acceptance of income tax treatments by the tax authority.

The interpretation clarifies that, if it is not probable that the tax authority will accept the income tax treatments, the amounts of tax assets and liabilities shall be adjusted to reflect the best resolution of the uncertainty.

IFRIC 23 will be effective for annual periods beginning on or after January 1, 2019, and the Company established processes and procedures to obtain information that is necessary to apply the Interpretation on a timely basis and did not identify significant impacts from the adoption of this standard.

4. Significant accounting judgments, assumptions and estimates

Judgments

The preparation of consolidated financial statements of the Company requires management to make judgments and estimates and adopt assumptions that affect the reports amounts of revenue, expenses, assets, liabilities and disclosures of contingent liabilities at the date of the financial statements. Uncertainty relating to these assumptions and estimates could lead to amounts that require a significant adjustment to the book value of assets or liabilities affected in future periods.

In the process of applying the Company's accounting policies, management has made the following judgments, which have the most significant effect on the amounts recognized in the consolidated financial statements:

Lease classification

The Company has assessed the classification of leases between finance and operating based on the terms and conditions of each arrangement. A lease agreement is classified as a finance lease when significant risk and rewards of the ownership of the aircraft are transferred; otherwise the contract is accounted for as an operating lease.

Estimates and assumptions

The main assumptions concerning the future and other key sources of estimation uncertainty at the reporting date, involving a significant risk of causing a material adjustment of the book value of assets and liabilities within the next financial year are discussed below:

Breakage

The Company recognizes revenue from tickets sold that are expected to expire unused based on historical data and experience. Estimating expected breakage requires management to make judgment, among other things, the extent to which historical experience is an indication of the customer behavior. Annually, or more frequently as the experience data suggests, management reassesses the historical data and makes required improvements.

Impairment of non-financial assets

An impairment loss exists when the book value of assets or cash-generating unit exceeds its recoverable amount, which is the higher of fair value less sales costs and value in use. The calculation of fair value less sales costs is based on information available of transaction for sale of similar assets or market price less additional costs for disposing of assets. The calculation of value in use is based on the discounted cash flow model.

Cash flows are derived from the budget for the next five years and do not include reorganization activities to which the Company have not yet been committed or significant future investments that will improve the basis of assets of the cash-generating unit subject matter of test.

The recoverable amount is sensitive to the discount rate used in the method of discounted cash flow and expected future cash receipts and growth rate used for extrapolation.

Transactions with share-based payments

The Company measures the cost of transactions settled with its own shares with employees based on the fair value of such shares at the grant date or at each reporting date, as applicable. The Company must estimate at each reporting date the quantity of awards expected to be vested considering performance and non-market vesting conditions. Estimating the fair value of share-based payments requires determining the most appropriate assessment model for the grant of shares, which depends on the terms and conditions of the grant. This also requires determining the inputs used in the valuation models, including the option's expected life, volatility, dividend income, and related assumptions. The assumptions and models used to estimate the fair value of share-based payments are disclosed in Note 26.

Provisions for tax, civil and labor risks

The Company recognizes provisions for civil and labor suits. The assessment of probability of loss includes assessing the available evidence and jurisprudence, the hierarchy of laws and most recent court decisions, and their relevance in the legal system, or the assessment of independent counsels. Provisions are reviewed and adjusted to take into account changes in circumstances such as the applicable limitation period, findings of tax inspections and additional exposures identified based on new issues or decisions of courts (Note 27).

Fair value of financial instruments

When the fair value of assets and liabilities presented in the statement of financial position cannot be obtained in an active market it is determined using valuation techniques, including the discounted cash flow model. The data for these methods is based on those prevailing in the market, when possible. However, when it is not feasible, a certain level of judgment is required to establish fair value. Judgment includes considerations on the data used, for example, liquidity risk, credit risk and volatility. Changes in assumptions about these factors could affect the fair value of the financial instruments.

"TudoAzul" Program - Loyalty Plan

As described in Note 3.18, the Company accounts for "*TudoAzul*" loyalty program using the deferred revenue method. Under the deferred revenue method, the Company accounts for awarded points as a separately identifiable component of the sales transactions in which they are granted and recognizes *based on the relative individual selling price*. Deferred revenue, other than breakage on points, remains recognized until customers redeem their points, or when they expire (Note 18).

Provision for return of aircraft and engines

For aircraft under operating leases, the Company is contractually required to return the equipment at a predefined level of operational capability.

The aircraft return cost provision is estimated based on expenditures incurred in aircraft reconfiguration (interior and exterior), licensing and technical certification, painting etc., according to return terms.

The engine's return cost provision is estimated based on evaluation and minimum contractual conditions of the equipment that should be returned to the lessor, considering not only the historical costs incurred, but also the equipment conditions at the time of evaluation.

Determination of useful life and significant components of property and equipment

The Company believes that important aircraft parts need to be separated, including engines, their respective scheduled heavy maintenance and structural checks. These parts are depreciated in accordance with the useful lives defined in the fleet renovation plan and the maintenance schedule.

5. Financial risk management objectives and policies

The main financial liabilities of the Company, other than derivatives, are loans, debentures and accounts payable. The main purpose of these financial liabilities is to finance operations as well as finance the acquisition of aircraft. The Company has trade accounts receivable and other accounts receivable that result directly from its operations.

(In thousands of Brazilian reais, except when otherwise indicated)

The Company also has investments available for trading and contracts derivative transactions such as currency forwards, options and swaps in order to reduce the exposure to foreign exchange fluctuations.

The Company's senior management supervises the management of market, credit and liquidity risks. All activities with derivatives for risk management purposes are carried out by experts with skills, experience and appropriate supervision. It is the Company's policy not to enter in to derivatives transactions for speculative purposes.

a) Market risk

Market risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk consists of three types of risk: interest rate risk, currency risk and other price risk, such as equity price risk and commodity risk. Financial instruments exposed to market risk include loans payable, deposits, financial instruments measured at fair value through profit or loss and financial instruments.

The Company may enter into derivative transactions to protect its Loans and financing against currency and interest rate fluctuations.

The table below shows the effects of our hedges designated for hedge accounting in our debt:

	December 31, 2018		
	Book value	Fair Value – hedge instrument	Consolidated post hedge strategy
Denominated in foreign currency - US$			
Purchase of aircraft	100,042	-	100,042
Finance lease (a)	949,891	9,422	959,313
Working capital (b)	1,656,947	(266,404)	1,390,543
Denominated in local currency - R$			
Purchase of aircraft (FINAME)	192,861	-	192,861
Working capital	73,376	-	73,376
Finance lease	2,386	-	2,386
Total in R$	2,975,503	(256,982)	2,718,521
Current position	295,913	-	295,913
Non-current position	2,679,590	(256,982)	2,422,608

(In thousands of Brazilian reais, except when otherwise indicated)

a) The table below shows the indebtedness related to finance lease denominated in foreign currency, designated as hedge accounting, considering the effects of the derivative instruments (exchanging the exposure for local currency) contracted by the Company:

						December 31, 2018		
Risk	**Type of hedge**	**Hedged Item**	**Nominal amount**	**Hedge Instrument**	**Nominal amount**	**Carrying amount - hedge item**	**Fair Value – hedge instrument**	**Debt Considering Hedge**
Finance lease								
Interest rate	Cash Flow Hedge	Floating interest rate - US Libor6M	US$ 83,5 million	Interest rate Swap (receives US Libor6M & pays fixed 6% to 6,5%)	US$ 83,5 million	**128,779**	**9,422**	**138,201**
Foreign exchange and interest rate	N/A	N/A	N/A	N/A	N/A	**821,112**	**-**	**821,112**
Total						**949,891**	**9,422**	**959,313**

b) The table below shows the indebtedness related to working capital denominated in foreign currency, designated as hedge accounting, considering the effects of the derivative instruments (exchanging the exposure for local currency) contracted by the Company:

						December 31, 2018		
Risk	**Type of hedge**	**Hedged Item**	**Nominal amount**	**Hedge Instrument**	**Nominal amount**	**Carrying amount - hedge item**	**Fair Value – hedge instrument**	**Debt Considering Hedge**
1) Senior Notes Azul LLP								
Foreign exchange risk	Cash Flow Hedge	Principal US$ on Senior Notes Azul LLP	US$ 400 million	Currency Options - Floor 3,2865 Cap 4,7500	US$ 400 million	**1,540,383**	**(246,323)**	**1,294,060**
2) Proceeds in foreign currency								
Interest rate swap	Fair value hedge	Principal & Interest on 4.131 Transaction	US$30 million	IRS - Interest Rate Swap (receives US Libor3M + spread 1,034% & pays 108% CDI)	98,940	**116,564**	**(20,081)**	**96,483**
Total						**1,656,947**	**(266,404)**	**1,390,543**

(In thousands of Brazilian reais, except when otherwise indicated)

a.1) *Interest rate risk*

Interest rate risk is the risk that the fair value of future results of a financial instrument fluctuates due to changes in market interest rates. The exposure of the Company to the risk of changes in market interest rates refers primarily to long-term obligations subject to variable interest rates.

The Company manages interest rate risk by monitoring the future projections of interest rates on its loans, financing and debentures as well as on its operating leases. To mitigate this risk, the Company has used derivative instruments aimed at minimizing any negative impact of variations in interest rates.

Sensitivity to interest rates

The table below shows the sensitivity to possible changes in interest rates, keeping all other variables constant in the Company's income before taxes that are impacted by loans payable subject to variable interest rates. For the sensitivity analysis, the Company utilized the following assumptions:

- LIBOR based debt: weighted average interest rate of 5.3% p.a.
- CDI based debt: weighted average interest rate of 6.8% p.a.

We estimated the impact on profit and loss and equity for the year ended December 31, 2018 resulting from variation of 25% and 50% on the weighted average rates, as shown below:

	25%	-25%	50%	-50%
Interest expense	**48,359**	**(48,359)**	**96,717**	**(96,717)**

a.2) *Currency risk*

Currency risk is the risk that the fair value of future dollar denominated commitments vary according to the fluctuation of the foreign exchange rate. The exposure of the Company to changes in exchange rates relates primarily to the U.S dollar denominated loans and financing, net of investments in the U.S. dollar, and also to operating expenses originated in U.S. dollar.

The Company is also exposed to changes in the exchange rate of the Euro through its investment in the TAP Convertible Bonds (Note 21).

The Company manages its currency risk by using financial instruments seeking to hedge up to twelve months of its projected non-operational activities.

