CCDG

COUNCIL ON CORPORATE DISCLOSURE & GOVERNANCE

29 October 2004

Ms Andrea Pryde
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30 Cannon Street
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(By email: CommentLetters@iasb.org)

Dear Ms Pryde,

EXPOSURE DRAFT ED 7 *FINANCIAL INSTRUMENTS: DISCLOSURES*

1. We are writing to provide our comments on Exposure Draft ED 7 *Financial Instruments: Disclosures* issued by the International Accounting Standards Board (IASB) in July 2004.

2. Our comments below address the specific questions set out in the "Invitation to Comment" section. We have received comments from some of the Singapore constituents which include banks, a listed shipping company and the regulator of financial institutions. Constituents' comments are reflected in our responses below.

3. We would like to propose a "scope out" provision from compliance with ED 7 for wholly-owned entities, unlisted entities and small and medium-sized enterprises (SMEs) to be exempt from the disclosure requirements on the basis that the costs of compliance would exceed the benefits for these entities. While the objective of ED 7 is to promote disclosures about financial instruments in financial statements, one needs to balance the costs with the benefits of more disclosures. Our responses to the issues raised in ED 7 are provided on the assumption that ED 7 does not contain the exemption as suggested. As we understand that the IASB is currently working on the project on financial reporting for SMEs, the IASB may wish to consider the exemption for the SMEs from the proposals in ED 7 as part of the project.

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).

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(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 are of the view that the proposals are appropriate. These additional requirements will provide users of financial statements with information to evaluate the impact of financial instruments on an entity's financial position and performance.

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 are of the view that the proposed requirement to disclose fair value of collateral pledged as security and other credit enhancements is not appropriate for the following reasons:

(a) For banks and other financial institutions, the fair value of collateral pledged against the balance of loans outstanding alone is one of the many indicators of credit risk. To ascertain credit losses, there are other factors to be considered like the underlying business and financial viability of the borrower and its cash flow sources; and

(b) Disclosure of fair value information is not practicable in certain instances, e.g. when the collateral pledged is a floating charge over the total assets of the borrower.

We have also considered the costs and benefits of the proposals and we are of the view that the costs of implementing the disclosure requirements outweigh the benefits. The collation and derivation of fair value of collateral pledged would be onerous for financial institutions. In addition, the IASB may also wish to consider the requirements under Pillar 3 of Basel II (Revised Framework for International Convergence of Capital Measurement and Capital Standards), where banks are already required to make

qualitative and quantitative disclosures on their risk management objectives and policies concerning credit risk, market risk and operational risk.

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 are of the view that it may be onerous for entities to provide sensitivity analyses of risks arising from changes in market variables in some cases. Examples of such entities are:

(a) Wholly-owned subsidiaries that have few financial instruments such as bank deposits and equities, and whose management and shareholders may not require such information; and

(b) SMEs that may not have the infrastructure to perform the necessary sensitivity analysis.

We are of the view that such requirements should not be included as part of the IFRS.

Notwithstanding, as the sensitivity analysis is an important management issue, it could be disclosed as part of the management discussion and analysis (MD&A).

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?

We do not agree with the proposed disclosures on internal capital targets set by management, especially for entities (e.g. financial institutions and insurance companies) which are subject to externally imposed regulatory capital requirements. The key reasons expressed are as follows:

(a) Disclosure of internal capital requirements has implications on the competitive positioning and strategy of an entity; and

(b) Compliance with internal capital targets differs between entities as different entities would have different tolerance levels under their respective risk management policies and practices. Therefore, internal definition of capital will not allow for comparability and may confuse users of the financial statements.

Notwithstanding, such disclosures could still be made in the MD&A.

We also do not support the requirement for entities to disclose compliance with externally imposed capital requirements if this includes disclosing a bank's entity-specific regulatory capital requirements that are imposed by the regulator above the minimum regulatory capital requirements for all other banks.

An entity-specific regulatory capital requirement may be imposed as a supervisory tool to address a range of supervisory considerations, including encouraging a bank to further enhance its risk management capabilities or processes. Therefore, it does not necessarily imply that the bank's financial condition has deteriorated. The setting of the entity-specific regulatory capital requirement is based on the supervisory judgment of the regulator, given its more intimate knowledge of the operations of the bank which the users of financial statements are unlikely to appreciate. We are concerned that the market will not look favourably at or tolerate such an entity-specific regulatory capital deficiency and will likely associate such deficiency with some form of financial distress in the bank. This could inadvertently lead to adverse market reactions and unnecessarily undermine public confidence in the banks.

In addition, the entity-specific regulatory capital requirement is subject to the regulator's periodic assessment and hence the quantum may change from time to time depending on the outcome of each assessment. It is, therefore, the regulator, and not the bank, which has the ultimate responsibility to decide whether a formal breach of an entity-specific capital requirement imposed has taken place.

For these reasons, we are of the view that the disclosure of such entity-specific regulatory capital requirement should be at its sole discretion and such entity-specific regulatory capital requirement that exceeds the industry-wide minimum capital standards should remain confidential between the regulator and the bank.

The IASB may also wish to consider the regulatory capital requirements and disclosure issues, which are covered in the Basel II requirements.

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 are of the view that while the transition requirements are appropriate, an IFRS resulting from this ED should be effective for annual periods beginning on or after 1 January 2007 for listed companies and for annual periods beginning on or after 1 January 2008 for all other entities. A deferral for entities other than listed companies will provide sufficient time for such companies to embrace the IFRS.

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 are of the view that disclosures about risks would provide useful information. However, the disclosures proposed in the draft IFRS should not be part of the financial statements. Depending on the extent of forward analysis involved in the risk disclosure, it could also be onerous for external auditors to form an opinion on the material accuracy of the information disclosed.

Generally, information on risk identification and risk management of financial institutions should be part of the MD&A, outside the financial statements. The key advantage in disclosing such information (e.g. the sensitivity analysis of market risks and capital disclosure) in the MD&A is that it allows the entity to discuss the risk issues and related information in relation to their specific sector's requirements and practices. In addition, listed entities in Singapore are required to report on corporate governance matters. Hence, the disclosures may be included within such reports.

We would also propose that an entity be given the option or flexibility to decide where to locate the disclosure of the risk information.

<u>Question 7 – Consequential amendments to IFRS 4 (paragraph B10 of Appendix B)</u>

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?

We agree that the risk disclosures in IFRS 4 should be amended to make them consistent with the requirements proposed in the draft IFRS. However, we suggest that this be done in Phase 2 of the Insurance Contracts Project.

<u>Question 8 – Implementation Guidance</u>

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?

We would suggest that an illustrative example of the minimum disclosures in paragraphs 39 to 45 be included in the Implementation Guidance to guide entities in disclosing the required information.

<u>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)</u>

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 have no comments.

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<u>Question 10 – Other comments</u>

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

Paragraph 30(d) requires disclosure of information about whether and how an entity intends to dispose of the financial instruments in 30(c) and paragraph 30(e) requires disclosure of the carrying amount at the time of sale and the amount of gain or loss when the financial asset is sold. We are of the view that such disclosures may be sensitive and only marginally beneficial to users of financial statements at the expense of the entity.

4. Should you require any further clarification, please contact Mr Ramchand Jagtiani, Deputy Director, at the Institute of Certified Public Accountants of Singapore via email at jagtiani@icpas.org.sg. Thank you.

Yours sincerely,

Derek How
Secretary, CCDG