Comment Letter : ED 7 Financial Instruments: Disclosures

CL 68

Nicki L. Tillinghast
34 rue François Bonvin
75015 PARIS
FRANCE

tillinghastn@yahoo.fr

October 22, 2004

Dear Sirs,

Specific critical appraisal of ED 7 is given in reply to the questions raised. The answers are intended to be read conjointly. In general, many of the proposed disclosures constitute considerable, undue enhancements of IAS 30 & 32 and entail a great deal of measurement, the avowed objective of IAS 39 for financial instruments. Such measurements require extension to IAS 39, unforthcoming modelling and application guidance, as well, in a number of cases, as proper definitions of terms, for example: "capital" and "risk"; which are, in all events, general concepts independent of "financial instruments".

In view of the favourable replies to the question on the amendment project to IAS 32 (presentation & disclosure) & 39 (recognition and measurement) for consolidating these standards into one standard on "financial instruments", the proposal to create three standards is hardly credible. Nor is the withdrawal of IAS 30, in view of the particular activity of Banks and the needs of users for a specific, alternative presentation to IAS 1 (what are a Bank's revenue or finance costs?) of their financial statements and related disclosures; these needs were also raised in connection with the comprehensive income project field-test. The Board has chosen to ignore the requests of its constituents. The equally credible, and previously expressed, needs for Insurance companies, which were also detailed in the draft statement of accounting principles, which the Board does not consider "binding" and yet cites partially to support its viewpoints (cf. BC45), have also been ignored. These are, of course, the very institutions making the most use of financial instruments.

Further, modifications intended by ED 7 to the most recent phase I "standard" on insurance contracts and financial instruments with a discretionary participation feature (IFRS 4) go well beyond the possible measurements and disclosures, as well as the consensus reached on feasible implementation. To cite only one example: ED 7 §29 (b), taken together with the withdrawal of §91A that IFRS 4 just introduced into IAS 32, implicitly assumes that a discretionary feature may be separated out in a financial instrument – presumably leaving a "guaranteed element" to be measured as a "financial liability".

Some of the disclosure requirements of ED 7, and their measurement, also conflict with those required by IAS 1, which despite being named "Presentation of Financial Statements" is in fact a general standard for disclosure requirements. Furthermore, as some of the ED 7 requirements are based on general concepts, such as risks and effects on equity, they would be misleadingly applied to financial instruments alone. Accordingly, it is IAS 1 which should be "enhanced" and not ED 7 which should be created.

Further examples and supporting consideration are given in the attached answers to the questions, though some of these appear prejudged in the Basis for Conclusions.

In all events, in explaining the need for the working group on insurance set up a month ago, on the 21st October 2004, Sir David Tweedie said: "As previously announced, we have set up a working group to examine issues relating to financial instruments and we are setting up another group to examine the reporting of comprehensive income. Our work in these two areas will interact with the work on insurance contracts, and the insurance working group will play an important role in advising us on the implications of these interactions."

Whilst some answers in the attached may provide useful input, they illustrate in general the need for these working groups to carefully consider disclosures and the related measurement issues. The ED 7 proposals are premature, incomplete, and onerous; furthermore, more likely than not, they would lead to misleading disclosures in the financial statements. Accordingly, at this stage, whilst the ideas in ED 7 may constitute a useful starting point for the further work needed, ED 7 should be withdrawn.

Yours faithfully,

Nicki L Tillinghast

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?

Answers

It would be helpful if ED 7 §10 and §21 specified that these disclosures were not required "on the face of" either or both of the financial statements concerned (cf. IAS 1 §68 & IAS §81-82); this seems to be the intention for the balance sheet cf. ED 7 §7: "….Entities shall provide sufficient information to permit reconciliation to the relevant items presented in the balance sheet".

For the income statement, IAS 30 §10, transposed to ED 7 §21, has been relied on by banks and similar financial institutions to provide an alternative and, given their extensive and almost exclusive use of financial instruments, more appropriate presentation of the income statement than that provided for in IAS 1, which was never drawn up with these institutions in mind.

ED 7 §B3 would modify IAS 1 §84 by deleting the "second last sentence" i.e. "For example, a bank amends the descriptions to apply the more specific requirements in IAS 30". This deletion is not appropriate. If a bank's income statement is now to be drawn up under IAS 1, it will be necessary to define what, for example, "revenue" or "finance costs" means in a bank and how it is to be measured as well as either amend IAS 1 or, at least, provide adequate implementation guidance to IAS 1 for such presentation and measurement. It is, however, preferable to allow these institutions to continue presenting their income statements in accordance with ED 7 §21 (ex-IAS 30 §10), as this would not be misleading.

Puttable instruments are not always accountable for at fair value or at amortised cost; an example is given for "account values" based on the unit values of a pool of assets –see under **Question 7 – Consequential amendments to IFRS 4 (paragraph B10 of Appendix B)**. As indicated, this does not comply with the benchmark requirements of IAS 39 etc. How are these to be classified and accounted for? Furthermore, some "classifications" of puttable instruments actually differ depending on redemption prohibitions (IFRIC Draft D8 §BC15). How are dividends payable on the "sub-classifications" to be accounted for? Some institutions have no share capital and others no equity at all (IAS 32 §18, illustrative examples 8 and 7). What are the "value bases", i.e. amortised cost or fair value, attaching to such "units" and the appropriate classifications of attaching income and expense? These measurement issues require solutions in order to implement the ED 7 disclosure requirements as a whole.