(In thousands of Brazilian reais, except when otherwise indicated)

The Company continuously monitors the net exposure in foreign currency and, when deemed appropriate, enters into arrangements to hedge the projected non-operating cash flow for up to 12 months to minimize its exposure. Adittionally, the Company may enter into longer than 12 months derivative financial instruments to protect itself against currency and/or interest rate risks related to "Loans and financing"

The Company's nominal foreign exchange exposure is shown below:

	Exposure to U.S. dollar		Exposure to Euro	
	December 31,		December 31,	
	2018	**2018**	**2018**	**2017**
Assets				
Cash and cash equivalents and short-term Investments	**356,174**	278,227	**-**	-
Security deposits and maintenance reserves	**1,513,963**	1,237,391	**-**	-
Long-term investments (Note 21)	**-**	-	**1,287,780**	835,957
Financial instruments	**116,564**	49,530	**-**	-
Other assets	**122,456**	314,609	**-**	-
Total assets	**2,109,157**	1,879,757	**1,287,780**	835,957
Liabilities				
Accounts payable	**(334,407)**	(255,646)	**-**	-
Loans and financing (*)	**(2,706,880)**	(2,609,704)	**-**	-
Other liabilities	**(50,278)**	(164,949)	**-**	-
Total liabilities	**(3,091,565)**	(3,030,299)	**-**	-
Derivatives (NDF) – notional	**2,186,356**	1,223,960	**-**	-
Net exposure	**1,203,948**	73,418	**1,287,780**	835,957

(*) As of December 31, 2018, US dollar denominated working capital loans totaling R$1,655,947 were swapped to Brazilian Reais, resulting in an total debt in Reais of R$2,655,087.

Sensitivity to exchange rates

At December 31, 2018, the Company used the closing exchange rate of R$3.8748/US$1.00 and R$4.4390/EUR1.00. We present below a sensitivity analysis considering a variation of 25% and 50% over the existing rates:

Exposure in US$	**25%**	**-25%**	**50%**	**-50%**
	R$4.8435/US$	**R$2.9061/US$**	**R$5.8122/US$**	**R$1.9374/US$**
Effect on exchange rate variation	**300,987**	**(300,987)**	**601,974**	**(601,974)**

Exposure in EUR	**25%**	**-25%**	**50%**	**-50%**
	R$5.5488/EUR	**R$2.3293/EUR**	**R$6.6585/EUR**	**R$2.2195/EUR**
Effect on exchange rate variation	**321,945**	**(321,945)**	**643,890**	**(643,890)**

(In thousands of Brazilian reais, except when otherwise indicated)

a.3) *Risks related to variations in prices of aircraft fuel*

The volatility of prices of aircraft fuel is one of the most significant financial risks for airlines. The company's fuel price risk management aims to balance the airline exposure to its market peers, so that the airline is neither overly affected by a sudden increase in prices nor is unable to capitalize on a substantial fall in fuel prices. The Company manages the risk related to fuel price volatility either through forward looking fixed-price contracts directly with a supplier, or derivative contracts negotiated with banks. The Company may use derivative contracts for oil or its sub products.

Fuel price sensitivity

The table below sets out the sensitivity of the Company's fuel hedges to substantial changes in the oil markets, maintaining all other variables constant as of December 31, 2018.

The analysis considers a change in oil prices, in Reais, relative to the market average for the current period and forecast the impact on the Company's financial instruments, stemming from a variation of 25% and 50% in the oil prices, as follows:

Change in Oil prices in Reais	**25%**	**-25%**	**50%**	**-50%**
Impact on fuel hedges	**41,709**	**(286,938)**	**208,229**	**(450,690)**

a.4) *Risk related to changes in the fair value of TAP Convertible Bonds*

Since the TAP Convertible Bonds contain a conversion option into shares of TAP, the Company is exposed to changes in the fair value of TAP.

The acquisition of the TAP Convertible Bonds is part of the commercial strategy of the Company of creating synergies between the Company and TAP by having the option to become a direct shareholder of TAP in case the stock price of TAP increases and is economically advantageous to convert the debt into TAP shares.

b) Credit risk

Credit risk is inherent in operating and financial activities of the Company, mainly represented under the headings of: trade receivables, cash and cash equivalents, including bank deposits.

The credit risk of "trade receivables" is comprised of amounts payable by major credit card companies, and also trade receivables from travel agencies, and sales payable in installments. The Company usually assesses the corresponding risks of financial instruments and diversifies the exposure.

Financial instruments are held with counterparties that are rated at least A in the assessment made by S&P, Moody's and Fitch, or, mostly, are hired in futures and commodities stock exchange, which substantially mitigates the credit risk. TAP Convertible Bonds are secured by liens over certain intangible assets.

(In thousands of Brazilian reais, except when otherwise indicated)

c) Liquidity risk

Liquidity risk takes on two distinct forms: market and cash flow liquidity risk. The first is related to current market prices and varies in accordance with the type of asset and the markets where they are traded. Cash flow liquidity risk, however, is related to difficulties in meeting the contracted operating obligations at the agreed dates.

As a way of managing the liquidity risk, the Company invests its funds in liquid assets (government bonds, CDBs, and investment funds with daily liquidity), and the Cash Management Policy establishes that the Company's and its subsidiaries' weighted average debt maturity should be higher than the weighted average maturity of the investment portfolio.

The schedule of financial liabilities held by the Company is as follows:

December 31, 2018	Immediate	Until 6 months	7 to 12 months	1 to 5 years	More than 5 years	Total
Loans and financing	98,244	111,550	125,257	3,269,976	100,995	3,706,022
Accounts payable	724,469	388,584	53,238	-	-	1,166,291
Accounts payable – Forfaiting	162,778					162,778
Liabilities from derivative transaction	16,920	93,348	70,707	260,019	-	440,994
Provisions	-	-	-	80,984	-	80,984
	1,002,411	593,482	249,202	3,610,979	100,995	5,557,069

Capital management

The Company's assets may be financed through equity or third-party financing. If the Company opts for equity capital it may use funds from contributions by shareholders or through selling its equity instruments.

The use of third-party financing is an option to be considered mainly when the Company believes that the cost would be less than the return generated by an acquired asset. It is important to ensure that the Company maintains an optimized capital structure, provides financial solidity while providing for the viability of its business plan. As a capital-intensive industry with considerable investment in assets with a high aggregated value, it is natural for companies in the aviation sector to report a high degree of leverage.

The Company manages capital through leverage ratios, which is defined by the Company as net debt divided by the sum of net debt and total equity. Management seeks to maintain this ratio at levels equal to or lower than industry levels. Management includes in the net debt the loans and financing (includes debentures) less cash and cash equivalents, restricted cash, short and long-term investments and current and noncurrent restricted investments.

(In thousands of Brazilian reais, except when otherwise indicated)

The Company's capital structure is comprised of its net indebtedness defined as total loans and financing (includes debentures) and operating leases net of cash and cash equivalents, restricted cash and others financial instruments. Capital is defined as equity and net indebtedness.

The Company is not subject to any externally imposed capital requirements. The total capital as total net equity and net debt as detailed below:

	December 31,	
	2018	**2017**
Equity	**3,163,700**	2,833,610
Cash and cash equivalents (Note 6)	**(1,169,136)**	(762,319)
Short-term investments (Note 7)	**(517,423)**	(1,036,148)
Long-term investments (Note 21)	**(1,287,781)**	(835,957)
Restricted financial investments (Note 8)	**-**	(8,808)
Loans and financing (Note 17)	**3,706,022**	3,489,887
Net debt	**731,682**	846,655
Total capital	**3,895,382**	3,680,265

6. Cash and cash equivalents

Cash and cash equivalents are comprised of the following:

	December 31,	
	2018	**2017**
Cash and bank deposits	**370,262**	160,429
Cash equivalents		
Bank Deposit Certificate – CDB	**480,052**	290,829
Investments funds	**318,822**	311,061
	1,169,136	762,319

The balances of cash and bank deposits represent amounts deposited in checking accounts with Brazilian and offshore banks.

The CDB investments are indexed to the Brazilian Interbank Deposit Certificate ("CDI") and are repayable on demand.

Investment funds are comprised of CDB's investments and repurchase agreements, denominated in Reais, with financial institutions (deposit certificates).

Cash equivalents investments are classified as financial assets at fair value through profit or loss.

(In thousands of Brazilian reais, except when otherwise indicated)

7. Short term investments

Investments are comprised of:

	December 31,	
	2018	**2017**
Other short-term investments	**16,039**	57,363
Investment funds	**501,384**	978,785
	517,423	1,036,148

Investment funds are comprised of Brazilian government bonds and bank notes, denominated in Reais, with financial institutions (deposit certificates) and debentures issued by B and BB+ risk rated companies bearing an accumulated average interest rate of 100% of CDI – Interbank Deposit Certificate rate. Brazilian government bonds are comprised of National Treasury Bills ("LTN"), National Financial Bills ("LFT") and National Treasury Notes ("NTN").

Short-term investments are classified as financial assets at fair value through profit or loss.

8. Restricted investments

Restricted financial investments are comprised of deposits to guarantee some of our stand-by letters of credit for aircraft operating lease and are managed within the business model of receiving contractual payments over a life time, which is classified as cost amortized, which were invested in floating rate CDBs – Bank Certificate Deposits and DI – Investments linked to the Interbank Deposit interest rate. On December 31, 2017, the return on these investments varies from 100% to 101% of the CDI rate.

9. Trade and other receivables

	December 31,	
	2018	**2017**
Trade and other receivables with customers:	**1.039.373**	894.996
Trade and other receivables with others	**42.406**	26.357
	1.081.779	921.353
Allowance for doubtful accounts	**(12.723)**	(6.925)
	1.069.056	914.428

The changes in the allowance for doubtful accounts are as follows:

	December 31,	
	2018	**2017**
Balance at the beginning of the year	**6,925**	5,339
Increases	**7,505**	2,358
Reversals	**(1,707)**	(772)
Balance at the end of the year	**12,723**	6,925

(In thousands of Brazilian reais, except when otherwise indicated)

The schedule of accounts receivables are as follows:

	December 31,	
	2018	**2017**
Not yet due	**1,025,211**	747,324
Up to 90 days	**43,845**	167,104
Over 91 days	**12,723**	6,925
	1,081,779	921,353

Accounts receivable from credit card companies are received in installments of up to twelve months. Installment receivables which are due more than 60 days amounted to R$691,839 at December 31, 2018 (December 31, 2017 – R$573,564). Average days-sales-outstanding was 37 days for the year ended December 31, 2018 (December 31, 2017 - 36 days). Generally, interest is charged on sales receivable in installments with more than six and ten months for domestic and internation flights, respectively.

