



Organización Internacional de Comisiones de Valores
International Organisation of Securities Commissions
Organisation Internationale des commissions de valeurs
Organização Internacional das Comissões de Valore

26 October 2004
Ms. Andrea Pryde
Assistant Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Ms. Pryde:

The International Organization of Securities Commissions (IOSCO) Standing Committee No. 1 on Multinational Disclosure and Accounting (SC1) appreciates the opportunity to provide our thoughts regarding Exposure Draft 7, *Financial Instruments: Disclosures* (ED 7).

IOSCO is committed to promoting the integrity of international markets through promotion of high quality accounting standards, including rigorous application and enforcement.¹ Members of SC1 seek to further IOSCO's mission through thoughtful consideration of accounting and disclosure concerns and pursuit of improved transparency of global financial reporting. The comments we have provided herein reflect a general consensus among the members of SC1 and are not intended to include all the comments that might be provided by individual members on behalf of their respective jurisdictions.

General Comments

In general, the SC1 supports and commends the Board on its ED 7 that updates IAS 30, *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* and combines all disclosure requirements for financial instruments into one IFRS. We view this comprehensive standard as having significant benefits for investors in understanding an entity's risks and exposure to those risks, and then assessing that entity's ability to effectively manage those risks. This resulting transparency will enhance users' ability to make better informed investment decisions.

Generally, we support the primary objectives of ED 7 for preparing financial instrument disclosures, which are to provide:

- (a) qualitative information about risk exposures arising from financial instruments;
- (b) quantitative data based on management's risk management system; and
- (c) minimum disclosures about credit risk, liquidity risk, and market risk (including interest rate risk).

¹ See IOSCO website, www.iosco.org

However, we have concerns with the application of these objectives. Although we see merits in disclosures which provide management's perspective, we believe that the value of this information diminishes if the user is unable to compare key data points between entities, or from period to period for a given entity. We make an analogy to the current format used for segment reporting in IAS 14, which many analysts of financial statements do not consider as useful as it needs to be². We discuss our concerns further in our response to *Question 8*.

Specific Comments to Questions Asked by the Board

Question 1 – Disclosures relating to the significance of financial instruments to financial position and performance

The draft IFRS incorporates disclosures at present contained in IAS 32 Financial Instruments: Disclosure and Presentation so that all disclosures about financial instruments are located in one Standard. It also proposes to add the following disclosure requirements:

- (a) financial assets and financial liabilities by classification (see paragraphs 10 and BC13).*
- (b) information about any allowance account (see paragraphs 17 and BC14).*
- (c) income statement amounts by classification (see paragraphs 21(a), BC15 and BC16).*
- (d) fee income and expense (see paragraphs 21(d) and BC17).*

Are these proposals appropriate? If not, why not? What alternative disclosures would you propose?

SCI Response

We consider the above mentioned disclosures to be necessary for full and transparent reporting of items related to financial instruments and thus, appropriate requirements for the [final] IFRS. In addition to these proposed disclosures, we believe that the Board should not eliminate disclosure of contractual repricing or maturity dates, and effective interest rates, which are currently required under paragraphs 67-69 of IAS 32. Such information has provided users of financial statements with data that enables them to forecast the future debt burden of the entity and to gauge how a firm's credit standing is reflected in the interest rates.

We recognize that the new requirement for sensitivity analysis will provide information to facilitate users' ability to project future cash flows and value an entity. However, we question whether sensitivity analysis, by itself, provides sufficient information unless the disclosures indicate the basis for the assumptions used in this analysis. Information about effective rates and contractual repricing or maturity dates will give users this basis, and in turn, the ability to assess the reasonableness of management's assumptions used in preparing the sensitivity analysis.

Question 2 – Disclosure of the fair value of collateral and other credit enhancements

For an entity's exposure to credit risk, the draft IFRS proposes to require disclosure of the fair value of collateral pledged as security and other credit enhancements unless impracticable (see paragraphs 39, 40, BC27 and BC28).

² The CFA Institute, an international organization of investment professionals, conducted a survey in 2003 that showed respondents considered segment reporting very important for their analysis (or a 4.2 rating out of 5) but deficient in meeting their needs (or a 2.9 rating out of 5).

Is this proposal appropriate? If not, why not? What, if any, alternative disclosures would you propose to meet the stated objective?

SC1 Response

We concur with the Board's decision to require disclosure of the fair value of collateral pledged as security. This information along with other qualitative information enables a user of financial statements to understand better the entity's loan underwriting criteria and credit risk management. In other words, one is able to gauge management's tolerance to risk; does management take unnecessary risks or are they more conservative?