Further comment: The acquisition and originating costs, corresponding to the various classifications of financial instruments, would undoubtedly be helpful to users of the financial statements, as some of these costs are effectively charged to income whilst others are not.

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?

Answers

The requirement is a considerable "enhancement" of IAS 30 §53, apart from its extension beyond the previous limitation to Banks and similar financial institutions. This extension will no doubt also cause problems in determining what constitutes "collateral and other credit enhancements" in other industries. However, as obtaining or calculating the information is not practically feasible (and will therefore be considered "impracticable"), for most intents and purposes, none of this will give rise to much creditable further disclosure.

It is not helpful, nor creditable to the needs of a separate "disclosure" standard, that all references to "netting" and "master netting" arrangements have been eliminated on the transposition of IAS 32 §76, 80 & 81 to the "disclosure" requirements of ED 7 §39. This leaves IAS 32 §50 (i.e. "presentation" in IAS 32 and, on amendment, referring to "paragraph 39 of IFRS X" i.e. ED 7) with the sole specific reference to disclosure requirements thereof.

More likely than not, in the improbable event that all fair values for "collateral and other credit enhancements" could be obtained, collated and calculated, the disclosure would be misleading. Firstly, where the fair value of the collateral pledged exceeds the carrying value of the specific collateralised assets, say, the entity will not be indemnified this full fair value but only that part of it covering the loss guaranteed. Secondly, other terms and conditions attaching to indemnification, diversely triggered, will also make adding up all fair values of such collateral and other guarantees together misleading. Thirdly, in all events, fair value does not include transaction costs of sale or transfer from the guarantor, and in those particular circumstances, as likely to apply as not on collection of collateral, fair value does not reflect the value of either block or forced sales.

It is not clear if the requirements for financial instruments under ED 7 §39 & 40 are for both pledges (and credit enhancements) given to and pledges (and credit enhancements) given by the entity. IAS 30 § 53 refers to the assets pledged by the bank as security for its liabilities —as, for all entities, does IAS 32 §94 (b) reduplicated under ED 7 §15. It is not clear why these identical requirements have been taken up twice in ED 7 (under §15 & §39). This should be made clear, as should the presumably different objectives for the (different?) disclosures (see beneath for a related matter). Further, the existing disclosures are for the book values of liabilities and pledged assets though it is not clear, nor is it clear in the reduplications in ED 7, whether the pledged assets are for financial assets only. This should be made clear. Whether the "fair values" of all these assets may be provided is, of course, the object of a number of standards. They would, however, be necessary to achieve the stated objective.

What is the "stated objective"? This should obviously be clarified and stated in the standard.

Disclosures of the fair values of collateral as required by ED 7 would, of course, entail a measurement bias, with respect to an objective relating to the effects of a loss (cf. BC27), where the on-book collateralised assets or liabilities are not themselves stated at fair value.

Neither partial nor value-basis biased information will, of course, achieve this "stated" objective, and its disclosure might well be misleading. Qualitative disclosure would most likely be less misleading.

Related matter cf. ED 7 §15 and ED 7 §39 commented above

Like problems to those commented on above, also requiring clarification, stem from the duplication (and different objective?) for collateral (and credit enhancements?) obtained – ED 7 §16 and ED 7 §41.

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?

Answers

It is not clear why this question is asked, as the answer seems to be prejudged –BC 36 (b): "a sensitivity analysis can be disclosed for all types of market risk and by all entities, and is relatively easy to understand and calculate"

May one beg to differ on all counts?

In general terms, a sensitivity analysis obviously seems like a "good idea". However, there are a number of serious drawbacks and open questions relating to the definition of what sensitivity is, its meaningfulness, whether the various sensitivity analyses required are not themselves "potentially misleading" (cf. BC41), the volume of the disclosures required, the corresponding auditing difficulties and requirements accompanying inclusion in the financial statements, the confidentiality of some analyses prepared by management for either internal or regulatory purposes or for both, the bases on which management assesses risks as opposed to those used for accounting data and purposes, the inclusion (required under European law) of risk disclosure in the management report…..

Some of these items are addressed in answers to **Question 6 – Location of disclosures of risks arising from financial instruments**, which should be read in conjunction with the replies hereunder, though obviously, for the substantive reasons alone developed here, location should not be in the financial statements.

1. Risks are a feature of business activities, not just financial instruments

- In other words, the use of financial instruments to invest in non-financial assets –a predominant feature outside of banks and other similar financial institutions- or the use of financial instruments to support non-financial liabilities –such as arise with insurance contracts- obviously means that any sensitivity analysis based purely on financial instruments is incorrect in principle and most likely misleading in practice.

2. Market risk is not a meaningful notion in the absence of market or fair values

- In other words, where assets and liabilities are not all at (marked-to-model) market value, a sensitivity analysis of market risk is meaningless. This is particularly important in view of the various options or impossibilities for other than fair values under IASB standards, including banks and insurance entities.