The Company enters into factoring transactions with banks or credit card management companies, in order to obtain funds for working capital. During the year ended December 31, 2018 the Company factored accounts receivable from credit cards with a face value of R$2,553,188 (December 31, 2017 - R$3,153,785). Because these receivables are from credit card companies and present a low credit risk, we were able to sell these receivables without any risk to the Company in the event of default by the customers. As such, the accounts receivable were derecognized in full and the discount interest cost recognized in the statement of operations, under financial expenses, for an amount of R$10,414 for the year ended December 31, 2018 (December 31, 2017 - R$35,351).

10. Inventories

	December 31,	
	2018	**2017**
Parts and maintenance materials	**206,729**	151,441
Catering and uniforms	**9,351**	11,627
Inventory provision	**(15,935)**	(12,675)
	200,145	150,393

11. Prepaid expenses

	December 31,	
	2018	**2017**
Insurance premium	**33,385**	24,337
Aircraft and engine leases	**76,610**	42,296
Guarantee commission	**20,682**	15,530
Other	**54,834**	32,093
	185,511	114,256
Non-current	**21,683**	4,472
Current	**163,829**	109,784

(In thousands of Brazilian reais, except when otherwise indicated)

Aircraft and engine lease prepayments are comprised of costs of aircraft lease agreements that are expensed on a straight line basis over the lease term.

12. Related parties

a) Compensation of key management personnel

Key management personnel include board of director members, officers and executive committee members. The compensation paid or payable to officers and directors services is as follows:

	For the year ended December 31,	
	2018	**2017**
Salaries and wages	**16,275**	17,377
Bonus	**7,263**	6,724
Share-based option plans	**21,508**	24,775
	45,046	48,876

b) Guarantees granted

The Company granted guarantees for some property rental agreements entered into by executive officers. The amounts involved are not material.

c) Maintenance agreements

ALAB entered into Maintenance Agreements to aircraft with TAP Manutenção e Engenharia Brasil S/A (“TAP ME”). TAP ME is part of the same economic group as TAP.

The total value of maintenance services acquired by the Company pursuant to such Maintenance Agreements during the year ended December 31, 2018 was R$83,831 (December 31, 2017 – R$83,295).

As of December 31, 2018, the amount payable to TAP ME was R$5,663 and is recorded under Accounts payable.

d) Codeshare Agreement

On 2015, ALAB signed a codeshare agreement with United (a shareholder), TAP and Aigle Azur which will provide transport of passengers whose tickets have been issued by one of the airlines and the service is performed by the other.

e) Transactions with Aigle Azur

On December 31, 2018, the Company recorded in “Prepaid expenses”, the amount of R$13,330 (December 31, 2017 - 0).

(In thousands of Brazilian reais, except when otherwise indicated)

f) Loan agreements receivable

On September 2, 2016 the Company entered into a loan agreement with a shareholder in the amount of US$2.8 million (December 31, 2018 - R$12,042). This agreement bears interest at a rate of Libor plus 2.3% p.a. and will be paid in full in 2019.

On November 24, 2017 the Company entered into a loan agreement with HNA, the borrower, in the amount of US$22 million. This agreement bears a one time upfront fee of 1% of the principal and interest at a rate of 1.0% per calendar month, and matures in 364 days from the signing date. The loan is guaranteed by a pledge of 25,472,852 preferred shares of Azul owned by HNA. On April 26, 2018, HNA repaid the full amount.

g) Transactions with TAP

The Company entered into certain transactions with TAP as described below:

	For the year ended December 31,	
	2018	**2017**
Aircraft sublease (i)	**(47,135)**	(8,570)
TAP Convertible Bonds (ii)	**403,459**	202,921
	356,324	194,351

i. Aircraft sublease

In March 2016, the Company subleased fifteen aircraft to its related party TAP. Seven of the fifteen leases had been executed at a time when the market for regional aircraft was higher than when the related seven subleases were executed. As a result, although the Company believes that the rates in these seven subleases represented approximate market rates at the time of their execution, the Company will receive from TAP an amount lower than the amount that the Company has to pay under the related leases. This difference considering the total term of sublease contracts discounted to its net present value was R$72,435 in December 31, 2018 (December 31, 2017 – R$68,949) and recorded as a provision for the obligations under onerous leases, as required by IAS 37 “Provisions, Contingent Liabilities and Contingent Assets”, representing the remaining amount of the future unavoidable costs under the leases.

The loss was recognized in the year ended December 31, 2018 in the “result from related party transaction, net” line in the statement of operations due to assumptions at fair value.

In July 2017, the Company subleased two additional aircraft to TAP. These aircraft are owned by the Company and the rates in these leases represented market rates at the time of their execution. Additionally, two of the fifteen initially subleased aircraft were returned by TAP, resulting in a total of fifteen aircraft subleased to TAP as of December 31, 2018.

For the fifteen subleases, over the year ended December 31, 2018, amounts received from TAP from the subleases amounted to R$112,046 (Decemeber 31, 2017 – R$113,391), and amounts paid to the lessors of the related aircrafts totaled R$129,958 (December 31, 2017 – R$138,042).

ii. TAP Convertible Bonds

On March 14, 2016, the Company acquired series A convertible bonds issued by TAP (the "TAP Convertible Bonds") for an amount of €90 million. The TAP Convertible Bonds are convertible, in whole or in part at, the option of Azul into new shares representing the share capital of TAP benefiting from enhanced preferential economic rights (the "TAP Shares"). Upon full conversion, the TAP Shares will represent 6.0% of the total and voting capital of TAP, with the right to receive dividends or other distributions corresponding to 41.25% of distributable profits of TAP.

The option is exercisable starting in July 2016. The TAP Convertible Bonds mature 10 years from their issuance and bear interest at an annual rate of 3.75% until September 20, 2016 and at rate of 7.5% thereafter. Accrued interest remains unpaid until the earlier of the maturity date or early redemption of the bonds.

TAP has the right to early redeem the TAP Convertible Bonds if not yet converted and upon the earlier of (i) occurrence of an IPO, or (ii) 4 years from issuance of the TAP Convertible Bonds provided that TAP should be in compliance with certain financial covenants. The TAP Convertible Bonds will be redeemed at their principal amount together with the accrued unpaid interest.

The TAP Convertible Bonds, as well as the option to convert them into TAP Shares, were classified as a single financial asset recorded at changes in the fair value through profit or loss, under "Result from related parties transactions, net", classified in "Long term investments".

h) Guarantees

ALAB entered into a Deed of Guarantee and Indemnity as of September 15, 2017, in connection with the obligations and liabilities related to the operating lease agreements of three A350-900XW aircraft entered into by Hong Kong Airlines and Beijing Capital Airlines, companies of the HNA Group, ex-shareholder of the Company, and Wilmington Trust SP Services (Dublin) Limited.

As explained in note 1, on June 29, 2018, upon the liquidation of the secondary public offer of 58,138,005 preferred shares of the Company, HNA sold its interest and, therefore, ceased to be a related party of the Company.

(In thousands of Brazilian reais, except when otherwise indicated)

13. Security deposits and maintenance reserves

	December 31,	
	2018	**2017**
Security deposits	**225,230**	180,992
Maintenance reserve deposits	**1,321,490**	1,078,135
	1,546,720	1,259,127

Security deposits and maintenance reserve deposits are denominated in US dollars and adjusted for changes to foreign exchange rates. Security deposits are related to aircraft lease contracts and will be refunded to the Company when the aircraft is returned at the end of the lease agreement. Maintenance reserve deposits are paid under certain aircraft leases to be held as collateral in advance of the performance of major maintenance activities and are reimbursable upon completion of the related maintenance event, under certain conditions.

As of December 31, 2018 maintenance reserve deposits are likely to be recoverable as they are lower than the expected cost of the related next maintenance event that the reserves are intended to collateralize. During the year ended December 31, 2018 the Company recognized a write-off of R$31,132 (December 31, 2017 - R$9,638) in the “Maintenance materials and repairs” in the income statements line item for maintenance reserve deposits that are not likely to be reimbursed in relation to aircraft that went through their last maintenance event prior to their return.

The Company replaced some of its security deposits and maintenance reserves deposits with bank guarantees, and was refunded an amount of R$18,125 and R$106,875, respectively as of December 31, 2018 (December 31, 2017 - R$ R$25,333 and R$32,624 respectively).

Presented below are the changes in the security deposits and maintenance reserve deposits balance:

	Maintenance reserves deposits	Security deposits	Total
Balance at December 31, 2016	858,233	219,772	1,078,005
Additions	291,429	25,815	317,244
Refunds from sublease (*)	-	3,275	3,275
Write-offs	(9,638)	-	(9,638)
Refunds/returns	(81,013)	(69,441)	(150,454)
Foreign exchanges variations	19,124	1,571	20,695
Balance at December 31, 2017	1,078,135	180,992	1,259,127
Additions	**317,698**	**39,593**	**357,291**
Write-offs	**(31,132)**	**(968)**	**(32,100)**
Refunds/returns	**(236,987)**	**(23,175)**	**(260,162)**
Foreign exchanges variations	**193,776**	**28,788**	**222,564**
Balance at December 31, 2018	**1,321,490**	**225,230**	**1,546,720**

(*) refers to the net amount received and refunds from TAP in relation to security deposits of subleased aircraft.

(In thousands of Brazilian reais, except when otherwise indicated)

14. Property and equipment

Property and equipment are mainly comprised of “aircraft and engines” and aircraft equipment. “Aircraft and engines” refers to owned aircraft and capitalized heavy maintenance and structural checks related to owned aircraft.

As of December 31, 2018, the amount of R$100,859 (December 31, 2017 - R$325,121) of the balance of property and equipment acquisitions refers to non-monetary items, no impact on cash flow statements.

During the year ended December 31, 2018, the Company entered into a sale and leaseback transaction on an owned engine. The loss associated with the sale and leaseback transactions which resulted in finance leases amounted to R$6,730 (December 31, 2017 - R$4,183) was recorded in “Other liabilities” and will be recognized in the statement of operations over the average lease term of 120 months.

During the year ended December 31, 2018, the Company entered into seven aircraft sale transactions resulting in a net loss of R$144,251, recognized in “Other operating expenses, net”.

