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Your ref Comment letter

Our ref PR/813

Contact Mark Vaessen
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29 October 2004

Dear Sir David

Comment letter – ED 7 *Financial Instruments: Disclosures*

We appreciate the opportunity to respond to the invitation to comment on the International Accounting Standards Board's Exposure Draft of its proposed International Financial Reporting Standard, ED - 7 *Financial Instruments: Disclosures* (hereafter: 'the Exposure Draft' or 'the ED'). This letter expresses the views of KPMG International[1].

We share the IASB's view that users of financial statements need supplementary information about an entity's exposure to risks and how those risks are managed. We believe that such information can influence a user's assessment of the financial position and financial performance of an entity or of the amount, timing and uncertainty of its future cash flows.

We welcome the IASB's efforts to develop IFRS that would locate in one place and enhance disclosures relating to financial instruments, and would be applicable to all entities.

We agree that banks, other financial institutions and other entities often use the same financial instruments and that all entities are exposed to risks arising from financial instruments to one extent or another. Accordingly, elements of the ED are relevant to all entities. However, we believe that the ED should clarify that the detail and nature of certain disclosure requirements depends whether financial risks are significant or not.

[1] KPMG International is a Swiss cooperative that provides no client services. All professional services are performed by its member firms. As used herein, "KPMG" refers to KPMG International and/or its member firms, as appropriate.

Whilst it may be the intention of the IASB that certain requirements may simply be ignored by entities with minor or limited exposure to risks arising from financial instruments (see paragraph BC 11), this is not clear from the ED as it requires substantial minimum disclosures.

Whilst we welcome the simplifications for financial institutions brought about by the ED when compared to IAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions* and IAS 32 *Financial Instruments: Disclosure and Presentation*, we nevertheless have concerns regarding some of the proposals. We address these in the responses to the questions raised by the IASB in the following pages.

Please contact Mark Vaessen at 020 7694 8089 if you wish to discuss any of the issues raised in this letter.

Yours faithfully

KPMG International

KPMG International

RESPONSES TO QUESTIONS RAISED BY THE IASB

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?

We agree with these proposals. In our view it is appropriate to provide disclosure of financial instruments (balance sheet and income statement) by category as defined in IAS 39 (please refer also to our comments on Question 10 - Drafting of the ED). This will enable users of the financial statements to better understand the entity's financial position and performance.

However, we believe that the impairment loss disclosure requirements could be enhanced by the additional requirement to disclose:

- the accounting policy, describing the basis on which uncollectible financial assets are recognised as an expense and written off;
- the amounts of financial assets written off; and
- the amounts of financial assets previously written off that have been recovered.

We believe that this information is relevant for users of the financial statements.

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).

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

We agree with the principle of the proposals and understand, that the IASB's underlying intention with this requirement is to require disclosure of the gross exposure to credit risk (maximum exposure to credit risk as required by paragraph 39 (a)) and the net exposure to credit risk (by disclosing the fair value of collateral accepted as security and other credit enhancement as required by 39 (b)).

However, we have serious reservations regarding the suitability of this disclosure as proposed in the ED. We believe that the disclosure of collateral accepted as security and other credit enhancements is useful information for users of financial statements if it requires the analysis of the fair value of collateral accepted split by comparable risk categories (rates or grades). We acknowledge that in some circumstances it might be difficult to achieve this in practice due to various credit ratings used, however aggregated disclosure of the fair value of collateral does not seem to be meaningful disclosure.

We believe that the ED, in paragraphs 39 (b), 40 (c), IG 15 or IG 16, should clarify that the fair value of collateral accepted does not exceed the amount of the gross exposure on an individual exposure basis. For example, a loan of CU 3 million may be collateralised by a pledge on equity securities with a fair value of CU 2 million and a mortgage with a fair value of CU 2 million. At the same time, another exposure with nil collateral might exist. Aggregation of the total fair values of the collateral accepted without regard to the actual exposure to credit risk on an individual exposure basis would be misleading and would not provide users of the financial statements with the information about net exposure to credit risk. We understand that this was the IASB's intention but believe it is not very clear from the ED.