We acknowledge that obtaining fair values of collateral pledged on a regular basis may be costly and time consuming. If this information is not readily available or is impracticable to obtain, then the entity should indicate this in the disclosures, as well as what management does to monitor the value of the collateral pledged. Therefore, we recommend that the Board consider putting this requirement in the [final] IFRS, or expanding its discussion in the Basis for Conclusions to include such disclosure.

Question 3 – Disclosure of a sensitivity analysis

For an entity that has an exposure to market risk arising from financial instruments, the draft IFRS proposes to require disclosure of a sensitivity analysis (see paragraphs 43, 44 and BC36-BC39).

Is the proposed disclosure of a sensitivity analysis practicable for all entities? If not, why not and what, if any, alternative disclosures of market risk would you propose to meet the stated objective of enabling users to evaluate the nature and extent of market risk?

SC1 Response

We agree with the Board's decision to require sensitivity analysis or other similar analyses. Such analyses enable users of financial statements to project more accurately the potential variability of an entity's cash flows, financial performance and financial condition. Moreover, this information has qualitative value in that it provides further insights into how management identifies and assesses risks, as well as the exposure to those risks.

As proposed, the current format permits entities flexibility in presentation as it does not require a specific method for preparing such analyses. Generally, we agree with this approach because entities have different financial structures with varying degrees of risks. As such, a standard format may not always provide all the necessary information to understand fully the risks, or the exposure to those risks. Nonetheless, we believe that certain key data, or risk variables, such as interest rates, currency rates, time horizons, etc., should also be provided as also noted in our response to *Question 1*.

Additionally, if management prepares its sensitivity analysis at the segment level, as well as at the entity level, we recommend that this level of analysis should be included in the disclosures. This disaggregated information will highlight offsetting risks, or the diversification and/or correlation between operating segments, as well as provide a better view of how the entity manages the various risks and exposure to those risks.

Question 4 – Capital disclosures

The draft IFRS proposes disclosure of information that enables users of an entity's financial statements to evaluate the nature and extent of its capital. This includes a proposed requirement to disclose qualitative information about the entity's objectives, policies and processes for managing capital; quantitative data about what the entity regards as capital; whether during the period it complied with any capital targets set by management and any externally imposed capital requirements; and if it has not complied, the consequences of such non-compliance (see paragraphs 46-48 and BC45-BC54).

Is this proposal appropriate? If not, why not? Should it be limited to only externally imposed capital requirements? What, if any, alternative disclosures would you propose?

SCI Response

We concur with the Board's conclusion that capital disclosures provide valuable information about the level of an entity's capital and how it manages capital, which are necessary to assess its risk profile. Disclosure about the nature of external capital requirements, as well as noncompliance with those requirements, should be provided in the notes to the financial statements. However, as noted in our response to *Question 6*, we believe that information about an entity's internal capital requirements is better suited for the management's discussion and analysis, or MD&A. We question why internal capital requirements would be compulsory in the notes to the financial statements when other information about the how a company manages its operations, such as forecasts and strategic plans, is not required.

Illustrative Example (IE2) discloses an event where a breach of an entity-specific capital requirement has occurred, but has also been resolved within the time frame specified by the regulator. We question whether this example supports the conclusions in BC52, and believe that it may be at odds with the common understanding that a breach of compliance is not present where agreed measures are in place to remedy that breach. Therefore, we recommend that the Board consider redrafting IE2 to provide an example of disclosure of non-compliance with an applicable industry-wide minimum capital standard, which has material consequences at the reporting date.

Question 5 – Effective date and transition

The proposed effective date is for periods beginning on or after 1 January 2007 with earlier adoption encouraged (see paragraphs 49 and BC62-BC67). Entities adopting IFRSs and the draft IFRS for the first time before 1 January 2006 would be exempt from providing comparative disclosures for the draft IFRS in the first year of adoption (see Appendix B, paragraph B9).

Are the proposed effective date and transition requirements appropriate? If not, why not? What alternative would you propose?

SCI Response

We concur with the proposed effective date and requirements for transition.

Question 6 – Location of disclosures of risks arising from financial instruments

The disclosure of risks arising from financial instruments proposed by the draft IFRS would be part of the financial statements prepared in accordance with International Financial Reporting Standards (see paragraph BC41). Some believe that disclosures about risks should not be part of financial statements prepared in accordance with IFRSs; rather they should be part of the information provided by management outside the financial statements.

Do you agree that the disclosures proposed by the draft IFRS should be part of the financial statements? If not, why not?