During the year ended December 31, 2017, the Company entered into sale and leaseback transactions on owned aircraft and engines. The gain associated with the aircraft sale and leaseback transactions, net of selling expenses of R$75,410 was recognized in “Other operating expenses, net”.

a) Breakdown

	December 31, 2018			December 31, 2017
	Cost	**Accumulated depreciation**	**Net amount**	**Net amount**
Leasehold improvements	**146,315**	**(53,030)**	**93,285**	71,591
Equipment and facilities	**130,655**	**(81,412)**	**49,243**	45,722
Vehicles	**3,238**	**(1,031)**	**2,207**	297
Furniture and fixtures	**18,797**	**(13,768)**	**5,029**	8,473
Aircraft equipment	**1,378,352**	**(338,879)**	**1,039,473**	647,963
Aircraft and engines	**2,382,837**	**(476,801)**	**1,906,036**	2,356,880
Advance payments for acquisition of aircraft	**112,923**	**-**	**112,923**	148,903
Construction in progress	**81,023**	**-**	**81,023**	45,706
	4,254,140	**(964,921)**	**3,289,219**	3,325,535

(In thousands of Brazilian reais, except when otherwise indicated)

b) Changes in property and equipment balances are as follows

	Cost				
	December 31, 2017	Acquisitions	Disposals/ Write-offs	Transfers	December 31, 2018
Leasehold improvements	117,903	**32,429**		**(4,017)**	**146,315**
Equipment and facilities	112,800	**18,677**	**(834)**	**12**	**130,655**
Vehicles	1,085	**2,153**		**-**	**3,238**
Furniture and fixtures	17,190	**1,613**	**(9)**	**3**	**18,797**
Aircraft equipment	908,659	**397,772**	**(48,922)**	**120,843**	**1,378,352**
Aircraft and engines	2,770,171	**182,246**	**(606,016)**	**36,436**	**2,382,837**
Advance payments for acquisition of aircraft	148,903	**27,199**	**(63,179)**	**-**	**112,923**
Construction in progress	45,706	**193,407**	**(4,813)**	**(153,277)**	**81,023**
	4,122,417	**855,496**	**(723,773)**	**-**	**4,254,140**

	Accumulated depreciation				
	December 31, 2017	Depreciation for the period	Disposals/ Write-offs	Transfers	December 31, 2018
Leasehold improvements	(46,312)	**(6,718)**	**-**	**-**	**(53,030)**
Equipment and facilities	(67,078)	**(14,781)**	**447**	**-**	**(81,412)**
Vehicles	(788)	**(243)**	**-**	**-**	**(1,031)**
Furniture and fixtures	(8,717)	**(5,056)**	**5**	**-**	**(13,768)**
Aircraft equipment	(260,696)	**(88,331)**	**10,148**	**-**	**(338,879)**
Aircraft and engines	(413,291)	**(165,142)**	**101,632**	**-**	**(476,801)**
	(796,882)	**(280,271)**	**112,232**	**-**	**(964,921)**

For owned aircraft, we employ the deferral method that results in the capitalization of heavy maintenance and structural checks. Under this method, the cost of major maintenance and structural checks are capitalized and amortized as a component of depreciation and amortization expense until the next major maintenance event. Heavy maintenance and structural checks on aircraft held under operating lease is expensed as incurred, and it is recorded in the “maintenance material and repair” line items.

The next major maintenance and structural check event is estimated based on the average maintenance costs and timing of the next scheduled maintenance event as suggested by the manufacturer and according to the fleet’s historical performance in the Company, and may change based on changes in aircraft utilization and changes in suggested manufacturer maintenance intervals. In addition, these assumptions can be affected by unplanned incidents that could damage a major component to the extent that would require a major maintenance event prior to a scheduled maintenance event.

The amortization of the costs of heavy maintenance and structural checks, accounted for under the deferred cost method and the expenses actually incurred, representing total maintenance and repair expenses, are as follows:

	December 31	
	2018	2017
Amortization of capitalized maintenance costs	**(24,783)**	(63,236)
Maintenance materials and repairs	**(504,477)**	(568,144)
	(529,260)	(631,380)

(In thousands of Brazilian reais, except when otherwise indicated)

As of December 31, 2018, the Company performed an impairment analysis. No impairment of property and equipment was recognized as a result of such impairment analysis.

15. Intangible assets

a) Breakdown

	December 31,			
	2018			2017
	Cost	Accumulated amortization	Net amount	Net amount
Goodwill (i)	**753,502**	**-**	**753,502**	753,502
Airport operating licenses (ii)	**82,196**	**-**	**82,196**	82,196
Software	**357,457**	**(176,599)**	**180,858**	125,302
	1,193,155	**(176,599)**	**1,016,556**	961,000

b) Changes in intangible assets balances are as follows:

	Costs				
	December 31, 2017	Acquisitions	Disposals/ Written-off	Transfers	December 31, 2018
Goodwill (i)	753,502	**-**	**-**	**-**	**753,502**
Airport operating licenses (ii)	82,196	**-**	**-**	**-**	**82,196**
Software	257,275	**100,204**	**(22)**	**-**	**357,457**
	1,092,973	**100,204**	**(22)**	**-**	**1,193,155**

	Accumulated amortization				
	December 31, 2017	Amortization for the year	Disposals/ Written-off	Transfers	December 31, 2018
Software	(131,973)	**(44,631)**	**5**	**-**	**(176,599)**
	(131,973)	**(44,631)**	**5**	**-**	**(176,599)**

(i) Refers to goodwill recorded in the acquisition of TudoAzul (former TRIP) in 2012. The amount of R$753,502 represents the excess of the consideration transferred over the fair value of the net assets acquired and liabilities assumed.

(ii) As part of the purchase price allocation of TudoAzul (former TRIP) acquisition, the Company recognized a separate intangible asset for the airport operating licenses. These intangible assets were deemed to have an indefinite life.

Impairment of goodwill and Airport operating licenses

The Company performed its annual impairment tests as of December 31, 2018. The Company assessed that the most appropriate method for estimating the recoverable amount of the Company’s single CGU (cash-generating unit) is by using the income approach through the discounted cash flows method, resulting in the value in use.

In order to determine the book value of the CGU, the Company adds the intangible assets recorded, given that it will only generate economic benefits by using the combination of both.

(In thousands of Brazilian reais, except when otherwise indicated)

The Company allocates goodwill and airport operating services to the cash-generating unit as follows:

	December 31,	
	2018	**2017**
Book value	**835,698**	835,698
Book value – CGU	**4,305,775**	4,286,535
Value in use	**13,735,495**	7,323,718
Discount rate before taxes	**10.6%**	11.5%
Perpetuity growth rate	**3.8%**	3.0%

The assumptions used in the impairment tests of goodwill and other intangible assets are consistent with the Company's operating plans and internal projections over a five-year period, and for longer periods the Company assumed growth rate in perpetuity.

These assumptions are both reviewed and approved by Management. The discounted cash flow that determined the value of the CGU was prepared in accordance with the Company's business plan, which was approved in December 13, 2018.

The Company took into consideration the following assumptions:

- Fleet and capacity: considers operational fleet plan, aircraft utilization and capacity per flight;
- Passenger revenue: considers the historical revenue per flown seat kilometer assuming the Company's growth plan;
- Operational costs: considers key performance indicators per cost line, aligned with Company's growth plan as well as macroeconomic variables (as described below);
- Investment needs: aligned to the Company's business plan.

The Company also considered forecasted market variables such as GDP (source: Central Bank of Brazil), the U.S. Dollar to Brazilian reais exchange rate (source: Central Bank of Brazil), the price of a barrel of kerosene (source: Bloomberg) and interest rates (source: Bloomberg).

The result of the impairment test, which includes a sensitivity analysis of the main variables, showed that the estimated recoverable amount is higher than carrying value of net assets allocated to the cash generating unit, and therefore no impairment was recognized as of December 31, 2018.

(In thousands of Brazilian reais, except when otherwise indicated)

16. Income tax and social contribution

a) Income tax and social contribution

	For the year ended December 31,	
	2018	**2017**
Income/(loss) before income tax and social contribution	**602,105**	597,844
Combined tax rate	**34%**	34%
Income tax and social contribution statutory rate	**(204,716)**	(203,267)
Adjustments to calculate the effective tax rate:		
Taxable profit on foreign subsidiaries	**(21,867)**	(13,496)
Exchange differences on foreign subsidiaries	**24,917**	27,064
Unrecorded deferred tax on tax loss and on temporary differences	**(40,499)**	39,872
Reversal of provisions for uncertain tax provisions (*)	**-**	3,573
Deferred Income Tax on Tax Losses included in the PRT (**)	**-**	83,143
Permanent differences	**65,971**	(8,006)
Other	**(5,634)**	2,312
Total income tax and social contribution expenses	**(181,828)**	(68,805)
Current income tax and social contribution	**(11,224)**	2,875
Deferred income tax and social contribution	**(170,604)**	(71,680)
	(181,828)	(68,805)

(*) Reversal of income tax provision prescribed considering the five-year statute of limitation
(**) Tax Recovery Program ("PRT")

b) Breakdown of deferred income tax and social contribution

	December 31,	
	2018	**2017**
Deferred taxes		
On temporary differences		
Provision for tax, civil and labor risks	**27,524**	17,746
Deferred revenue of TudoAzul program	**(132,740)**	(109,698)
Aircraft lease expense	**(167,972)**	(233,057)
Depreciation of aircraft and engines	**(33,973)**	(55,258)
Exchange rate	**(13,397)**	(11,338)
Deferred gain related to aircraft sold	**34,241**	49,270
Cash flow hedge (*)	**52,349**	4,994
Fair value of TAP convertible bonds	**(274,520)**	(147,418)
Provision for onerous contract	**24,628**	23,442
Financial instruments	**(73,735)**	(688)
Fair value of aircraft	**(397)**	(428)
Fair value of slots	**(27,947)**	(27,947)
Other on business combination fair value adjustment	**(2,707)**	(4,276)
Others	**61,993**	41,633
Net deferred tax (liabilities)	**(526,653)**	(453,023)
Deferred tax assets on net operating losses	**82,759**	126,112
Net deferred tax (liabilities)	**(443,894)**	(326,911)

(*) Deferred tax recorded in "Other comprehensive income (loss)"

(In thousands of Brazilian reais, except when otherwise indicated)

The Company offsets tax assets and liabilities if and only if it has a legally enforceable right to offset current tax assets and current tax liabilities and the deferred tax assets and deferred tax liabilities related to income taxes levied by the same tax authority.

The Company has income tax losses that are available indefinitely for offsetting against future taxable profits, as follows:

	December 31,	
	2018	**2017**
Net tax losses	**1,829,244**	1,940,059
Income tax loss carryforwards (25%)	**457,311**	485,015
Social contribution negative base tax carryforwards (9%)	**164,632**	174,605

Deferred income tax assets on tax losses have not been recognized as there is no evidence of recoverability in the near future, except for R$82,759 (December 31, 2017 – R$126,112) related to 30% of the deferred tax liability balance as of December 31, 2018 in accordance to the limit provided by the tax law.