Furthermore, we would like to draw your attention to the fact that the ED does not require disclosure of the fair value of collateral accepted as security and other credit enhancement when it is impracticable. Paragraphs BC 28 and IG 16 provide additional guidance in this respect. It should be noted that paragraph 11 of IAS 1 *Presentation of Financial Statements* defines when applying a requirement is impracticable, namely when the entity cannot apply the requirement after making every reasonable effort to do so. We are concerned whether it was the IASB's intention.

In addition, we believe that the requirement to disclose the fair value of collateral accepted as security and other credit enhancements should be amended to require disclosure of the fair value or, if impracticable (subject to the above comment), management's best estimate of fair value (or range of fair values) of collateral and other credit enhancement.

We also suggest that the ED requires that the methods and assumptions applied in determining fair values of collateral to be determined by reference to the guidance included in IAS 39, and disclosed as part of the disclosure requirements of paragraph 31 of the ED (please refer also to our comments on Question 9).

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?

We agree that sensitivity analysis disclosure might provide valuable information to users of the financial statements, but we propose that this be presented outside the financial statements (please refer also to our comment on Question 6).

Furthermore, we are concerned that entities will have to prepare two sets of sensitivity analyses i.e. one which is prepared for risk management purposes including all financial risk exposures and a second one as required by the ED including only exposures arising from financial instruments (please refer to our comments on Question 10 – Scope of the ED). We believe that users of the financial statements benefit only from a sensitivity analysis, which includes all financial risk exposures.

Furthermore, while we believe that users of financial statements of entities with significant financial instruments risk exposure may benefit from sensitivity analysis, we believe that such information may be onerous in the case of entities with limited or minor exposure to such risks (subject to our comment on Question 10 – Minimum disclosures).

For example, a non-financial company with very limited exposures to risks arising from financial instruments is unlikely to prepare any type of sensitivity analysis for risk management purposes. Therefore, it might be costly and burdensome to implement a sensitivity analysis for entities that do not use it as a risk management tool already. Such an entity may have difficulty selecting assumptions and identifying and explaining the results. We also believe that in certain circumstances, disclosure of monetary assets and liabilities per currency and the interest rate ‘gap’ analysis are potentially appropriate disclosures on their own.

Accordingly, we believe that entities with limited exposure to risks arising from financial instruments that do not prepare a sensitivity analysis for internal management purposes, should be excluded from this requirement and alternative disclosures should be allowed.

Entities with significant exposure to financial risks often analyse each risk in isolation, whereas in reality a change in one market risk is often linked to a change in another (or several) market risk(s). The ED addresses this limitation in paragraph 44 but only in instances where management already prepares a sensitivity analysis that reflects interdependencies. Accordingly, we believe the disclosures could be improved by a discussion that describes interrelationships between the risks where an inter-related analysis is not provided.

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?

Certain industry sectors are subject to external minimum capital requirements (e.g. banks). We believe that the proposed disclosures in paragraph 47 (d) and (e) of the ED on compliance with capital targets imposed externally and on the consequences of non-compliance with such externally imposed capital requirements are important and appropriate.

However, we believe that management 'capital targets' (as required by paragraph 47 (a) – (d)) should not be part of the required disclosures in the notes to the financial statements. We believe that this is a very subjective area, not very relevant to users of financial statements, which belongs to reports and statements presented outside the financial statements.

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?

We agree with the proposed effective date and also the exemption from the need to prepare comparatives for a first time adopter of IFRS who adopted before 1 January 2006.

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?

We share the IASB's view that the financial statements would be incomplete and potentially misleading without disclosures about risks arising from financial instruments. Consequently, we believe that risk disclosures arising from financial instruments should be included within the financial statements in the same way as accounting policies, since they support the figures disclosed. However, we believe that the sensitivity analysis should be presented outside the financial statements (please refer to our comments on Question 3 and Question 10 – Scope of the ED).

In addition, as mentioned above, we are concerned that some of the proposals of the ED might be onerous and costly for entities with limited or minor exposure to the risks relating to the financial instruments (subject to our comment on Question 10 – Minimum disclosures).