- In particular, this means that any sensitivity analysis requires not only a model for "sensitivity" *per se*, but also a derivative model to relate the bookkeeping "effects" on fair values back to the accounts. This is particularly onerous when the market value model output has to be recalculated to show the bookkeeping effects of the accounting options practised or envisaged in the projected circumstances, i.e. any effects on "profit and loss and, …..equity" –ED 7 §42(a). And it is an important source of potential error and distortion with a knock-on effect on the calculation of "sensitivity" - see 3 below.

3. Different categories of risk are distinguished for convenience of reference: market risk, credit risk, liquidity risk …..

- In other words, these categories are inadequate descriptors for the formal requirements of any modelled "risk" output that they would purportedly disclose. It follows that the significance of any one "type of risk" output would always be seriously questionable and most likely misleading.

- It is generally understood that market risks may arise through the occurrence of liquidity risks on the market. Conversely, if an entity has illiquid assets, this would compound its market risk. Also, market risks may arise through widening credit spreads. In fact, market values for all financial instruments, except reputably government bonds, are affected by actual or perceived changes in credit quality. Exchange rates are also affected by changes in country default risk. Conversely, if an entity's own credit standing suffers, this would compound its market risk. Market risk obviously also includes reinvestment risk, e.g. the risk that lower yields will arise on reinvesting repayments of the returns and the principle of existing investments. This risk arises with or without "prepayment risk" which, furthermore, together with "residual value risk" is independently defined in ED 7 without any other reference thereto (ED 7 IG43 "suggests" these are "other types of market risk").

- Let us simply take interest rate risk as further illustration. Interest rate "risk", which is also conveniently considered a "type of market risk" (i.e. a model output) as well as a risk variable (i.e. a model input), is itself comprised of: basis risk, mismatch risk, option risk, yield curve risk… (i.e. respectively: spread risk –the risk that interest rate changes do not affect similar instruments equally, gap risks –the risk of mismatching effects of interest change on assets compared to liabilities and the liquidity mismatch risk in further funding, adverse cash flow timing risk –usually associated with the exercise of early repayment options, twist risk – the risk that interest rate changes do not affect the same instruments equally for each available term, …..). In terms of the interest rate (i.e. the model input), and in the context of measurements at fair value, of course, the corresponding injective risk variables are: basic interest rate, credit risk premium, liquidity risk premium, any other premium or discount for risks of adverse or favourable variability in expected cash flows …..

- In other words, the convenient categorisations of risk do not correspond to the formal requirements of any meaningful sensitivity analyses:

    - "for each type of market risk at the reporting date, showing the effect of reasonably possible changes in the relevant risk variable (such as interest rates or exchange rates) on profit and loss and, when changes in fair value are recognised in equity, on equity" – ED 7 §43(a).

- In particular, sensitivity analyses constructed in this way, as if the risk variables were independent (ED 7 §44 actually indicates that "interest rates and exchange rates typically vary with each other"!) and as if the model outputs were uncorrelated or did not require correlation, is highly likely to be meaningless in economic terms. In particular, any effects on "profit and loss and, …..equity" which could be calculated –which also means modelling the market value model output to recalculate the bookkeeping effects of accounting options practised or envisaged in the projected circumstances (see 2 above)- would either overstate or understate "sensitivity" to any "relevant risk variable". Accordingly, such outputs would almost certainly be misleading.

- Further, even if a meaningful model could be constructed, the outputs would in general be highly and 'non-linearly' sensitive to "reasonably possible changes in the relevant risk variable" —ED 7 §43(a)- whatever this might mean and whatever confidence level is supposed to attach to "reasonably possible"; not only for input, but also for outputs.

- Such modelling and related disclosures would also require an inordinate volume of explanation and auditing – see also answers to **Question 6 – Location of disclosures of risks arising from financial instruments**

4. Management risk (sensitivity) assessments are not necessarily accounting based.

- The implications of this have been detailed in the answers to **Question 4 – Capital disclosures**, which also enlarge on some aspects of the above observations.

<u>Other (related) matters</u>

As Question 3 does not refer to the related question of "liquidity risks", these are commented on under **Question 10 – Other comments**.

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?

Answers

This proposal is not appropriate. By any definition, capital is neither an attribute of, nor a conception limited to, financial instruments; requirements for any disclosures thereto must be of a general nature and have no place in ED 7.

What is "capital"? The *Framework* refers to various concepts, the selection of which "should be based on the needs of the users of its financial statements" including the "productive capacity of the enterprise". The latter might be of some concern in a group manufacturing and selling motor cars, the example given in ED7 IG IE1, which in fact relates entirely to dividend payments and debt maintenance, not to capital management, under any concept.

Further, the IASB standards do not define "capital". If another concept of capital, indicated in the *Framework*, is "synonymous with the net assets or equity of the enterprise" then the term Equity should be used. If not, the term must be properly defined. Obviously Equity, i.e. net assets, even of a group manufacturing and selling motor cars, is not made up uniquely of financial instruments.

For Banks, the Basel committee has the question of the definition of capital on its agenda. The current definition relates to the regulatory capital of a banking group and does not correspond to Equity under IASB standards. This also requires deconsolidation of "capital" relating to insurance subsidiaries, for example.

It is also noteworthy that some "share capital" may be considered as a debt under IASB standards (cf. IAS 32: "*puttable instruments*") despite any "residual interest" pertaining. Further, there are "mezzanine" classifications or straight-forward provisions in underlying company accounts which may highly distort any relationship between "capital" and Equity. Other distortions are: differing valuation bases used for assets, liabilities, hedging, impairments and future losses, as well as risk evaluation methodology.