17. Loans and financing

	December 31	
	2018	**2017**
Loans	**2,975,503**	3,287,427
Debentures	**730,519**	202,460
	3,706,022	3,489,887
Non-current	**3,370,971**	2,921,653
Current	**335,051**	568,234

Interest-bearing loans, financing and debentures are measured at amortized cost, using the effective interest rate method.

(In thousands of Brazilian reais, except when otherwise indicated)

17.1. Loans

	Guarantees	Interest	Final maturity	Consolidated December 31, 2018	Consolidated December 31, 2017	Fair value of designated derivatives (*) December 31, 2018
Denominated in foreign currency - US$						
Purchase of aircraft	Chattel mortgage	LIBOR plus "spread" between 2.55% and 4.00% p.a.	05/2023	**100,042**	124,361	**-**
Finance lease (*)	Chattel mortgage	LIBOR plus spread between 2.05% and 5.96% p.a.and fixed of 5.0% p.a	06/2028	**949,891**	1,108,265	**9,422**
Working capital (*) (a)	Receivables of Azul and cash collateral	LIBOR plus fixed interest of 0.88% p.a. and fixed of 5.90%p.a	10/2024	**1,656,947**	1,377,078	**(266,404)**
Denominated in local currency - R$						
Purchase of aircraft (FINAME) (**)	Investments and chattel mortgage of aircraft	Fixed between 6.00% to 6.50% p.a. and SELIC plus 5.46% p.a.	05/2025	**192,861**	258,432	**-**
Working capital	Receivables of Azul	5.0% fixed p.a and 125% to 126% of CDI	07/2021	**73,376**	412,056	**-**
Finance lease	Chattel mortgage	CDI plus fixed spread between 3.97% p.a. and 4.91% p.a.	04/2019	**2,386**	7,235	**-**
Total in R$				**2,975,503**	3,287,427	**(256,982)**
Current position				**295,914**	405,643	**-**
Non-current position				**2,679,589**	2,881,784	**(256,982))**

(*) Ilustrates the effect of hedges designated for hedge accounting, which are detailed in Note 21. The debt position considering the effects of the hedge can be seen on Note 5.

(**) FINAME are a special credit line from BNDES (the Brazilian development bank).

(In thousands of Brazilian reais, except when otherwise indicated)

a) Senior notes

The Company issued US$400 million in unsecured senior notes in October 2017 at 5.875% per year and maturity on October 26, 2024. Interest on the notes will be payable semi-annually in arrears on April 26 and October 26 of each year, beginning on April 26, 2018.

On December 14, 2017, the total amount referring to the Senior Notes was exchanged from Dollars to Reais by means of swap derivative contracts and exchange options to protect interest expenses, and through exchange options to protect the principal amount.

As a result of the implementation of this hedge structure, on April 1, 2018, the Senior Notes are protected against foreign currency fluctuations, up to an exchange rate of R$4.7500 for US$1.00, and above this level will be exposed only to the difference between the effective exchange rate and R$ 4.7500. In addition, the Company will benefit from any upside from the devaluation of the Brazilian real in case the exchange rate is bellow R$3.2865 for US$1.00. The options were financed, yielding a total hedging cost of 99.3% of CDI.

The result of the hedge recognized in the “Derivative financial instruments” asset and liability line itens and the consolidated debt position including the effect of the hedge is detailed in note 5.

The details of this transaction is following:

Options Structure	**Coupon Payments**		**Principal Payment**
Period	Apr/2018 to Apr/2019	Oct/2019 to Oct/2024	Oct/2024
Notional	US$12 million	US$12 million	US$400 million
Put option bought	-	3.2865	N/A
Call option bought	N/A	N/A	3.2865
Call option sold	-	4.7500	4.7500

	Senior notes	**Swap**
Currency	**US$**	**R$**
Amount	**US$400 million**	**R$1,314,600**
Interest	**Fixed**	**Floating**
Interest rate	**5.875%**	**99.3% of CDI**

b) Long term loans mature as follows:

	December 31,	
	2018	**2017**
2019	**-**	292,683
2020	**362,318**	434,707
2021	**233,518**	367,149
2022	**215,098**	195,236
2023	**146,557**	127,788
After 2023	**1,722,098**	1,464,221
	2,679,589	2,881,784

(In thousands of Brazilian reais, except when otherwise indicated)

c) The following assets serve as guarantees to secure the financing agreements

	December 31, 2018	December 31, 2017
Property and equipment (carrying value) used as collateral (Note 16)	**1,906,036**	2,356,880

17.2. Debentures

	Guarantees	Interest	Final maturity	December 31, 2018	December 31, 2017
Eight issue	Credit cards receivable	CDI + 1.50% p.a.	01/2019	**40,758**	202,460
Nine issue	Credit cards receivable	122% of CDI	12/2021	**493,990**	-
Tenth issue	Credit cards receivable	117% of CDI	12/2023	**195,771**	
Total				**730,519**	202,460
Current position				**39,137**	162,591
Non-current position				**691,382**	39,869

Long term debentures mature as follows:

	December 31, 2018	December 31, 2017
2019	**-**	39,869
2020	**296,338**	-
2021	**296,777**	-
2022	**49,131**	-
2023	**49,136**	-
	691,382	39,869

17.3. Finance leases

Future minimum lease payments under finance leases together (included in loans) with the present value of minimum lease payments are as follows:

	December 31, 2018	December 31, 2017
2018	**-**	219,920
2019	**185.381**	206,091
2020	**177.397**	212,614
2021	**180.204**	159,015
2022	**171.756**	151,144
2023	**113.673**	92,289
After 2023	**159.854**	116,749
Total minimum lease payments	**988,265**	1,157,822
Less finance charges	**(35,988)**	(42,322)
Present value of minimum lease payments	**952,277**	1,115,500
Less short-term portion	**178,583**	211,852
Long-term portion	**773,694**	903,648

(In thousands of Brazilian reais, except when otherwise indicated)

Lease agreements under which the Company has substantially all the risks and rewards of ownership were classified as finance leases. Finance leases were capitalized on lease inception at present value of the minimum lease payments.

Some finance leases were designated as hedged objects in an effective cash flow hedging relationship. The Company used interest rate swaps to convert the floating US Libor rate to a fixed rate exposure, protecting the volatilities of its future cash flow. The interest rate swaps have the same maturity and common terms as the finance leases that they are hedging (Note 21).

17.4 Covenants

As of December 31, 2018 the Company had an outstanding balance of R$822,578 million in "loans and financing" subject to financial covenants related to leverage and debt coverage ratios. Both covenants are measured annually.

Covenants relate to	Ratios measured
8th issuance of debentures 9th issuance of debentures 10th issuance of debentures Aircraft financing	(i) adjusted debt coverage ratio (ICSD) equal or higher to 1.2; and (ii) leverage ratio equal or lower than 5.5.

As of December 31, 2018 the Company was in compliance with all the covenants related to financial transactions.

18. Air traffic liability

Air traffic liability is comprised of the following:

	December 31,	
	2018	**2017**
Advance ticket sales	**1.099.978**	886,987
TudoAzul program	**572.474**	400,447
	1.672.452	1,287,434

19. Equity

a) Issued capital and authorized shares, all registered and without par value

	Company´s capital is - R$	Common shares	Preferred shares
At December 31, 2018	**2,209,415**	**928,965,058**	**326,631,190**
At December 31, 2017	2,163,377	928,965,058	321,753,720

(In thousands of Brazilian reais, except when otherwise indicated)

Conversion of shares

Each common share entitles its holder to 1 (one) vote in the General Shareholders' Meeting. Preferred shares of any class are not entitled to vote. Preferred shares have: i) priority of reimbursement of capital upon liquidation; ii) the right to be included in a public offering of the Company for a purchase of shares upon transfer of the Company's control for the same conditions as the common shareholders and for a price per share equivalent to seventy-five (75) times the price per share paid to the controlling shareholder; iii) in case of the Company's liquidation, the right to receive amounts equivalent to seventy-five (75) times the price per common share upon splitting of the remaining assets among the shareholders; and iv) the right to receive dividends in an amount equivalent to seventy-five (75) times the price paid per common share.

Issuance of shares and issued capital

i. IPO

On April 10, 2017, the Company approved a capital increase in the total amount of R$1,323,000 for the subscription of 63,000,000 preferred shares of Azul.

On April 19, 2017, the Company concluded its global initial public offering ("IPO") of 96,239,837 shares of preferred stock, of which 63,000,000 preferred shares were offered by Azul and 33,239,837 preferred shares were offered by selling shareholders, at an offering price of R$21.00 per preferred share and US$20.06 per ADS (each ADS represents three preferred shares).

ii. Exercise of stock options

During the year ended December 31, 2018 and 2017, the Company issued shares in the amount of R$46,038 and R$13,276 comprised of 4,877,470 and 4,182,454 preferred shares in connection with the exercise of stock options.

b) Share issuance costs

As set forth Pronouncement CPC 08 – Costs of Transaction and Premium on the Issuance of Marketable Securities, the Company accounted for the underwriter fees and other offering costs directly attributable to the IPO as a deduction from equity, net of tax effects. The amounts recorded are as follows:

	December 31, 2017
Shared issued costs	**68,596**
Tax credits from income tax and social contribution	**(23,320)**
Shared issued costs, net	**45,276**

Additional share issuance costs of R$26,007 were recognized in 2017 in relation to the obligation to HNA arising from the capital contribution.

c) Capital reserve

i. The share-based payment reserve is used to recognize the value of equity-settled share-based payments provided to employees, including key management personnel, as part of their compensation. For the year ended December 31, 2018, the Company recognized compensation expense for an amount of R$22,930 (December 31, 2017 – R$29,889).

ii. As of April 10, 2017, the Company recognized the amount in excess of par value of the shares issued at IPO in capital reserves in the total amount of R$646,479 net of foreign exchange loss of R$15,021.

iii. As of December 31, 2017, the Company recognized the amount in excess of par value of the shares issued to exercise for stock options in capital reserves in the total amount of R$10,186.

iv. As of December 31, 2018, the Company realized the amount of R$3,967 related to 537,806 shares issued to the Company's key management personnel, in connection with the share based option plan, not yet fully paid.

d) Dividends

According to the by-laws of the Company, unless the right is waived by all shareholders, the shareholders are guaranteed a minimum mandatory dividend equal to 0.1% of net income of the Company after the deduction of legal reserve, contingency reserves, and the adjustment prescribed by Law No. 6,404/76 (Brazilian Corporate Law). If the Company has accumulated losses, there will be no distribution of dividends.