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?

Since the disclosure requirements of IFRS 4 were based upon IAS 32 we agree in principle that the disclosures should be updated to reflect the final form of the ED to maintain consistency.

Nevertheless, we believe that, in the context of the proposed amendments to old paragraph 39 (b) of IFRS 4 and the significant efforts undertaken by insurers to meet those requirements, there should be sufficient flexibility for insurers to provide an appropriate balance in risks disclosures and disclosures of terms and conditions that best achieve the objectives of IFRS 4.

In addition, we are concerned that the requirement of the new paragraph 39 (b) (iii) of IFRS 4, namely that an insurer shall disclose '*…the amount of the risk exposure associated with all contracts sharing that characteristics'* might be difficult to meet due to the lack of a reliable and comparable methodology to determine the amount of insurance risk.

Furthermore, we would like to draw your attention to the fact that the ED proposes to revise the wording of paragraph 38 of IFRS 4. The paragraph is proposed to read '*An insurer shall disclose information that <u>enables</u> users of its financial statements to <u>evaluate</u>…'* instead of *'An insurer shall disclose information that <u>helps</u> users to <u>understand</u>…'* as it currently appears. It should be noted, that the proposed amendment reverses the wording of paragraph 38 closer to the wording originally proposed in ED5. The IASB might consider providing an explanation for the proposed change.

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?

Subject to any consequential amendments that arise from our comments elsewhere in this letter, we have no major observations regarding the implementation guidance.

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 (unrealised 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?

We agree that the requirements in the ED provide adequate disclosure of fair value compared with those proposed in the FASB's Exposure Draft.

However, if the intention is to ensure that GAAP differences are avoided by ensuring that the ED meets the requirements of the FASB's proposals, we are not entirely convinced that the ED has been successful in this regard.

For example, the illustrative example contained in paragraph B22 of the FASB proposal suggests that disclosures regarding the basis of fair value measurement could be presented quantitatively i.e. an analysis of assets held at fair value by components that are valued by reference to items that are identical or similar for quoted instruments and significance of market inputs versus entity inputs for the valuation of non-quoted instruments. We consider such numerical disclosure to be useful to the reader and we would recommend the IASB to strengthen the ED to encourage such disclosure. Presently, we do not believe that the reader would naturally read the ED as recommending this level of disclosure.

Question 10 – Other comments

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

Disclosures of other risks

We believe that IFRSs also should require disclosure of risks other than risks arising from financial instruments e.g. legal risk, operational risk, warranty risk etc. For certain entities risks other than those arising from financial instruments are more relevant than the financial risks. Currently, IAS 1.9 only encourages entities to disclose such information outside the financial statements.

Consequently, we believe that IFRSs should be enhanced to require disclosure of all other risks outside the financial statements to assist users in predicting the entity's future cash flows and, in particular, their timing and certainty. We propose that this is addressed in a different project.

Scope of the ED

Many contracts, which do not meet the definition of a financial instrument in IAS 32, bear financial risks. For example, commodity contracts such as firm commitments or operating leases may bear foreign currency, interest rate and/or credit risks.

The risks arising from those contracts might have a potentially significant impact on the overall risk position of an entity, but are not within the scope of the ED. We believe that a sensitivity analysis of financial risks is meaningful only if all exposures are included.

Minimum disclosures

As indicated earlier in this letter, we accept that all entities are exposed to risks arising from financial instruments to some extent. Accordingly, elements of the ED are relevant to all entities. However, in our view the level of detail and sometimes the nature of the disclosure should be allowed to differ between entities where significant exposure to a particular financial risk exists and where only a limited exposure is present.

Whilst it may be the intention of the IASB that certain requirements may simply be ignored by entities with minor or limited exposure to risks relating to financial instruments, this is not clear from the ED.

To address the above concern, we would propose that the wording of paragraph 8 of the ED is strengthened to make it clear that certain disclosure requirement of the ED, even those referred as ‘*Minimum disclosures*’, could be omitted by an entity, if it is not significantly exposed to risks arising from financial instruments.