For insurance companies, obvious further examples are the differences that arise between 'disclosed surplus' and 'realistic surplus' (as these terms are understood by actuaries), the effects of new business strain, reinsurance accounting, "shadow accounting", accounting for "equalisation and catastrophe provisions", and the measurement of provisions in general. Apart from the manifest and avowed inadequacy of the phase I standard (IFRS 4), reference to the DSOP (BC45) seems additionally inappropriate, as the Board has already indicated that it will not be bound by the previous work on insurance, and has recently found it necessary to set up an international working group on the subject.

Any "economic" or "management-based" approach to "capital" could therefore require a complete restatement of the financial statements. Furthermore, the specific activities of subsidiaries require different "capital" management. The volume alone required for such disclosures would be prohibitive in most consolidations. Furthermore, the information concerned would often be confidential and also require far more expertise "to evaluate the entity's capital" —ED 7 §46 than that possessed by most users. Finally, the expert user would and will still want to have discussions and dialogue with management and see the results of using other valuation bases and models to enable them to evaluate the entity's capital.

If, BC 46, "risk profiles" and "unexpectedly adverse events" are the objective, then the related matters under **Question 3 – Disclosure of a sensitivity analysis** need to be addressed. If, BC 46, "the entity's ability to pay dividends" is the objective – as indeed the example given in ED7 IG IE1 suggests – then this needs to be addressed. For example, it is remarkable that the only restrictions on "reserves" requiring disclosure are the revaluation reserves arising under IAS 16 - §77(f) and IAS 38 -§124(b). Obviously, unrealised profits on assets are not necessarily "available for distribution" and unrealised losses may not reduce what is "available for distribution". However, in discussing Performance Reporting: "the Board noted that distributable profits are not an accounting issue but a legal issue of countries concerned". The same, or very similar, point is made here in respect to "capital adequacy", which is not an "accounting issue" and is not based on the "accounting" principles or data required for the financial statements.

Internally "imposed capital requirements" may not either, of course, be found in the accounts at all, which further adds to the difficulties already mentioned. This is because both the principles and data for "management objectives" are not actually based on those used for accounting. This also concerns auditing. The question of "non-compliance", actually described as "breach" under BC54, is a moot point. This would obviously give rise to serious difficulties within entities and with auditors. It seems obvious that entities not desirous of exposing themselves to reporting themselves in "breach" would therefore set internally "desirable" targets, the failure to meet which would be specified as "not constituting a breach". This is not particularly recommendable – from the point of view of "moral suasion" alone —cf.BC52 (d). Quite obviously, where good sense and shareholder interest dictate setting targets, i.e. future strategies and objectives, then this will form the object of "discussion" (cf.BC48), and performance may be discussed and disclosed in the information provided by management outside the financial statements.

With respect to reporting breaches of "externally imposed capital requirements", it seems equally likely that regulators will have difficulty confirming "breaches" for disclosure purposes to the entity and auditors for all the reasons set out in BC52. Furthermore, regulators examine entities' underlying accounts and additional, copious regulatory returns, taking time well beyond that required for publishing financial statements. In addition, their views are judgemental and a "breach" is not the consequence of a simple, 'mathematical equation'. It is highly unlikely that regulators would wish to play the role that the IASB assigns. If, however, a regulatory authority should notify a "breach" at some stage, then this would obviously already require disclosure if the effect was likely to be significant. Auditors, as primary expert users of financial statements, are, of course, well apprised of such matters and pay careful attention to significant disclosures required.

Further, if regulatory "capital requirements" are not required disclosure, "breaches" thereof will not necessarily be easy to explain. Indeed, the example given in ED7 IG IE1 already begs a related question as it simply states: "Group A is not subject to an externally imposed capital requirement". If it, or presumably its 'financial' subsidiary as part of "Group A", were "subject", and the fact requires specific disclosure, then most users of the financial statements would obviously require further information. Nor is it realistic to suppose that "internally imposed capital requirements" would not require respecting regulatory requirements. Indeed, virtually any "target" that management sets in both Banks and Insurance companies would include such requirements. Clearly then, the Board's decision "not to require disclosure of externally imposed capital requirements" (BC53) is specious.

To conclude, disclosing information in the financial statements that enables users to evaluate the entity's "capital" (whatever this might be) is an impossibly onerous task, if not simply an impossible task. Such disclosure is a question for management reporting —see also answers to **Question 6 – Location of disclosures of risks arising from financial instruments**.

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?

Answers

In the absence of appropriate clarifications of the proposals and guidance, including measurement guidance--see other answers–setting an effective date is premature.

Transition requirements and comparatives

Early application in 2005 does not require prior year restatements, sensitivity analyses, capital adequacy, etc. Early application in 2006 does require all of these for the prior year (2005). Application in 2007 requires all of these for 2006. This is highly progressively punitive and inappropriate.

Of course--cf. BC63 (b)--entities adopting IFRS from 2005 will want to apply ED 7 for 2005. The question of whether this constitutes constructive abuse of the so-called stable platform for 2005 apart, those entities not adopting ED 7 for 2005 will obviously have some serious problem with doing so, as "most of the proposed requirements are relatively easy to comply with" *(sic)*– cf. BC66.