Interest paid on equity, which is deductible for income tax purposes, may be deducted from the minimum mandatory dividends to the extent that it has been paid or credited. Interest paid on equity is treated as dividend payments for accounting purposes.
The Company has not distributed dividends for the year ended December 31, 2018 and 2017.

e) Other comprehensive loss

Changes in fair value of derivative instruments designated as cash flow hedges are recognized in other comprehensive loss, net of tax effects, for a loss of R$117,324 and R$11,192, as of December 31, 2018 and 2017 (net of R$36,645 and R$3,495 tax effect) respectively.

(In thousands of Brazilian reais, except when otherwise indicated)

f) Treasury shares

	Number of shares	R$
At December 31, 2017	103,000	2,745
Purchased	**447,000**	**12,179**
Cancelled	**(217,020)**	**(4,374)**
At December 31, 2018	**332,980**	**10,550**

20. Income per share

Basic earnings or loss per common share are calculated by dividing net income (loss) attributable to the equity holders of Azul by the weighted average number of common shares outstanding during the year ended December 31, 2018 and 2017, including the conversion of the weighted average number of preferred shares outstanding during the year ended into common shares.

Diluted earnings or loss per common share are calculated by dividing the net income (loss) attributable to the equity holders of Azul, by the weighted average number of common shares outstanding during the year ended December 31, 2018 and 2017, including the conversion of the weighted average number of preferred shares outstanding during the years into common shares, plus the weighted average number of common shares that would be issued on conversion of all the dilutive potential common shares into common shares.

Basic earnings or loss per preferred share are calculated by dividing net income (loss) attributable to the equity holders of Azul by the weighted average number of preferred shares outstanding during the year ended December 31, 2018 and 2017, including the conversion of the weighted average number of common shares outstanding during the years into preferred shares.

Diluted earnings or loss per preferred share are calculated by dividing the net income (loss) attributable to the equity holders of Azul, by the weighted average number of preferred shares outstanding during the year ended December 31, 2018 and 2017, including the conversion of the weighted average number of common shares outstanding during the years into preferred shares, plus the weighted average number of preferred shares that would be issued on conversion of all the dilutive potential preferred shares into preferred shares.

The following table shows the calculation of income or loss per common and preferred share in thousands, except for values per share:

	For the year ended December 31, 2018	2017
Numerator		
Net income	**420,277**	529,039
Denominator		
Weighted average number of common shares	**928,965,058**	928,965,058
Weighted average number of preferred shares	**325,310,485**	303,200,642
75 preferred shares (*)	**75,0**	75.0
Weighted average number of preferred equivalent shares (*)	**337,696,686**	315,586,842
Weighted average number of common equivalent shares (**)	**25,327,251,414**	23,669,013,177
Weighted average number of shares based payment	**11,530,390**	15,446,459
Weighted average number of shares that would have been issued at average market price	**6,400,619**	9,253,991
Basic net income per common share	**0.02**	0.02
Diluted net income per common share	**0.02**	0.02
Basic net income per preferred share	**1.24**	1.68
Diluted net income per preferred share	**1.23**	1.64

(*) Refers to a participation in the total equity value of the Company, calculated as if all 928,965,058 common shares outstanding had been converted into 12,386,200 preferred shares at the conversion ratio of 75 common shares to 1.0 preferred share.

(**) Refers to a participation in the total equity value of the Company, calculated as if the weighted average preferred shares outstanding had been converted into common shares at the conversion ratio of 75 common shares to 1.0 preferred share

21. Derivative financial instruments

The Company has the following financial instruments:

		Book value		Fair value	
		December 31,		December 31,	
	Level	2018	2017	2018	2017
Assets:					
Short-term investments (Note 7)	**2**	**517,423**	1,036,148	**517,423**	1,036,148
Long term investments (Note 21)	**3**	**1,287,781**	835,957	**1,287,781**	835,957
Restricted investments (Note 8) (*)	**2**	**-**	8,808	**-**	8,808
Financial instruments (Note 21) (*)	**2**	**595,380**	420,822	**595,380**	420,822
Liabilities:					
Loans and financing (Note 17) (*)	**2**	**3,706,022**	3,489,887	**3,692,250**	3,461,008
Financial instruments (Note 21) (*)	**2/3**	**440,994**	426,937	**440,994**	426,937

(*) Includes current and non-current.

(In thousands of Brazilian reais, except when otherwise indicated)

The carrying value of cash equivalents, short and long-term investments, restricted investments, trade and other receivables and accounts payable approximate their fair value largely due to the short-term maturity of these instruments.

Derivative financial instruments

	December 31, 2018		December 31, 2017	
	Assets	**Liabilities**	**Assets**	**Liabilities**
Cash flow hedge				
Interest rate swap contract	**-**	**(9,422)**	-	(14,755)
Foreign currency options	**246,323**	**-**	-	-
Fair value hedge				
Interest rate swap contract	**21,813**	**(1,732)**	4,747	(24)
Derivatives not designated as hedge				
Interest rate swap contract	**93,606**	**(260,593)**	4,239	(385,185)
Forward foreign currency contract	**233,638**	**(74)**	219,930	-
Heating oil forward contracts	**-**	**(123,224)**	4,469	-
Foreign currency options	**-**	**(45,949)**	187,437	(26,973)
	595,380	**(440,994)**	420,822	(426,937)

The maturity of the derivative financial instruments held by the Company is as follows:

December 31, 2018	Immediate	Until 6 months	7 to 12 months	1 to 5 years	More than 5 years	Total
Assets from derivative transactions	**212**	**3,735**	**2,707**	**588,652**	**74**	**595,380**
Liabilities from derivative transactions	**(16,920)**	**(93,348)**	**(70,707)**	**(260,019)**	**-**	**(440,994)**
Total financial instruments	**(16,708)**	**(89,613)**	**(68,000)**	**328,633**	**74**	**154,386**

Cash flow hedge

Definition	Origin of Risk	Risks designated for hedge	Hedge instrument	Recognition
Hedge of exposure to variability in cash flows attributable to a particular risk associated with a recognized asset or liability or a highly probable forecasted transaction that could affect the Company's results.	Financial leasing of aircraft with post-fixed interest rates	Interest Rate (Libor USD)	Cash Flow Swap - swapping post-fixed interest rate to pre-fixed.	• Protected item: Amortized cost - Liabilities in contra-entry result. • Hedge instrument: Fair value - Assets / Liabilities (MtM) in contra-entry profit (accrual) and other comprehensive income (MtM).
	Senior Notes denominated in foreign currency (only amortization)	Exchange Variation of dolar	Foreign currency options	• Protected item: Amortized cost - Liabilities in contra-entry result. • Hedge instrument: Fair value - Asset / Liability (MtM), in income statement (Intrinsic Value), offsetting the effect of the exchange variation on debt and other comprehensive income in Equity (Value in time)

As of December 31, 2018 and 2017, the Company had interest rate swaps designated as cash flow hedges to hedge against the effect of changes in the interest rate on a portion of the finance leases payments and forward foreign currency contract for the protection of the Senior Notes principal denominated in foreign currency in the next 12 months.

(In thousands of Brazilian reais, except when otherwise indicated)

The positions were:

December 31, 2018	Notional amount	Asset position	Liability position	Fair value
Cash flow hedge:				
Loans and financing	**57,805**	**LIBOR US$**	**Fixed rate**	**(9,422)**
Foreign currency options	**1,314,600**	**US$**	**R$**	**246,323**
	1,372,405			**236,901**

December 31, 2017	Notional amount	Asset position	Liability position	Fair value
Cash flow hedge:				
Loans and financing	87,395	**LIBOR**	**Fixed rate**	(14,755)
	87,395			(14,755)

The critical terms of the swap contracts matched with the terms of the hedged loans. Considering all transactions were deemed effective, the fair value changes on cash flow hedge were recorded in other comprehensive loss against financial instruments in liabilities or assets.

The gains and losses of hedge items (accrual of interest and exchange variation – financial lease and senior notes respectively) are impacted monthly, and are therefore offset monthly by the hedge instruments.

Factors that may influence hedge effectiveness include: i) the time difference between the hedging instrument and the hedged item and ii) the counterparty's credit risk substantially impacts the fair value of the derivative instrument, but not the hedged object (Senior Notes).

Changes in other comprehensive loss (cash flow hedge reserve) are detailed below:

	December 31,	
	2018	2017
Balance at the beginning of the year	**(11,192)**	(33,785)
Transactions settled during the period	**6,444**	6,435
New transactions recognized in income statement	**(215,765)**	-
Fair value adjustment	**66,544**	12,663
Deferred tax effect	**36,645**	3,495
Balance at the end of the year	**(117,324)**	(11,192)

(In thousands of Brazilian reais, except when otherwise indicated)

Fair value hedge

Definition	Origin of Risk	Risks designated for hedge	Hedge instrument	Recognition
Hedge of exposure to changes in the fair value of recognized asset or liability or unrecognized firm commitment.	Financial leasing of aircraft with pre-fixed interest rates	Interest rate	Cash Flow Swap - swapping pre-fixed interest rate to post-fixed.	• Protected item: Fair value - Liabilities in contra-entry result. • Hedge instrument: Fair value - Assets / Liabilities in contra-entry result (MtM).
	Debt instruments denominated in US$	Exchange Rate and Interest Rate	Cash Flow Swap - swapping US $ + Spread to reais at% CDI.	• Protected item: Fair value - Liabilities in contra-entry result. • Hedge instrument: Fair value - Assets / Liabilities in contra-entry result (MtM).

As of December 31, 2018 the Company had fixed to floating interest rate swap contracts with a notional amount of R$163,353 (December 31, 2017 - R$103,669). These contracts entitle the Company to receive fixed interest rates and pay floating interest based on CDI.

Adjustment to fair value of these contracts resulted in the recognition of an unrealized gain of R$20,081 (December 31, 2017 – R$4,723) which was recorded as financial income. The impact on the statement of operations was offset by a negative adjustment on the debt hedged. There was no ineffectiveness during the year ended December 31, 2018.

Derivatives not designated as hedge accounting

i) Forward foreign currency contract

The Company is exposed to the foreign currency risk, and therefore entered into currency forward contracts, options and foreign currency swaps.