SC1 Response

We believe that disclosures of risks arising from financial instruments are important and necessary information for providing a complete picture of an entity's financial condition. For example, IOSCO issued a report issued in February 2003³, which identified the following general principles for MD&A-type disclosures; this disclosure:

1. *Enables investors to see the company "through the eyes of management;"*
2. *Improves financial disclosure overall and provides the context within which financial statements should be analyzed;*
3. *Provides information about the different components of earnings and cash flow and the extent to which they are recurring elements, thereby enabling investors to make a better prediction about the sustainability of earnings and cash flow in the future; and*
4. *Provides information about the risks to a company's earnings and cash flow.*

Further stated in the report:

The purpose of MD&A-type disclosure is to provide management's explanation of factors that have affected the company's financial condition and results of operations for the historical periods covered by the financial statements, and management's assessment of factors and trends which are anticipated to have a material effect on the company's financial condition and results of operations in the future. Companies should provide the information that is necessary for an investor's understanding of the company's financial condition, changes in financial condition and results of operations.

IOSCO observes that many disclosures currently proposed in ED 7 would fall within the scope of IOSCO's MD&A guidance. As such, we suggest that the IASB consider developing principles that determine the disclosure information that belongs within the financial statements and that which belongs outside the financial statements in a management's commentary or MD&A-type disclosure.

In October 2003, we understand that the Board discussed the benefits of having a framework to deal with presentation and disclosure issues with national standard setters from the U.S. and Canada. Additionally in April 2004, the Board discussed a research project to develop a discussion paper on management commentary or MD&A, involving national standard setters from Canada,

³ Report of the Technical Committee of the International Organization of Securities Commissions, *General Principles Regarding Disclosure of Management's Discussion and Analysis of Financial Condition and Results of Operations* – February 2003. This report is available at the following web link: <http://www.iosco.org/library/>.

Germany, New Zealand and the U.K. At this time, there are no formal timetables to issue papers for these initiatives. SC1 encourages the IASB to move forward with these initiatives.

Question 7 – Consequential amendments to IFRS 4 (paragraph B10 of Appendix B)

Paragraph B10 of Appendix B proposes amendments to the risk disclosures in IFRS 4 Insurance Contracts to make them consistent with the requirements proposed in the draft IFRS. The requirements in IFRS 4 were based on disclosure requirements in IAS 32 that would be amended by the draft IFRS. The Board's reasons for proposing these amendments are set out in paragraphs BC57-BC61.

Do you agree that the risk disclosures in IFRS 4 should be amended to make them consistent with the requirements proposed in the draft IFRS? If not, why not and what amendments would you make pending the outcome of phase II of the Board's Insurance project?

SC1 Response

We support the Board's decision to converge the disclosure requirements for insurance contracts with other financial instruments under IAS 32. Many consider insurance instruments to embody similar risks that affect the value of financial instruments, such as interest rate risk, credit risk, currency risk, etc. Since insurance contracts contain insurance risks not associated with other financial contracts, it seems appropriate to require additional disclosures under IFRS 4 to address insurance risk and related financial information.

Similar to the concerns noted in our response to *Question 1*, we believe that information currently required in paragraph 39(b) of IFRS 4 is still necessary, and may not necessarily be provided in sensitivity analysis disclosures. Paragraph 39(b) requires disclosure of "those terms and conditions of insurance contracts that have a material effect on the amount, timing and uncertainty of the insurer's future cash flows". Information about the terms and conditions of insurance contracts gives users the means to assess the reasonableness of management's assumptions used in preparing the sensitivity analysis. Therefore, we believe that this information should still be required.

Question 8 – Implementation Guidance

The draft Implementation Guidance accompanying the draft IFRS suggests possible ways to apply the risk disclosure requirements in paragraphs 32-45 (see paragraphs BC19, BC20 and BC42-BC44).

Is the Implementation Guidance sufficient? If not, what additional guidance would you propose?

SC1 Response

Although we agree with objectives-based standards, such as this proposed IFRS that allow flexibility for changes in market activities, we have concerns with the consistency of the application and users' ability to make comparisons between entities. Comparability is further impaired because of the different approaches to risk management used by entities.

We believe that some aspects of our concerns could be addressed by relocating certain illustrative examples, which are currently in the proposed Implementation Guidance (IG), into the body of the [final] IFRS.