Such an entity might well still want to apply ED 7 as early as possible, e.g. from the first quarter of 2006. But, as we said, this entity has had a serious problem, such as--cf. BC65(c)--having to reorganise the whole of the risk management throughout the group in 2005 to provide the consistency required by an accounting standard. Whatever, it must be clear that in no circumstances can the entity provide the prior year restatements that early application in 2006 would require under ED 7.

Should an entity be punished by having to continue preparing throughout 2006 the less "easier to prepare"--BC63(a)--disclosures, as well as the new information for the comparatives to 2007? Should an entity be prevented from applying the more "relevant standard"--BC65 (a)--as soon as possible? Are the users of the financial statements to be deprived throughout 2006 of this "necessary information"--BC41--, the lack of which might be "potentially misleading" ? If "the proposed disclosures will be more useful if they are accompanied by comparatives"--BC66--, does the reduction in usefulness, attributable to the lack of comparatives for 2005, outweigh the relevance, the necessity and the otherwise "potentially misleading" absence of this information in 2006?

There are two principles here: 2005 should in no circumstances of adoption, early or on the effective date, require restatements, etc.; and early application in 2006 cannot be punitively encouraged.

Further, with respect to disclosures requiring at date assumptions relating to futurities, such as sensitivity analyses, capital adequacy targets, and possibly collateral effects, what exactly does prior period restatement entail and mean?

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?

<u>Answers</u>

The proposed disclosures should not be part of the financial statements for the substantive reasons given in answers to **Question 3 – Disclosure of a sensitivity analysis**.

The statement in BC41 that "IAS 32 previously required similar disclosures to be part of the financial statements" is misleading. Notably, ED 7 § 32 **requires enabling users to evaluate the nature and extent of risks during and as at the end of the reporting period** whilst IAS 32 §52 indicated that the purpose of the disclosure required was to "provide information to enhance understanding". This is quite different. For another example, there is no requirement for a series of sensitivity analyses by type of market risk (ED 7 §43-46). The disclosure requirements in IAS 32 §67-74 are largely narrative and factual. The possibility of providing the effects of a simple hypothetical change in interest rates is mooted in IAS 32 §75: "in some circumstances", i.e. at least where the reporting entity thought this was feasible and not itself misleading.

<u>Management reporting and audit requirements</u>

Whatever the requirements for disclosures in financial statements, risks--whether deriving from financial instruments or not--are required disclosure in the management report for European entities, whether consolidated or not. Auditors are required to review these reports and, one may hope in all events, will note any financial instrument or other risks which would be required to complete the financial statements, and not mislead their users.

The statement in BC41 that there "is no other mechanism for ensuring that the necessary information is provided, other than including the disclosures in the financial statements" is, quite apart from the prejudicial use of "necessary", disingenuous. The IASB is examining "Management Discussion and Analysis" and should complete its work in due course without creating new and onerous "necessities" because it has failed to do so at this time. The same applies to its work on financial instruments with discretionary participation features – see also answers to **Question 7 – Consequential amendments to IFRS 4 (paragraph B10 of Appendix B)**.

There is of course no reason to believe that the risk disclosures, which the Board recognises anyway as being dependent on each entity's assessment of the relevant economic parameters (cf. BC38), would be inferior or less comparable under European law. In particular, for Banks one would expect appropriate cognisance of the Basel process including operational risk (cf. BC40). It is also noteworthy that the European requirements, like those of Basel, recognise the existence of specific activity risk profiles for entities (banks, insurance companies, etc.) within the group, while the IASB recognises only the reporting entity.

Furthermore, nothing stops the Board requiring risk information in the financial statements where entities do not (have to) provide it in the management report. This would be far less onerous and much more reasonable whilst permitting the IASB to complete its work properly in due course.

Incomplete and potentially misleading financial statements and audit requirements.

The statement in BC41 that "financial statements would be incomplete and potentially misleading without disclosures about risks from financial instruments" is open to question, apart from begging the question for risks not deriving from financial instruments *per se*. In those actual circumstances in which there might be the need to disclose some specific risk, without which the financial statements would be incomplete or misleading, the implication is that both management and auditors would ignore the requirements to present a true and fair view.

On balance, this is probably a general risk, whatever disclosures are made. In particular, if those management analyses performed by management which are otherwise supposed to be disclosed under ED 7 do not evidence such a specific risk in these circumstances, then it is not to be supposed that their publication will do so, either.

Given the unreliability of the quantitative disclosures sought, it is at least equally arguable, and in fact more than probable, that they will be misleading for the substantive reasons already noted. At this juncture, it must therefore be preferable to retain the existing disclosure requirements of IAS 32. This will enable management and auditors to concentrate on any major risk-related issues and avoid onerous, voluminous and potentially meaningless work, costs and disclosures (which would also be duplicative with management reporting, at least in Europe: see above) in seeking to comply with requirements that are questionable.

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?

The proposals for amending IFRS 4 are inappropriate for all of the reasons set out in BC59 at the least. The proposals made effectively extend the implementation requirements for insurers, who will obviously have to take them into consideration for 2006 at the latest, even if they could in theory defer the applications to 1st January 2007 thereby incurring restatement requirements. See also observations on transition requirements and comparatives given under **Question 5 – Effective date and transition**.