During the year ended December 31, 2018, the Company had entered into NDF contracts of US$375 million to protect itself from currency fluctuations (December 31, 2017 - US$370 million) that generated an unrealized gain of R$233,564 (December 31, 2017 – R$219,930).

ii) *Foreign currency options*

The Company also has currency options with notional of US$159 million (December 31, 2017 – US$544 million), of which US$129 million are in connection with the Senior Notes hedge and US$30 million (December 31, 2017 - US$15 million) in connection to a dollar loan. As of December 31, 2018, these options generated an unrealized loss of R$45,949 (December 31, 2017 – gain of R$ 160,464).

On April 1, 2018, the Company designated for cash flow hedge accounting options with notional in the amount of US$ 400 million contracted for the purpose of protecting the principal of Senior Notes and was presented on topic “Cash Flow Hedge” (Note 21).

(In thousands of Brazilian reais, except when otherwise indicated)

iii) *Interest rate swap contract*

As of December 31, 2018 the Company had interest rate swap contracts in connection with the Senior Notes. Changes in fair value of these instruments resulted in the recognition of an unrealized loss of R$166,987 (December 31, 2017 - R$380,946).

iv) *Heating oil forward contracts*

As of December 31, 2018, the Company also had average NDF contracts on over-the-counter (OTC) Market with three different counterparties on the local market indexed to Heating Oil forward contract traded on the NYMEX, on monthly tranches, with a notional value of R$804,929 (December 31, 2017 - R$15,495). The fair value of these instruments amounted to an unrealized loss of R$123,224 (December 31, 2017 – gain of R$4,469).

Fair value of financial instruments

The Company applies the following hierarchy to determine the fair value of financial instruments:

Level 1: quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2: other techniques for which all data that have significant effect on the fair value recorded are observable, directly or indirectly;

Level 3: techniques that use data that have significant effect on fair value recorded that are not based on observable market data.

Assets measured at fair value	December 31, 2018	Level 1	Level 2	Level 3
Financial assets at fair value				
Short-term investments	517,423	-	517,423	-
Restricted investments (a)	1,287,781	-	-	1,287,781
Interest rate swap contract - fair value hedge option (b)	21,813	-	21,813	-
Interest rate swap contract- not designated as hedge	93,606	-	93,606	-
Forward foreign currency contract	233,638	-	233,638	-
Foreign currency options	246,323	-	246,323	-

Liabilities measured at fair value	December 31, 2018	Level 1	Level 2	Level 3
Financial liabilities at fair value				
Interest rate swap contract - cash flow hedge	(9,422)	-	(9,422)	-
Interest rate swap contract - fair value hedge option (b)	(1,732)	-	(1,732)	-
Interest rate swap contract- not designated as hedge	(260,593)	-	(260,593)	-
Forward foreign currency contract	(45,949)	-	(45,949)	-
Forward foreign currency contract	(74)	-	(74)	-
Heating oil forward contracts	(123,224)	-	(123,224)	-

Assets measured at fair value	December 31, 2017	Level 1	Level 2	Level 3
Financial assets at fair value				
Short-term investments	1,036,148	-	1,036,148	-
Restricted investments (a)	8,808		8,808	-
Long-term investments (c)	835,957	-	-	835,957
Interest rate swap contract - fair value hedge option (b)	4,747	-	4,747	-
Interest rate swap contract- not designated as hedge	4,239		4,239	
Forward foreign currency contract	219,930	-	219,930	-
Foreign currency options	187,437		187,437	
Heating oil forward contracts	4,469	-	4,469	-

Liabilities measured at fair value	December 31, 2017	Level 1	Level 2	Level 3
Financial liabilities at fair value				
Interest rate swap contract - cash flow hedge	(14.755)	-	(14.755)	-
Interest rate swap contract - fair value hedge (b)	(24)	-	(24)	-
Interest rate swap contract- not designated as hedge	(385.185)	-	(385.185)	-
Foreign currency options	(26.973)	-	(26.973)	-

(a) Includes current and non-current.

(b) Portion of the balances consist of loans from FINAME PSI, and standard FINAME presented at their value adjusted by the hedged risk, applying fair value hedge accounting rules.

(c) The Company calculated the fair value of the call option based on a valuation for TAP and binomial model considering the term of option, discount rate and the market volatility of publicly traded comparable airlines, calculated on a 2 years average. The resulting amount of the binomial model calculated in Euros was converted into Reais using the period-end exchange rate. See Note 21

Description of significant unobservable inputs to valuation:

The significant unobservable inputs used in the fair value measurements categorised within Level 3 of the fair value hierarchy, together with a quantitative sensitivity analysis as at December 31, 2018 and 2017 are shown below:

Non-listed equity investments - Level 3 financial assets

Valuation technique	Significant unobservable inputs	Rate	Sensitivity of the input to fair value (amounts in millions of brazilian reais)
Discounted cash flow method	Long-term growth rate for cash flows for subsequent years	2018: 1.9% 2017: 1.8%	10bps (2017 – 10bps) increase (decrease) in the growth rate would result in an increase (decrease) in the fair value of R$3 (2017 - R$19)
	Cost of equity	2018: 12.2% 2017: N/A *	50bps increase in cost of equity would result in a reduction in the fair value of R$23 (2017 - 0). 50bps reduction in cost of equity would result in an increase in the fair value of R$25 (2017 - 0).

(*) In 2017 the Company used another methodology not directly comparable.

(In thousands of Brazilian reais, except when otherwise indicated)

Level 3 financial assets reconciliation

Changes in the fair value of the TAP Convertible Bonds is detailed below:

	December 31, 2018	December 31, 2017
Balance at the beginning of the period	**835,957**	752,095
Foreign currency exchange gain (loss) (*)	**48,365**	47,781
Interest accrual (Note 12.f.ii) (**)	**29,630**	29,569
Net present value adjustment (Note 12.f.ii) (**)	**13,219**	(11,844)
Fair value of call-option (Note 12.f.ii) (**)	**360,610**	18,356
Balance at the end of the period	**1,287,781**	835,957

(*) recorded in the “Foreign currency exchange, net” in the income statements line item.

(**) recorded in the “Result from related parties transactions, net” in the income statements line item.

22. Operating revenue

	For the year ended December 31,	
	2018	**2017**
Revenue		
Passenger revenue	**9,029,960**	6,985,044
Other revenue	**527,018**	1,139,427
Gross revenue	**9,556,978**	8,124,471
Taxes levied on		
Passenger revenue	**(359,828)**	(289,704)
Other revenue	**(43,793)**	(45,270)
Total taxes	**(403,621)**	(334,974)
Net revenue	**9,153,357**	7,789,497

(In thousands of Brazilian reais, except when otherwise indicated)

23. Financial result

	For the year ended December 31,	
	2018	**2017**
Financial income		
Interest on short-term investments	**31,947**	50,604
Federal tax installment payment program	**-**	28,838
Other	**9,446**	15,363
	41,393	94,805
Financial expenses		
Interest on loans	**(217,889)**	(278,840)
Interest on factoring credit card and travel agencies receivables	**(10,625)**	(36,188)
Interest on other operations	**(79,822)**	(110,375)
Guarantee commission	**(26,187)**	(24,880)
Loan costs amortization	**(23,169)**	(36,598)
Other	**(52,515)**	(37,152)
	(410,207)	(524,033)
Derivative financial instruments, net	**298,094**	(90,171)
Foreign exchange result, net	**(194,706)**	57,871
Net financial expenses	**(265,426)**	(461,528)

24. Other operating expenses, net

	For the year ended December 31,	
	2018	**2017**
Accommodation and meals	**(215,808)**	(184,035)
IT services	**(188,936)**	(132,572)
Professional services	**(80,890)**	(52,931)
Taxes, civil and labor risks	**(54,463)**	(66,955)
Aircraft insurance	**(23,827)**	(21,631)
Flights interrupted	**(48,319)**	(41,269)
Write-off of fixed assets and intangibles	**(194,121)**	59,917
Others	**(68,784)**	(133,021)
	(875,148)	(572,497)

25. Commitments

a) Operating leases

The Company has obligations arising from its operating lease agreements, denominated in US dollars, for aircraft and engines, totaling 123 aircraft,14 engines and 3 simulators as of December 31, 2018 (December 31, 2017 – 114, 17 and 3 , respectively). The lease terms range from 60 to 144 months for Embraer, ATR and Airbus. Bank guarantees or cash deposits were used to guarantee payments under these agreements.

Operating lease agreements require that the Company make periodic lease payments and do not include aircraft purchase options at the end of the agreements. These payments are denominated in U.S. dollars and are generally subject to LIBOR rate.

(In thousands of Brazilian reais, except when otherwise indicated)

The future minimum payments of non-cancellable operating leases for aircraft and engines are presented below:

	December 31,	
	2018	**2017**
Up to one year	**1,688,080**	1,256,660
From one to five years	**5,664,189**	4,577,550
More than five years	**3,098,914**	2,560,290
	10,451,183	8,394,500

For the year ended December 31, 2018 lease expense amounted to R$1,417,897 (December 31, 2017 - R$1,114,416) with a cash impact of R$1,520,988 (December 31, 2017 was R$1,092,543).

The operating lease agreements do not have covenant restrictions.

b) Commitments for future acquisition of aircraft

The Company has purchase commitments for the acquisition of 94 aircraft (December 31, 2017 – 73), under which the following futures payments will be made:

	December 31,	
	2018	**2017**
Up to one year	**243,857**	-
More than one year up to five years	**10,695,827**	11,769,181
More than five years	**3,960,657**	3,704,580
	14,900,341	15,473,761

c) Letter of credits

As of December 31, 2018, the Company had issued letters of credit totaling US$282 million (December 31, 2017 - US$161 million) equivalent to R$1,091,744 (December 31, 2017 – R$533,201) and bank guarantees in the amount of R$47,676 in relation to security deposits, maintenance reserves and local sureties.

d) Guarantees

ALAB entered into a Deed of Guarantee and Indemnity as of September 15, 2017, in connection with the obligations and liabilities related to the operating lease agreements of three A350-900XW aircraft entered into by Hong Kong Airlines and Beijing Capital Airlines, companies of the HNA Group, ex-shareholder of the Company, and Wilmington Trust SP Services (Dublin) Limited.

26. Share-based option plan

26.1. Equity-settled awards

26.1.1. First share option plan

The first share option plan ("First Option Plan") of the Company was approved on a Shareholders' Meeting held on December 11, 2009. The plan has a term of 10 years, and no option may be granted after this period. Exercise conditions of options issued under the First Option Plan require in addition to a vesting period of 4 years, the occurrence of an initial public offering (IPO) of the shares of the Company.

26.1.2. Second share option plan

The second share option plan ("Second Option Plan") was approved on a Shareholders' Meeting held on June 30, 2014, as amended.