Financial assets and financial liabilities at fair value through profit or loss (paragraphs 11 and 12)

The Basis for Conclusions accompanying the ED does not provide insight into the IASB’s intention for the disclosure requirements proposed in paragraphs 11 and 12.

If the intention of these paragraphs was to require disclosure of the impact of the change in an entity’s own credit rating on its financial statements (as paragraph 12 (a) suggests), we do not believe that this purpose is fully achieved.

For example, changes in the fair value of a financial liability not attributable to changes in a benchmark interest rate may include changes in currency exchange rates or other indexes (e.g. notes issued paying fixed interest rate plus change in the market price of certain security or index).

To address the above concern, we propose that both paragraphs be reworded to require the disclosure of the amount of change in the fair value of a financial liability that is attributable to changes in entity’s own credit risk profile. Furthermore, we propose that paragraph 12 should be included in the implementation guidance rather than in the standard.

Designation of financial assets and financial liabilities as at fair value through profit or loss

We note that paragraph 23 (a) of the ED requires disclosure of criteria for the designation of financial assets or financial liabilities as at fair value through profit or loss. This implies that an entity has such a policy and assumes the consistent application of the criteria for designation while IAS 39 gives an entity free choice on designating any financial instrument as at fair value through profit or loss on an instrument by instrument basis.

If it was the IASB’s intention to amend IAS 39 and require consistent classification of financial instruments as at fair value through profit or loss, we recommend that the ED clearly points this out and provides the rationale behind.

Hedge accounting

We believe that, in addition to the disclosures required by the ED, it would be useful for users of financial statements that the following disclosures of the amounts included in each income statement line item to be provided:

(a) gains and losses on derivatives recycled from the cash flow hedge reserve;

(b) gains and losses related to ineffectiveness of fair value hedges and cash flow hedges; and

(c) gains and losses on derivatives not designated as hedging instruments.

Withdrawal of IAS 30

The proposed IFRS supersedes IAS 30 (paragraph 50, BC55 and BC56). We agree in principle that the ED replaces the disclosure requirements regarding risks arising from financial instruments in IAS 30, whilst the other requirements of IAS 30 are no longer relevant or are covered by other Standards.

However, we are concerned that certain requirements of IAS 30 relating to the format of banks' financial statements (e.g. included in paragraph 19 of IAS 30) are not transferred to IAS 1. In addition, IAS 1.81 (a) requires disclosure of revenue on the face of income statement. We do not believe this is the most relevant disclosure for banks and other financial institutions. The consequential amendment to IAS 1.84 (deletion of the last second sentence '*For example, a bank amends the descriptions to apply the more specific requirements in IAS 30.'*) may be interpreted as a requirement to present the amount of revenue on the face of the income statement of bank.

Drafting of the ED

Classification and classes of financial instruments

We would like to draw your attention to the wording of the ED where certain disclosures are required for *classifications* as defined in IAS 39 (e.g. paragraph 10 of the ED), whereas IAS 39 distinguishes four *categories* of financial instruments. We believe that the meaning of both *classifications* and *categories* is identical and therefore consistent wording should be used in IAS 39 and the ED.

In addition, certain disclosures of the ED are required by classes of financial instruments whilst others are required for classifications as defined in IAS 39. IAS 32 refers to classes of financial instruments, leaving it to the entity's discretion to determine what would be considered classes in its specific circumstances. We believe that the use of both notions, i.e. *classes* and *classifications* is unclear and we would recommend disclosures to be presented in a manner that enables users of financial statements to reconcile the notes and disclosures provided to the face of the balance sheet and income statement.

Definition of prepayment risk

Appendix A to the ED defines prepayment risk as *'The risk that the counterparty to a financial asset will repay other than when expected'*. We believe that the paragraph should read *'The risk that the counterparty to a financial asset will repay earlier than contractually obliged to'*.

Collateral accepted

Paragraph 39 (b) of the ED requires an entity to disclose '…a description of collateral *pledged* as security and other credit enhancements…'. We believe that the sentence should read '…a description of collateral *accepted* as security and other credit enhancements…'