The proposals require extensive further review of existing accounting systems, data bases and risk management for the "disclosure" requirements, which in fact entails a great deal of measurement. There are no agreed bases and models for such measurements, for both insurance contracts and contracts with discretionary participation features. Furthermore, there are no stable bases for measuring impacts on income and equity, given the IFRS 4 requirements for the continuance of insurers' current accounting models, as may be partially adapted from time to time under exemptions to IAS 8. The proposals constitute a constructive, substantial and further "interim" modification of insurers' implementation requirements, and run counter to the commitments made to avoid potentially onerous and temporary system costs for insurers, as well as to the consensus that requirements for insurers, whose activity is predominantly related to risk, are not to be further dealt with on a piecemeal basis but must be properly researched, understood and measured (Phase II).

In addition, as for "financial instruments"–see observations made in answers to **Question 3 – Disclosure of a sensitivity analysis**--the risk disclosures appear to be based on continuing misunderstandings of the possibilities of measuring divers financial risks, after separating out discretionary participation features, discretely, as well as insurance risks separately; of the possibilities of separating out interactive risk-factors; and of the measurements required by "unit of account", including "contract-books" and "participating assets" involving natural "hedging", as well as the development of measurement models to eliminate "mismatching". Implementing the proposed measures requires extensive guidance, the more particularly as there is no "*market*" for these contracts.

This is equally true for contracts with discretionary participation features, despite the fact that they depend not only on the bases of liability measurements used but equally on asset measurements. In particular, ED 7 §29 (b) implicitly assumes that such features may be separated out in financial instruments, presumably leaving the so-called "guaranteed element" to be measured as a financial liability. This goes far beyond the requirements of IFRS 4 itself: §35(b) and its introduction of §91A into IAS 32, which ED 7 proposes to cancel. Even for disclosure purposes, §91A clearly does not require the separation of the discretionary participation feature, as this is in fact not possible.

Not only "*market risks*" but also "*liquidity risks*" (an import from IAS 30 for Banks) for both these contract "types", much "enhanced", are brought into the disclosure requirements of IFRS 4 by ED 7. It is, however, not at all clear what these risks are or how they may be evaluated for such contracts, and the more so in view of the imposition of a "deposit floor" (which is, even for Banks, the subject of much dispute with respect to risk and hedging). See also observations on Maturity analysis and Liquidity risks under **Question 10 – Other comments**.

As a simple example, a very basic product for insurers, which may be an insurance contract or not, depending on the accessory guarantees, is that denominated in the unit values of a pool of assets – the "account value". This liability measurement, for a financial instrument, may apparently be regarded by insurers as "either the fair value or the amortised cost" (IFRS 4 IG Example 2.15), as the Board has not been able to determine how the basic concepts of IAS 39 apply. The conceptual difficulty is ever greater for contracts commonly catering to policyholders' investment preferences and enabling underlying asset backing to be redistributed on an ongoing basis between such pools and other fund investments involving contractual rights including discretionary participation features. In the light of this specific failure, of which the need of phase I for insurers' accounting is a general demonstration, how are the much "enhanced" requirements in ED 7 –based on the unjustified hypothesis that the recognition and measurement principles of IAS 39 itself pertain – to be applied? For example, how is "*effective interest*" to be calculated, let alone disclosed--ED 7 §21(c)--and how is the sensitivity of the liability at "amortised cost" to be calculated? If "regarded as fair value", what is the "*benchmark interest rate*"--ED 7 §11--and how is the "*credit risk*" to be calculated?

Taking "*credit risk*" alone, IAS 32 AG40 has not been simply "deleted" from this application guidance (ED 7 §B2), but actually incorporated into the enhanced "Disclosure standard" (ED 7 §12) – with the notable removal, after "benchmark interest rate", of the explanatory term, "(e.g. LIBOR)". This paragraph, which is in all events a measurement requirement, obviously relates to the issue of a "classical" financial instrument with an observable "*market price*" and was conceived in that context. Insurance companies do not issue such instruments to policyholders; the deletion of "(e.g. LIBOR)" is misleading, the term "*benchmark interest rate*" now requires definition, and the measurement and consequential application of such rates for instruments with no "*observed market price*" require adapted, and no doubt extensive, application guidance – particularly for all contracts issued by insurers.

The difficulties encountered and ongoing research required by the Board in still seeking to provide a practicable and economically based model for insurers accounting should be sufficient evidence that models for evaluations of multivariate risks and their sensitivities, of which the accounting model would simply represent the "most probable outcome", is a somewhat larger undertaking. It can only be recommend that the Board include these requirements, which are measurement requirements, in their ongoing research and as a topic for the working group set up on the 21st September 2004 and, at this stage, neither prejudice nor destabilise the already onerous and disparate requirements of IFRS 4 –unless it can simplify them.

Related matter : evaluation of insurance contract cash flows

The risk disclosures commented on above relate principally to the measurements required "as if" ED 7 §32-45 could apply to insurance contracts (and financial instruments with a discretionary participation feature) – in accordance with the proposed revision set out in ED 7 §B10 to IFRS 4 §39(c) and for financial instruments with a discretionary participation feature, directly in accordance with ED 7 §32-45. They also apply to the impossible requirement for sensitivity analyses for insurance contracts, in accordance with the proposed revision set out in ED 7 §B10 to IFRS 4 §39 (b).