For example:

1. *IG17 – 18: Credit quality –*
 - *IG17 - Paragraph 39(c) requires an entity to disclose information about the credit quality of financial assets with credit risk that are neither past due nor impaired. In doing so, an entity might disclose the following information:*
 - (a) *an analysis of credit exposures using an external or internal credit grading system;*
 - (b) *the nature of the counterparty (see paragraph IG9(b));*
 - (c) *historical information about counterparty default rates; and*
 - (d) *any other information used to assess credit quality.*
 - *IG18 – When the entity considers external ratings when managing and monitoring credit quality, the entity might disclose information about:*
 - (a) *the amounts of credit exposures for each external credit grade;*
 - (b) *the rating agencies used;*
 - (c) *the amount of an entity's rated and unrated credit exposures; and*
 - (d) *the relationship between internal and external ratings.*
2. *IG23 – Paragraph 40(b) requires an analysis of impaired financial assets by class. This analysis might include:*
 - (a) *the carrying amount, before deducting any impairment loss;*
 - (b) *the amount of any related impairment loss; and*
 - (c) *the nature and fair value of collateral pledged and other credit enhancements obtained.*
3. *IG37 – For interest rate risk, the sensitivity analysis might show separately the effect of a change in interest rates on:*
 - (a) *interest income and expense;*
 - (b) *other line items of profit and loss (such as trading gains and losses); and*
 - (c) *when applicable, equity.*

A sensitivity analysis for interest rate risk might be disclosed for each major currency in which financial instruments are denominated.

We believe that standard formats for the presenting quantitative information would facilitate users' ability to evaluate and compare information across entities..

Question 9 – Differences from the Exposure Draft of Proposed Statement of Financial Accounting Standards Fair Value Measurements published by the US Financial Accounting Standards Board (FASB).

The FASB's Proposed Statement of Financial Accounting Standards Fair Value Measurements, which is open for public comment at the same time as this Exposure Draft, proposes guidance on

how to measure fair value that would apply broadly to financial and non-financial assets and liabilities that are measured at fair value in accordance with other FASB pronouncements. That Exposure Draft proposes disclosure of information about the use of fair value in measuring assets and liabilities as follows:

- (a) For assets and liabilities that are remeasured at fair value on a recurring (or ongoing) basis during the period (for example, trading securities)*
 - (i) the fair value amounts at the end of the period, in total and as a percentage of total assets and liabilities,*
 - (ii) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and*
 - (iii) the effect of the remeasurements on earnings for the period (unrealized gains or losses) relating to those assets and liabilities still held at the reporting date.*
- (b) For assets and liabilities that are remeasured at fair value on a non-recurring (or periodic) basis during the period (for example, impaired assets), a description of*
 - (i) the reason for remeasurements,*
 - (ii) the fair value amounts,*
 - (iii) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and*
 - (iv) the effect of the remeasurements on earnings for the period relating to those assets and liabilities still held at the reporting date.*

Disclosures similar to (a)(ii) above are proposed in paragraph 31 of the draft IFRS (and are currently required by paragraph 92 of IAS 32) and disclosures similar to (a)(iii) are proposed in paragraph 21(a).

Do you agree that the requirements in the draft IFRS provide adequate disclosure of fair value compared with those proposed in the FASB's Exposure Draft? If not, why not, and what changes to the draft IFRS would you propose?

SC1 Response:

We have no comment at this time.

Question 10 – Other comments

Do you have any other comments on the draft IFRS, Implementation Guidance and Illustrative Examples?

SC1 Response:

Disclosure of Assets under Management

Based on our understanding, the current proposed requirements in paragraphs 21(d) and BC17 do not fully address disclosures for trust activities, or assets under management. Currently, paragraph 55 of IAS 30 addresses disclosure of trust activities, "... If the bank is engaged in significant trust activities, disclosures of that fact and an indication of the extent of those activities is made in its financial statements because of the potential liability if it fails in its fiduciary duties..." We believe

the current requirement in IAS 30 would provide information about assets under management in addition to income statement amounts relating to trust activities.

We are concerned about this disclosure gap regarding assets under management. There are significant amounts of financial assets under management by trusts, investment firms, or other fiduciary arrangements, which are not explicitly covered in ED 7. In addition to income statement items, we recommend that the Board consider disclosure requirements for assets under management. Users of financial statements need this information to understand fully the nature of these arrangements and the potential effects on the fee income generated from assets under management.

Paragraph 8

We believe that the wording in paragraph 8 is disconnected from, or possibly conflicts, with the classifications in paragraph 10 and minimum disclosure requirements in paragraphs 39 through 45. The proposed wording permits a company to decide how much detail to disclose, the emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics. We suggest that additional wording be included to reference the minimum requirements.

If you have any questions or need additional information on the recommendations and comments that we have provided, please do not hesitate to contact me at 1.202.942.4400.

Sincerely,

A handwritten signature in black ink, appearing to read "Scott Taub".

Scott Taub
Chair
IOSCO Standing Committee No. 1