Exercise conditions of options issued under the programs of the Second Option Plan, prior to Azul's IPO, require in addition to a vesting period of 4 years, the occurrence of an initial public offering (IPO) of the shares of the Company. Additionally, the options have an 8-year life.

The options issued under the programs of the Second Option Plan, after Azul's IPO, require a vesting period of 4 years. The options have a 10-year life and the exercise price shall equal to the lowest stock price traded in the stock market during the thirty (30) trading sessions prior to the options grant approved by the Board of Directors.

26.1.3. Third share option plan

The third share option plan ("Third Option Plan") was approved on a Shareholders' Meeting held on March 10, 2017.

Exercise conditions of options issued under the Third Option Plan require a vesting period of 5 years. The options have a 5-year life and options can only be exercised within15 days after each vesting anniversary.

26.1.4. Information about the fair value of share options and expense

The grant-date fair value of share options has been measured using the Black-Scholes model. Expected volatility has been calculated based on historical volatility of airline shares listed on stock exchanges in Brazil and Latin America. The inputs are mentioned below.

(In thousands of Brazilian reais, except when otherwise indicated)

	First Option Plan		
	1st program	2nd program	3rd program
Total options granted	5,032,800	1,572,000	656,000
Date of compensation committee	Dec 11, 2009	Mar 24, 2011	April, 05, 2011
Total options outstanding	769,520	335,600	37,560
Option exercise price	R$3.42	R$6.44	R$6.44
Option fair value as of grant date	R$1.93	R$4.16	R$4.16
Estimated volatility of the share price	47.67%	54.77%	54.77%
Expected dividend	1.10%	1.10%	1.10%
Risk-free rate of return	8.75%	12.00%	12.00%
Average remaining maturity (in years)	-	-	-
Maximum life of the option	10 years	10 years	10 years
Expected term considered for valuation	7 years	7 years	7 years

	Second Option Plan				Third Option Plan
	1st program	2nd program	3rd program	4rd program	1st program
Total options granted	2,169,122	627,810	820,250	680,467	9,343,510
Date of compensation committee	June 30, 2014	July 01, 2015	July 01, 2016	July 06, 2017	Mar 14, 2017
Total options outstanding	1,029,281	355,176	555,702	633,182	7,474,808
Option exercise price	R$19.15	R$14.51	R$14.50	R$22.57	R$11.85
Option fair value as of grant date	R$11.01	R$10.82	R$10.14	R$12.82	R$4.82
Estimated volatility of the share price	40.59%	40.59%	43.07%	43.35%	50.64%
Expected dividend	1.10%	1.10%	1.10%	1.10%	1.10%
Risk-free rate of return	12.46%	15.69%	12.21%	10.26%	11.32%
Average remaining maturity (in years)	-	0,4	1,5	2,5	3,2
Maximum life of the option	8 years	8 years	8 years	10 years	5 years
Expected term considered for valuation	4.5 years	4.5 years	4.5 years	5.5 years	5 years

Changes in stock options are disclosed below:

	Number of stock options	Weighted average exercise price (in reais)
Balance as of December 31, 2016	10,877,982	R$8.38
Granted	10,023,977	R$12.58
Cancelled	(468,818)	R$8.19
Exercised	(4,182,454)	R$5.61
Balance as of December 31, 2017	16,250,687	R$11.69
Cancelled	**(182,388)**	**R$18.48**
Exercised	**(4,877,470)**	**R$8.57**
Balance as of December 31, 2018	**11,190,829**	**R$12.55**
Number of options exercisable as of:		
December 31, 2018	**2,572,640**	**R$11.60**
December 31, 2017	4,788,718	R$8.11

Share-based compensation expense recognized in the statement of operations during the year ended December 31, 2018 with respect to the share options amounted to R$16,677 (December 31, 2017 - R$19,862) recognized in income statement.

(In thousands of Brazilian reais, except when otherwise indicated)

26.2. Restricted share units

The Shareholders' Meeting held on June 30, 2014 approved a restricted share units plan ("RSU Plan"). Under the terms of the RSU Plan participants were granted a fixed monetary amount (in Reais) which would be settled in a quantity of preferred shares determined by dividing the monetary amount by the price per share of the preferred shares at IPO.

Exercise conditions of RSUs require, in addition to a vesting period of four years, the occurrence of an IPO of the shares of the Company for the RSUs to become exercisable. The Company can settle the portion of the RSUs for which the vesting period was completed in cash or in shares. The fair value of the award, prior to the IPO, was determined at each statement of financial position date as the monetary amount of the awards in Reais discounted from the earliest date at which the Company could settle the amount in cash using the risk-free interest rate and the obligation was recorded as a liability.

At the date of the IPO, the monetary amount of the awards was converted into units based on the IPO date fair value of the preferred shares. The related liability was reclassified to equity in line with the post IPO settlement method.

Subsequent grants are measured based on the grant date fair value of the awards.

26.2.1. Information about the fair value of RSUs and expense

	Date of compensation committee	**Total shares granted**	**Total shares outstanding**	**Fair value as of grant date (in reais)**
1st program	June 30, 2014	487,670	11,902	R$21.00
2nd program	July 01, 2015	294,286	66,651	R$21.00
3rd program	July 01, 2016	367,184	160,412	R$21.00
4th program	July 06, 2017	285,064	199,019	R$24.17
5th program	August 07, 2018	291,609	291,609	R$24.43
		1,725,813	729,593	

Changes in RSU are disclosed below:

	Number of RSU
As of December 31, 2016	859,940
Granted	285,064
Cancelled	(63,676)
Paid	(271,382)
As of December 31, 2017	809,946
Granted	**291,609**
Cancelled	**(72,303)**
Paid	**(299,659)**
As of December 31, 2018	**729,593**

(In thousands of Brazilian reais, except when otherwise indicated)

Share-based compensation expensed recognized in the statement of operations during the year ended December 31, 2018 with respect to the RSU amounted to R$6,254 (December 31, 2017 - R$10,027) recognized in income statement.

26.3. Virtual Stock Option Plan

On August 7, 2018, the Compensation Committee approved the Virtual Stock Option Plan ("Phantom Shares"). The plan consists of a remuneration in cash, as there is no effective trading of the shares. There will be no issue and / or delivery of shares for settlement of the plan. A liability is recorded monthly, based on the fair value of the Phantom Shares granted and the vesting period, with an offsetting entry in the income statement. The fair value of this liability is reviewed and updated for each reporting period, in accordance with the change in the fair value of the benefit granted.

The options issued under the programs of the Phantom Shares, require a vesting period of 4 years. The options have an 8-year life and the exercise price shall equal to the lowest stock price traded in the stock market during the thirty (30) trading sessions prior to the options grant approval by the Compensation Commitee. Expected volatility has been calculated based on historical volatility of airline shares listed on stock exchanges in Brazil and Latin America.

26.3.1. Information about the fair value of share options and expense

The fair value of share options on December 31, 2018 has been measured using the Black-Scholes model using the informations below.

	Phantom Shares
	1st program
Total options granted	707,400
Date of compensation committee	August 7, 2018
Total options outstanding	707,400
Option exercise price	R$20.43
Option fair value	R$9.85
Estimated volatility of the share price	34.00%
Expected dividend	1.10%
Risk-free rate of return	6.40%
Average remaining maturity (in years)	3.6
Maximum life of the option	8 years
Expected term considered for valuation	6 years

The liability recorded as of December 31, 2018 is R$1,596 (December 31, 2017 - R$0) and is presented in the consolidated statement of financial position under “Salaries, wage and benefits”.

Share-based compensation expensed recognized in the statement of operations during the year ended December 31, 2018 with respect to the Phantom Shares amounted to R$1,184 (December 31, 2017 - R$0) recognized in income statement.

(In thousands of Brazilian reais, except when otherwise indicated)

27. Provision for taxes, civil and labor risks

The Company is party to certain labor, civil and tax lawsuits for which appeals have been filed. Based on the Company's external and internal legal counsels' opinion, Management believes that the recorded provisions are sufficient to cover probable losses. In addition, the Company has made judicial deposits when required by court.

These provisions are as follows:

	December 31, 2018	December 31, 2017
Taxes	**1,962**	1,896
Civil	**44,960**	48,751
Labor	**34,062**	22,551
	80,984	73,198

Changes in these provisions are as follows:

	Total
Balance at December 31, 2016	76,353
Provisions recognized	78,469
Utilized provisions	(81,624)
Balance at December 31, 2017	73,198
Provisions recognized	**70,439**
Utilized provisions	**(62,653)**
Balance at December 31, 2018	**80,984**

The total amount of claims, which according to management represent losses that are reasonably possible but not probable, for which no provision was recorded are as follow:

	December 31, 2018	December 31, 2017
Taxes	**87,384**	80,648
Civil	**43,203**	23,304
Labor	**135,311**	133,283
	265,898	237,235

The Company's management, together with its legal counsel, analyzes the proceedings on a case-by-case basis and records the amount of the provision for labor, civil and tax risk based on the probable cash disbursement for the related proceedings.

a) Tax proceedings: The Company has tax proceedings related to additional charge of 1% of COFINS on imports of aircraft and engines, in accordance with the provisions of Law 10,865 / 04, the application of COFINS at a zero rate for imports of aircraft and parts and parts. Management believes that the chances of loss is possible and therefore no provision was recorded for such amounts.

b) Civil lawsuits: the Company is party to various types of civil lawsuits, for compensation claims in relation to flight delays, cancellations of flights, luggage and damage loss, and others.

c) Labor lawsuits: the Company is party to various types of labor lawsuits, related to overtime, additional remuneration for undertaking hazardous activities and safety related payments and others.

The Labor Prosecution's Office filed on February 22, 2017 a lawsuit against the Company claiming that it had violated certain labor regulations, including limitations on daily working hours and rest periods. The claim totals approximately R$66,000 in punitive damages. The lawsuit is currently suspended and the Company is negotiating an agreement and classifies the likelihood of loss as possible.

29. Subsequent events

On March 11, 2019 the Company announces that it has signed a non-binding agreement with Avianca Brasil to acquire certain assets of Avianca Brasil for the indicative purchase price of up to US$105 million. As provided by the Brazilian Bankruptcy and Judicial Reorganization Law, the assets will be transferred to a new entity free and clear of all debts and liabilities ("NewCo"). The proposed NewCo solely includes certain assets selected by Azul including Avianca Brasil's operating certificate, 70 pair of slots and approximately 30 Airbus A320 aircraft.

The offer is non-binding and remains subject to a number of conditions precedent, including due diligence, regulatory and creditors approvals, and the conclusion of Avianca Brazil's judicial reorganization. Azul estimates that the process could take up to three months to be concluded.