The particular related matter dealt with here is the ED 7 §B10 revision to IFRS 4 §38, compliance with which is the object of all the revisions to the supporting IFRS §39 and its subparagraphs:

Amount, timing and uncertainty of cash flows (ED 7 revisions to IFRS 4)	**Nature and extent of risk arising from financial instruments (ED 7)**
Paragraphs 38 and 39 are amended as follows:	
38 An insurer shall disclose information that ~~helps~~ <u>enables</u> users <u>of its financial statements to</u> ~~understand~~ <u>evaluate</u> the amount, timing and uncertainty of future cash flows from insurance contracts.	**32 An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity was exposed during the period and at the reporting date.**

Whilst the drafting in the proposed revisions to IFRS 4 is remarkably consistent with that in ED 7, the question of whether users can be **enabled to evaluate** the "amount, timing and uncertainty of future cash flows" is substantially different from that relating to the "nature and extent of risks".

Surely, it must be obvious that the volumes of data required, some of it extending over twenty or more years, some of it by books of contracts for similar risks, some of it by risk for books of contracts, all of it assorted with probabilities relating to expected loss frequencies and severities, associated reinsurance mitigations, risk margin factors, new business strains (which also have effects on asset-liability management, e.g. disinvestment projections), and so on and so forth, could not possibly be disclosed in the financial statements. And in any event, all this could only be "evaluated" by an expert user such as an actuary and, even then, not without considerable difficulty and contact with the insurer.

Furthermore, as already recalled above and elsewhere (see also observations under **Question 10 – Other comments: Maturity analysis and Liquidity risks**), there is no established basis for this information or its use in modelling insurance liabilities, with or without discretionary participation features.

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?

Answers

The risk disclosure requirements have been extensively commented on in the answers to the specific questions raised and also under **Question 10 – Other comments**. The disclosures required have been considered inappropriate, impracticable and, on the whole, misleading. Further comment, under **Question 10** for example, suggests feasible disclosures, not proposed in ED 7 and relating to some highly informative aspects of the effect of risk on the financial statements, possibly (to be) regarded as necessary by the FASB (finalisation of its own) proposals.

As the foregoing suggests, the Implementation Guidance can only be regarded as insufficient.

Further, in the absence of appropriate clarifications of the proposals, which also require the development of clear principles and methods of measurement, as well as the attention of the IASB working groups, it is not feasible to propose the consequent changes required to 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?

Answers

ED 7 does not require disclosures enabling users of financial statements to appreciate the effects on profit and loss, and equity where concerned, of the uses made of fair value – as suggested by the proposed FASB disclosures indicated.

In particular, as fair values are based on the net present values of expected future cash flows, the income (and equity) effects expected in any future period are as calculable as the fair value at the beginning of the period, e.g. the previous year-end for the current year's income (and equity movement) being reported on in the financial statements. In order for users of the financial statements to appreciate the uses of fair value, disclosures of these effects and their comparison with the actual movements in income (and equity) are required, highly informative, and also a matter of record. This is particularly important as the drawbacks relating to hypothetical "sensitivity analyses" do not apply- see observations on this subject under **Question 3 – Disclosure of a sensitivity analysis**. Incidentally, it is worth noting that actuaries calculating insurance liabilities on a prospective basis are generally required to analyse differences (cf. effects on income and equity) that have actually arisen, under various analytical but apposite 'headings', over a given period.

A simple example to illustrate the necessary disclosure as consequently envisaged, say, for trading securities--cf. item (a) in the question–may be illustrated as follows:

Example

1. Period being reported on in the financial statements: year N. Holdings of trade securities at year-end N-1: fair value (market) of 10,000 MU. Market rate for year N : 4%; i.e. expected effect on income for year N: 400 MU

2. Income recorded in year N is based on the following facts:

   - Dividends received for 300 MU and immediate *post-div.* sale of 50% of the holding on 30/6/N for 3,000 MU
   - Residual (i.e. 50% remaining) holdings at fair value (market) of 7,000 MU on 31/12/N

Disclosures under ED 7:

As half the holdings were sold half way through the year, the appropriate return may be thought to be three-quarters of 4%, i.e. 3% or 300 MU, equalling the dividend. This may be recorded separately from net gains or losses under ED 7 §21(b).

The first 50% of the holdings sold shows a book loss of 2,000 MU (i.e. 3,000 less half of 10,000). The remaining 50% records a gain of 2,000 MU (i.e. 7,000 less 'the other' half of 10,000). The net gain or loss recorded under ED 7 §21(a) will be zero.

Quite obviously, the disclosure required by ED 7 is inadequate for, if not actually misleading to, users of the financial statements, both for understanding the financial statements being reported on, and for evaluating "the nature and extent of risks ….exposed during the period and at the reporting date"--ED 7 1(a). Indeed, there is an undisclosed key source of significant risk likely to cause "a material adjustment to the carrying amounts of assets and liabilities within the next financial year" –IAS 1 IN3(e). For example, if the same–presumably natural–volatility in the fair value model repeats identically in the half-year N+1, and the company then sells the same number of securities, a loss of 2,000 MU will occur. This volatility, as it has occurred, is a matter of record and should be disclosed in the notes accompanying the financial statements. In general, information should be provided explaining the variances noted, under appropriate 'headings' by type of variance, and these explanations should indicate whether such variances are reasonably attributable to the fair value model employed and would be likely to reoccur, or whether they are at least partially attributable to other, "unnatural" factors.

There is, of course, as much justification for including fair values based on observable market prices, as those based on other models, as the FASB makes clear.

ED 7 §31 (a) provides a starting point for the appropriate 'headings' required for this disclosure. As the above example shows, ED 7 §31 (c) and (d) are misleading. It is neither because fair values are based on a valuation technique nor because of changes in a valuation assumption that there are not significant "changes in fair values", and ongoing implications intrinsic to this measurement method. Clearly, it is particularly these effects on income (and equity), as they generally arise, whether or not assumptions have been changed, which should be disclosed to users of the financial statements.

Question 10 – Other comments

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

Answers

Some "other comments" have been included in answers to the questions if the problem is considered directly related, for example on collateral for ED 7 §15 and §41 see under **Question 2 – Disclosure of the fair value of collateral and other credit enhancements**.

Maturity analysis and Liquidity risks

It is generally understood that liquidity risk is the risk that insufficient cash will be available from other assets or liabilities to meet cash requirements. Liquidity risk obviously includes the risk, dropped from the definition in ED 7, that may "result from an inability to sell a financial-*sic* asset quickly at close to its fair value" – IAS 32 §52(c). An entity incurs liquidity risk when its credit rating falls and as a result of market risk in markets on which it depends and of credit risk in market places in, or entities with, which it deals. For further comments on risk interdependence and related factors see answers to **Question 3 – Disclosure of a sensitivity analysis**.

"The risk that an entity will encounter difficulty in meeting commitments associated with financial liabilities"--the "new" definition of liquidity risk in ED 7--is therefore misleading. Obviously, this must include risks due to difficulties in meeting such commitments because of an inability to liquidate assets or obtain replacement funding.

Liquidity, unlike other "risk factor" effects on "profit and loss and, …..equity", is of course independent of bookkeeping rules. The cash is either available or it is not. The bookkeeping rules merely allow the effects of liquidity on the various lines of the balance sheet to be calculated if they are to be displayed at book values. IAS 1 requires what is effectively a 'maturity schedule' in requiring disclosure of balance sheet amounts that are expected to be recovered or settled within or beyond twelve months (IAS 1 §52). Banks and other financial institutions are required to present an explicit maturity schedule for all balance sheet items (IAS 30 §30). The latter requirement has been reduced to presenting a maturity schedule for liabilities under financial instruments. This is as misleading, and for the same reasons, as the "new" definition.

IAS 1 §52 refers to all assets and liabilities (not just financial). This is appropriate for the reasons already indicated in the answers to **Question 3 – Disclosure of a sensitivity analysis**.

Furthermore IAS 1 §52 refers to the expected recovery or settlement of assets and liabilities. This is appropriate. IAS 30 and ED 7 refer to contractual maturity dates. This is conflicting and inappropriate in principle. The same applies to the bookkeeping rule relating to financial liabilities that an entity can be required to repay on demand (cf. ED 7 IG25). This also conflicts with reasonably expectable cash-flows, which are also dependent on risk variables, some of which might act to the advantage of existing "depositors" or "policyholders" (this is a somewhat different point to the rules-based problems arising from "macro-hedging").

As with sensitivity analyses for market risks, a liquidity risk analysis does, of course, require using "fair-values" appropriately. These are, however, required to be calculated for disclosure purposes. It is to be hoped that phase II on insurance contracts and financial instruments with a discretionary participation feature will soon shed some light on the latter, but ED 7 already wrongly assumes that insurers can evaluate future cash flows to calculate liabilities arising under these contracts (cf. IFRS 4 §16 or §17). The problem with the assumption is not knowing what comprises the liability and how it should be calculated (cf. Shadow Accounting IFRS 4 §30 and IFRS 4 BC101) – see also answers to **Question 7 – Consequential amendments to IFRS 4 (paragraph B10 of Appendix B)**.

The further advantages of disclosing liquidity on the basis of a maturity schedule is that the users of financial statements will readily understand this use of the balance sheet and that it corresponds to the IASB conceptual principle of equity expressed as the difference between assets and liabilities (*in fine* there is no difference between movements in retained earnings and in equity).

Liquidity risk also captures the effects of all risk variables, unlike sensitivity analyses. Work on this question should be in the remit of the working groups set up by the IASB and should give rise to a conceptually consistent revision of IAS 1.

Pending the results of this work, for the reasons given above, further objections to ED 7 have been raised:

- The "new" definition of liquidity risk is misleading.
- Requiring a maturity schedule of financial liabilities alone is misleading.
- Holding that financial instruments alone determine liquidity risk is unfounded and misleading.
- A requirement based on contractual maturity dates is misleading and inappropriate.
- These requirements conflict with the requirement under IAS 1.
- The stipulations for the maturity dating of financial liabilities repayable on demand are equally misleading, inappropriate and conflicting. This is always the case. A specific case is when it is to the advantage of "depositors" or "policyholders" not to demand repayment.

These objections complement those raised in answers to the preceding questions and further support the conclusion reached in the covering letter.